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How Institutional Framework Affects the Formation of Capitalism in Countries in Transition: Following the Path or Finding New Ways? The Case of Latvia

Master thesis

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ABSTRACT

Title How Institutional Framework Affects the Formation of Capitalism in Countries in Transition: Following the Path or Finding New Ways? The case of Latvia

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Summary There is a variety of capitalist systems in Europe that many scholars attempt to classify using social, political and economical determinants. Among a diversity of methods, institutional approach has received a growing recognition in the recent years. It tries to explain why the European countries' socio-economic models follow different paths in their developments through analysis of formal and informal institutional frameworks.

As a theoretical basis for the thesis, Hall and Soskice's theory of "Varieties of Capitalism" is used. This theory distinguishes three models, which have developed along fundamentally different lines and currently are operating in the EU countries – co-ordinated market economy, liberal market economy and Meditteranean one. In the centre of the study are the countries in transition, which represent newly founded unique capitalist systems characterised by turbulent changes and dynamic progress.

The present study assumes that VoC model may be applicable to study the countries in transition that cannot be taken for granted though due to the specifics of countries institutional system. Empirical analysis attempts to find an answer to the key question of the thesis: "Which of the varieties of capitalism does Latvian system represent and how does it relate to other European capitalistic systems?", Latvia being chosen as a sample country in transition. Analysis conducted in the legal part complements to the discussion by adding valuable legal and political perspectives to the topic. As a result, the analysis represents an interdisciplinary study that incorporates political, economic and legal aspects of the problems, thus, underlining the interdependence of institutional elements and socio-economical determinants.

The study demonstrates how the unique characteristics of Latvian institutional framework can be fitted into the VoC model, and argues that countries in transition are on the way of forming their specific form of capitalist system, which incorporates features of the three existing models.

Keywords Varieties of capitalism, institutional foundations, countries in transition, Latvia

LIST OF ABBREVIATIONS

CEE(C) – Central and Eastern European Countries

CME – Coordinated Market Economy

CMEA – Council for Mutual Economic Assistance, also known as Comecon

ECJ – European Court of Justice

LBAS - Free Trade Union Federation of Latvia

LDDK - Latvian Employers' Confederation

LME – Liberal Market Economy

LSC – Latecoming Semiindustrialized Country (used in the same context as "country in transition")

MNC – Multi National Corporations

MS – Member States

NTCC - National Tripartite Collaboration Council

SE – Societas Europaea

SME – Small and Medium Size Enterprises

VoC – Varieties of Capitalism

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1. INTRODUCTION

1.1. Background

> "Laws and institutions are constantly tending to gravitate. Like clocks, they must be occasionally cleansed, and wound up, and set to true time."[1]

My interest in this topic was inspired by the phrase accidentally thrown out by the PhD student-resident of one of the countries in transition in the kitchen of our dorm. His message carried more emotional than academic meaning expressing that despite the common belief that countries in transition are undergoing through "drastic and turbulent changes" transforming their socio-economic models, these institutional changes in legal, economic, social and political spheres are representing more artificially created foundations rather than reflecting the true picture of the actual situation. This critical statement supported with my theoretical knowledge and empirical investigations became the basis for my Master thesis.

Being a national of Latvia - "latecoming semi-industrialized country" as defined by M.Storper[2], I had my personal experience seeing that a lot of measures aimed on transferring country to the market economy simply fail. New regulations receive negative response from the population; lack of trust in government causes politically passive citizens; laws, blindly copied from the Western system are not enforceable in practice. In contrast, reports to European Commission along with National Development Reports draw more optimistic picture. Gradually closing negotiation chapters also prove the fact that reforms are successfully implemented. On the one hand, Commission recognises the fact "Latvia *is* a functioning market economy" and "continuation of current reform path should enable Latvia to cope with competitive pressure and market forces within the Union". [3] On the other hand, it emphasises "while the legislative framework has been largely put in place, particular attention must be paid to further *removal of the remaining regulatory and administrative constraints"* [4]. This ambiguity makes an analysis of the countries in transition quite complicated though exiting task, as it is particularly hard to grasp "real" unbiased picture of the ongoing events and institutional transformations.

1.2. Problem Area

The map of European continent appears to be as colourful and diversified as the countries constituting this map itself. Due to contrasting historical, social and political events each country developed its

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[1] Cited by Henry Ward Beecher, Life Thoughts, 1858 taken from the Oxford Dictionary of Humorous Quotations, Oxford University Press, 2001
[2] Storper M., S.B.Thomadakis and L.J. Tsipouri (1998), Latecomers in the Global Economy, Routledge, for definition of LSC see chapter 3.4.
[3] Commission of the European Communitites(2002), Regular Report on Latvia´s Progress Towards Accesssion, emphasize by the author
[4] Ibid.

unique characteristics and patterns of behaviour. Nevertheless, some common features may still be discovered, as it was done by the authors of Varieties of capitalism (hereinafter-VoC) model.[5] In their model Hall and Soskice categorise OECD countries into two types of market economies - co-ordinated and liberal ones, leaving 6 countries in an ambiguous position (France, Italy, Spain, Portugal, Greece and Turkey) and suggesting "Mediterranean" form of capitalism as a possible typology for these countries. In a liberal market economy, relations between firms and other actors are co-ordinated primarily by competitive markets. In co-ordinated market economies, firms typically engage in strategic interaction with trade unions, suppliers of finance and other actors while in the Mediterranean one firms are operating in hierarchy-based type of economy.

This approach though does not help much to understand the peculiar position of the countries in transition on the international arena, despite the fact that interest to these countries has never been higher than now, in the light of the EU enlargement round 2004. Is it possible to apply VoC model of developed countries to the ones in transition? Undoubtedly, countries of Central and Eastern Europe do have a capitalist system. Although, in contrast to developed EU countries, it is not that easy to find the distinctive model of capitalism for these countries. While the model of Western European capitalism has sound historical background and proved its stability through several economic and political crises, it is quite hard to grasp the one of countries in transition due to its highly turbulent environment. There have been no precedents before with such a comprehensive transition from party-dictatorship to democracy and from plan to market. The constantly changing conditions and inconsistency between law and reality make long-term predictions hardly possible, though any static model can be applicable in short-term. VoC approach though is quite flexible and does not limit capitalism to two or three models[6]. This allows to assume that there *can* be a model with its own specific characteristics relevant to the countries in transition. Not static one, changing over time, but which reflects the current situation and also takes into consideration the further possible development of the system.

Varieties of capitalism approach pays particular attention to the institutional foundations with which companies interact routinely. Analysis of country's formal and informal institutional frameworks tries to explain why the socio-economic models of European countries follow different paths in their developments. Institutional transformations encompass not only legal, economic or political changes but also social and cultural ones, the latter being particularly hard to define and tackle. Institutional framework is considered in its wider sense - rather as "the rules of the game"[7] than "an organisation or establishment founded for a specific purpose"[8]. In the transition from planned to market economy institutions are "the underlying determinants of the long-run performance of economies"[9].

[5] P.A. Hall, D. Soskice (2001), Varieties of Capitalism: The Institutional Framework of Comparative Advantage, Oxford University Press
[6] The third model is "Mediterranean" one marked by a large agrarian sector and recent histories of extensive state intervention. Typical examples include France, Italy, Spain, Portugal, Greece and Turkey.
[7] North, D.C., The contribution of the new Institutional Economics to an Understanding of the Transition Problem, March 1997, Wider Annual lectures 1.
[8] http://www.wordreference.com/English/definition.asp?en=institution
[9] North D.C. (1997), Institutions, Institutional Change and Economic Performance: Political Economy of Institutions and Decision, Cambridge University Press

The interconnection of key words: varieties of capitalism, countries in transition and institutional framework mentioned in the "problem area" part lead to the definition of the study purpose.

1.3. Objectives

The general research question is placed in the title of the thesis. It is formulated as "How institutional framework affects the formation of capitalism in countries of transition: following the path or finding new ways?" In other words, the paper aims to establish whether capitalist system in the countries in transition has its unique characteristics or it merely copies (or follows) the already established system of developed countries.

More specifically, paper aims to identify the model of institutional foundations in Latvia and find out the similarities and discrepancies with the classic VoC model specifics. The question I focus on in my work is: "Which of the varieties of capitalism does Latvian system represent and how does it relate to other European capitalistic systems?".

The structure and operations of the institutional foundations are a matter of national government. In the meantime, the EU has the competence to legislate in the certain fields and under principle of the supremacy Community law shall prevail upon national law[10]. In the increasing integration and globalisation conditions institutions and regulatory instruments retain their national competencies and differ from country to country so that no united model can be identified. But does the lack of harmonisation constitute a problem? Is there a need for convergence or the above situation does not preclude successful integration process? These questions become the central ones for the legal part of the thesis.

1.4. Thesis Structure

The research is structured in the following way: examination of theory is followed by the analysis of empirical data and concluded by explanation of their relationship and interplay. The thesis consists of 6 chapters: introduction and methodology, theoretical framework, legal framework, empirical analysis, discussion and concluding remarks.

Introduction provides reasoning behind the choice of the topic and formulation of the purpose of study and its structure. Methodology unfolds the type of study, research method and the choice of sources.

Theoretical framework assesses the models applied for the empirical research. Firstly, it reviews the various methods of classification of the capitalist systems. This is followed by the outline of liberal vs. co-ordinated vs. Meditteranean market economies models by Hall and Soskice elaborated in their book

[10] Principle of supremacy was first developed in the case 6/64, Costa v. ENEL

"Varieties of Capitalism: the Institutional Foundations of Comparative Advantage". Further, the study gives an insight into the concept of institutions and differentiates between its narrow and wide meanings. It attempts to answer how some institutions in the political economy can reinforce the operation of others to generate distinctive forms of capitalism from country to country basis (institutional complementaries). Then, the applicability of the VoC model to the latecoming semi-industrialized countries is discussed based on the Storper[11] book "Latecomers in the Global Economy". Chapter three is finalized by the review of the role of institutions in the countries in transition.

The legal part is structured in the following way. The discussion opens by the issue of *competition between legal systems* that may or may not affect the company's strategy by choosing legal system that offers more favourable jurisdiction within the EU internal market. It continues in chapter 4.3. where issue of competition is assessed from the company law perspective. The study is followed by the analysis of the concept of *competition between national institutional foundations* – market, the court and the political processes[12]. The analysis is based on two interdisciplinary theories: ones of institutional choice and institutional change, which attempt to explain the interrelations between the institutions from the interdisciplinary perspective. This issue is complemented by the notion of bargaining administration and presented by the case of interest groups operating in the social policy field. Further on, the many times mentioned principles of *distribution of competencies* follow and the chapter is finalised by discussion of which type of institutional system the EU represents now.

The empirical part explores the specifics of the five elements of the VoC model in its application to the countries in transition, and specifically Latvia, attempts to identify the country's institutional framework and modifications caused by local environment to the variety of capitalist model. Analysis of each element of the VoC model helps to find an answer to the main question of the paper.

In the last chapter, impact of the four elements of the VoC model to the company's behavior is discussed. Concluding remarks summarize thesis´ findings and plans for future related research are presented.

1.6. Limitations

There are several limitations that should be mentioned. The paper focuses on identification of the model of institutional foundations in Latvia. Presumably, this work is not free from bias. As the author is of Latvian nationality, it is not always possible to critically evaluate and conclude on the economical and political measures taken by the State. The risk of bias though is reduced by the usage of foreign sources of information but possibly it is still not totally eliminated.

[11] Storper M., S.B.Thomadakis and L.J. Tsipouri (1998), Latecomers in the Global Economy, Routledge
[12] According to Kompesar (1997) classification in his work Imperfect Alternatives: Choosing Institutions in Law, Economics, and Public Policy.

Further, the certain concern might cause lack of political background of the author, which certainly may explain certain weaknesses in the discussion of the political aspect of the work. The lack of time to analyse and cover all the aspects in-depth has also affected the scope of the thesis. This limitation also justifies the absence of use of comparative politics method in the study, which apparently could be applied if the scope of the thesis would be wider.

The research is based on the theoretical VoC model, firstly introduced in 2001 in the book "Varieties of Capitalism: The Institutional Framework of Comparative Advantage". Due to novelty of the topic, this area has not been studied yet in detail. The mentioned work provides quite restrained description of the models, particularly Mediterranean one. It is a reason, of very limited mentioning of the latter model in this study. Moreover, there is still no fundamental research concerning application of this model to the countries in transition, as far as I know, although certain attempts was made to fill the gap in this field.[13]

In the legal part, analysis of competition between jurisdictions from the company perspective is made. However, the microlevel of company and company law have been avoided and also no attempt was made to go into detailed analysis and implications of SE regulation[14].

1.7. Target Audience

Development of the countries in transition, their integration in economic and political life of Western Europe have great impact for national and the EU decision-making. Thesis is of interest to scholars of business and politics as well as students doing the research in the related field. It can also be used for the further research shifting the focus to specific areas, for instance examining industrial policy development in the countries in question (see details in chapter 6.2.) The period of research is December – May 2003.

[13] I have references in my work to the article of Giedrius Jucevicius, a former student of MEA Programme
[14] European Company Statute, Council Regulation 2157/2001

2. METHODOLOGY

The method used in this work is a case study. In this part explanation and rationale of the chosen method for the research is given. Also, discussed and reasoned are the types of sources used in the study.

2.1. Choice of Method and Literature

In order to find answers to the questions raised in this thesis, the combination of theoretical analysis with an empirical description of the current transition, as well as the development of the theoretical model through its extension to the latecoming semi-industrialized countries is proposed. The study is of qualitative nature. Qualitative approaches to research "often imply interpretative procedures, assumptions, and verbally rather than numerically based representations of data"[15]. By conducting qualitative study the attempt is made to explore the problem in-width and in-depth by using descriptive techniques and to link qualitative findings to initial theoretical propositions in order to derive the answer to the research question.

In the classical research method literature, use of three basic methods is suggested. There is a choice between the experiment, survey and case study, or the combination of them. Despite the fact that each method can in principle be used for any of the research purposes (exploratory, descriptive and explanatory), the most typical linkage is between experiments for explanatory studies and surveys for descriptive studies and case studies for exploratory studies. As the purpose of the thesis may be identified as exploratory and descriptive, and it is of qualitative nature, therefore, it largely falls into case study category rather than experiment or survey[16].

Case study is defined as "a strategy for doing research that involves empirical investigation of a particular contemporary phenomenon within its real life context using multiple sources of evidence" [17] or, in other words, it is development of detailed, intensive knowledge about a single case – Latvian VoC model. The work, therefore, may be divided into 3 parts: firstly definition of goals, identification of research questions and structuring the design of the study; then analysis of theoretical sources and collection and analysis of empirical data; finally, discussion of the empirical findings and their relevance and applicability to the theoretical model.

Multiple sources of evidence are used in order to obtain sufficient information and provide reasonable reliability of the results. Data and evidence collection are based on the analysis of primary and secondary data. Using these sources together help to collect full and reliable information and to obtain a clear picture of the problem. This study mainly relies on secondary data due to lack of time and the

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[15] Sutton, B. (1993). The rationale for qualitative research: A review of principles and theoretical foundations. Library Quarterly, 63

[16] Robson C. (1993), Real world research, A research for Social Scientists and Practitioner Researchers, Blackwell,; Yin R. K (1994), Case study research design and methods, Applied Social Research Methods Series Volume

[17] Yin R. K (1994), Case study research design and methods, Applied Social Research Methods Series Volume

absence of opportunity to perform fieldwork in the country of question. However, the author is aware about significance of primary data, interviews in particular, which can be targeted to the right person. Information received may be really insightful, providing perceived casual interference. In the course of research fieldwork few interviews were conducted. One, with Patrick Lindberg[18], who is the representative of International Affairs Enlargement Team in DG Competition, Brussels, was an expert interview, aimed to overview rather broad range of questions in order to find new aspects to the research problem. Open-ended interview was chosen for this purpose because of questions flexibility, easiness with which interviewer can go in more depth of what he chooses, enabling to test the limit' of a correspondent knowledge and allowing the interviewer make a truer assessment of what respondent really believes. It helped to get an insight into the current situation of the countries in transition, particularly Latvia in the field of competition, as well as to understand the EU position and evaluation of the processes in the light of upcoming enlargement. Other interviews were conducted with the residents of Latvia, in order to obtain empirical evidence regarding functionality of the elements of the VoC model in Latvia. Ziedonis Antapsons[19], LBAS experts in job security questions assisted by e-mail in finding the additional information sources for the study of industrial-relations element. Phone interview with Galina Romanova[20], chief accountant of SIA "New Rosme" helped to understand the real current power of trade union in the one of manufacturing companies in Latvia. Finally, the personal interview with Jury Kondratenko[21], former employee of Latvian recruitment company, during his stay in Lund gave an insight in education and training tendencies in Latvia regarding the top management field.

As it was mentioned, mainly secondary data was used in this paper, the data that has been already transformed by a third person. Use of secondary data provides stable, precise and quantitative information, which can be reviewed repeatedly. It is less obtrusive and has a broad exposure covering many events and settings. At the same time, the weaknesses of the above source, namely its retrievability, biased selectivity, accessibility and reporting bias would be eliminated by interviews. As a secondary sources a variety of information has been used:

- legal, political and economical books – among them the most widely used were ones of Hall and Soskice (2001), North (1990), Whitley (1992) and Storper (1998);
- magazines and journals – particularly Economic Journal, the Journal of Law and Economics, Journal of Comparative Economics, etc.;
- annual reports and prospectuses – ones of Ministries and companies;
- lectures during MEA 2002/2003 Programme in Lund University, Sweden – given in IDC and Financial Integration courses;
- speeches recorded at the various international and national conferences;
- Ministry reports, including National Development Reports; other EU Reports;
- Project proposals;
- Information from National Information centres – mainly statistical data;

[18] On 20th of February, 2003, in Brussels
[19] Contact established on 9th April 2003
[20] Interview on 29th April, 2003
[21] Interview on 5th May 2003

- other internet published information.

2.2. Legal Methodology

The study is based on the analysis of the EU primary and secondary legal sources of law as well as the investigation of legal literature. Primary source of the Community law is the Treaty of Rome, which contains a set of general provisions. Secondary sources include regulations, directives and decisions as well as ECJ case law. In this study analysis of primary sources is concentrated on the Art. 3(g), 5(2) and 81. Secondary sources used are mainly case law regarding applicability and enforcement of the above articles. The Legal part comprises of the 4 parts. First one, about the concept of competition between legal systems, is mainly based on Easterbrook (1983) theory and discussion subsequently conducted by Ulla Neergaard (1998). The second chapter represents the interdisciplinary study of law and politics based on theories of Douglass North (1997) and Neil Komesar (1997). A deviation to the field of social policy is also made in order to illustrate the principle of subsidiarity, dealt in details in chapter 4.4. The discussion relates to the Art. 139 of EC Treaty and Art.3 of Agreement on Social Policy. In third chapter, the ECJ case law regarding freedom of establishment (company law) is applied and discussion evolves around Art. 43 of the EC Treaty. Finally, fourth chapter is devoted to distribution of competencies and reflects 5 principles governing this issue. In order to sum up information in a brief, comprehensive manner, a number of legal articles from European Law Review, Common Market Law review etc., as well as Ulla Neergaad (1998) and other books, mainly published by Kluwer Law Intrernational was widely used.

2.3. Interdisciplinary Perspective of the Subject

Abundance of interesting issues is involved in this research. The interdisciplinary approach allows conducting multi-faceted and comparative analysis of societies. Firstly, the study concerns the field of political economy as it aims to explain interrelationships between political and economic institutions and processes[22]. Secondly, inquiring in the company's behaviour through assessment of the macroeconomic environment sheds light on economic issues. Thirdly, the discussion on the comparative advantage of the systems, for example, the choice of jurisdictions represents the areas of business administration and management. Finally, as long as company operates in a given legal framework general aspects of company law as well as issues of the EU and national competencies and competition between legal systems are involved as well.

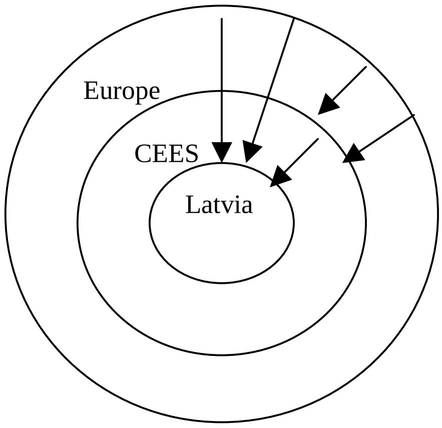
Approach employed in this study is one of comparative analysis. This includes comparison of different political and economic systems. It is aimed for integration of different disciplines in a unite analysis of the socio-economic systems and promotion of interdisciplinary approach. The trade-off between

[22] Moreover, the political economists analyses and explains the ways in which various sorts of government affect the allocation of scarce resources in society through their laws and policies.
http://www.auburn.edu/~johnspm/gloss/index.html?http://www.auburn.edu/~johnspm/gloss/money_stock.html

complexity and generalisation is made in this respect. This is done due to the fact that "the more case method takes into account the context and the complexities of any one political system, or a limited range of systems, the less capable that research strategy will be of generalisation".[23] On the other hand, "the more an approach attempts to furnish generalisations and to test theories broadly, the less nuances are tackled"[24] and analysis become somehow limited.

2.4. Choice of Country

The scope of the work was reduced in the following way.



Due to limited scope of the work, it appears impossible and unnecessary to conduct a study of all accession countries. For a detailed research Latvia, a one of the Baltic state countries was chosen. This choice was made mainly because of convenience. As the author is of Latvian nationality, the choice of Latvia eliminates concern of foreign language barrier and provides access to information in the national language of the country. This fact also explains author's particular interest in this country. Latvia is an important economical centre connecting the Baltic States to a large market, with capital located only a few hours' to Vilnius, Lithuania or to Tallin, Estonia. Latvia, being positioned between "East and West", functions as a bridge between two economies with different cultural and historical backgrounds.

One could notice that in thed study two concepts - countries in transition and latecoming semi-industrialized countries - are used interchangeably. Under these concepts author implies the countries of Central and Eastern Europe, ones which expressed their interest to joint the EU (see also appendix 2).

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[23] Peters B.G. (1998), Comparative Politics: Theory and Methods, Serie Comparative Government and Politics, Editor: Vincent Wright, Mac press
[24] Ibid.

2.4. Credibility of the Results and Critique of the Sources

Regarding critique of secondary sources of evidence two problems may be mentioned: firstly, the validity of information due to outdating and secondly, reliability and credibility of national as well as international information sources. Due to the dynamic nature of the countries in transition its analysis requires the possession of up-to-date information as facts changes rapidly and data, especially statistical one outdates quickly. However, as the processing of primary data requires time, secondary sources as a result provide at least one-year-old information. Another issue is the reliability of the sources. Empirical information was collected mainly from governmental sources and may be biased to the some extent, as it is not excluded that local institutions were attempting to provide more favourable or unfavourable impression on situation as it is in reality. In order to ensure reasonable credibility of this study, general approach was taken that information from National Ministries prevails over media sources (although, discrepancies between them were noted and discussed), while international reports (incl. one of the EU) prevails over national ones. As regards the critique of primary source of information, interviews, it must be mentioned that they are not free from bias as are highly personified.

3. THEORETICAL FRAMEWORK

Capitalist economies in Europe do not have similar features and characteristics due to different historical, political and economic patterns of development. These differences, accordingly, affect institutional foundations of capitalism that vary across business systems. The economic and political theories propose several possible classifications of capitalism models depending on the chosen variables.

3.1. Varieties of Capitalism in Europe

The classical Smith-Keynes approach distinguishes between liberal and interventionist national economic systems. While latter justifies the state government intervention in the economy and argues that pro-active industrial policy is a precondition to national competitiveness, the supporters of the former view believes that equilibrium, stable and self-regulatory environment may be achieved by free interplay of the market forces. It is possible to find both economic systems at the European highly diverse arena. Market-oriented liberal states are the U.K., the Netherlands, Denmark, Finland and Ireland. Countries, where state intervention plays a substantial role are France, Italy, Spain, Greece, Germany, Sweden, Austria, Belgium.[25] Modern economies are very complex. Attempt to find a common linear pattern that does not fully reflect a country's unique socio-economic model may lead to generalisation and oversimplification of the national business system.

Whitley[26] characterises business systems as a product of hierarchy-market relationship. Analysis of economic actors from the independent (the nature of the firm), dependent (market organization) and interdependent (authoritative co-ordination and control systems) perspectives reveals differences in social institutions and in its distinctive ways of ensuring competitiveness and efficient functioning of the entire system. In the meantime, Whitley's hierarchy-based approach should be applied very cautiously to the European countries. The author conducted most of research in the South Asian countries where social order and hierarchical structure of the business organisations are the prevailing ones and it does not necessarily means that the discovered paradigms may be applied to the European capitalist systems.

"Varieties of capitalism" theory of Hall and Soskice[27] distinguishes two polar models – model of liberal market economy (LME) and model of co-ordinated market economy (CME), which have developed along fundamentally different lines[28]. In the liberal market economy (LME) relations between firms and other actors are co-ordinated primarily by competitive markets. Two Anglo-Saxon

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[25] Darmer, M. and L. Kuyper (2000), Industry and the European Union: Analysing Policies for Business. Cheltenham, England, Edward Elgar Publishing
[26] Whitley R. (1992), European Business Systems: Firms and Markets in their National Contexts, Sage Publications, article by Whitley R. "The Comparative Analysis of Business Systems"
[27] Hall P.A. and D. Soskice (2001), Varieties of Capitalism: The Institutional Foundations of Comparative Advantage, Oxford University Press
[28] Whitley R. (1992), European Business Systems: Firms and Markets in their National Contexts, Sage Publications, article by Lane C. "European Business Systems: Britain and Germany compared"

countries have distinctive features of liberal market economy in Europe – Britain and Ireland. In the co-ordinated market economies, (CME) companies are typically engaged in more strategic interactions with trade unions, suppliers of finance and other actors. This type of economy is typical for Germany, Switzerland, the Netherlands, Belgium, the Nordic countries and Austria. The brightest, classical examples of the above models are business systems of Britain and Germany. There is also the third, Mediterranean type of economy, typical for France, Italy, Spain, Portugal, Greece and Turkey. It did not receive extensive coverage by the authors mainly due to its "ambiguous" position. This system is characterised by large agrarian sector and high level of state intervention in the sphere of corporate finance but more liberal arrangements in the sphere of labour relations.[29] As VoC theory form the basis of the research, its features will be explored more in details in the three following chapters.

3.2. Varieties of Capitalism Approach. Liberal Market Economy vs. Coordinated Market Economy Models[30]

Varieties of capitalism approach assume that firms are the central actors of the economy whose behaviour aggregates into national economic performance.[31] It analyses the influence of institutional foundations on the company from the four perspectives: corporate governance system and financial system; system of inter-company relations; education and training system and industrial relations system. Financial system and corporate governance deal with the availability of capital and access to financial resources, as well as structure of the market for corporate governance. Inter-company element covers the relations with the stakeholders – suppliers, customers, and competitors. One of a firm's most important assets is employees, and the third pillar deals with education and training issues, particularly in the field of vocational training. Finally, industrial-relations system comprises of bargaining of wages and working conditions, relations with the labour organisations and regulation of unemployment.

3.2.1. Model of Liberal Market Economy

Liberal market economy is characterised by highly competitive environment, which is co-ordinated, by market arrangements. The peculiarity of the *finance and corporate governance system* is that it has highly developed integrated equity markets. As the system is based on publicly available information, attention is drawn to valuation and share price fluctuations, as well as the assessment of company's financial stability and current profitability. Merger & acquisitions are favoured in the LMEs - hostile take-overs also take place, although this practice is more widespread in the US rather than Europe.

At the *industrial relations arena,* employer-employee relationships depend heavily on the market conditions. Trade unions are generally not very powerful and, therefore, company's management has ultimate power to exercise personnel recruitment and dismissal. The above situation encourages

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[29] Rhodes M., P. Heywood, V.Wright (1997), Developments of West European Politics, Macmillan Press Ltd.
[30] Please refer to the graphic models of the systems in appendixes 3 and 4.
[31] Hall D., D.W. Gingerich (2001), Varieties of capitalism and Institutional complementarities in the macroeconomy: an empirical analysis, Harvard University, August

individuals to invest in general and not in company-specific skills, and to view their careers as an upward movement, changing several firms on the way up.

Education and training system is complementary to the industrial relations network. It adapts to the fluid labour markets conditions and stresses the development of general skills, rather the specific ones, and considers that the high personnel turnover is almost inevitable phenomenon. General skills are aggregated starting from the level of secondary school to that of college and university. Further, companies are supposed to provide necessary in-house training in order to teach employees company-specific skills. For example, vocational training has always been of secondary importance[32] in Britain and this fact has affected also the social prestige of the teaching profession. The power of the trade unions historically has been weaker in the U.K. than in Germany, and employer organisations have been relatively weaker either.

Inter-company relations are based on the standard market relationships and enforceable contracts[33]. Some influence has also firm reputation, which provides some degree of reliance that the company will fulfil its obligations. The technology transfer relations, jointly with science and innovation, also form a part of the element. LME is characterised by quite intense movement of scientists and engineers from one company to another due to existence fluid labour market. Historically, the importance of R&D was recognised in Britain later than in Germany[34]. Industry has also been less forthcoming in sponsoring university research, which also negatively influenced the relations between industry and research departments.

Apart from integrating with each other and forming the institutional framework of the market, these elements directly influence internal environment of a company, the central element of the model. A classical example of the LME is British market-based system. Despite the historical focus on centralisation, state does not play an active role in economic policy-making in the U.K. In line with the shareholder model of corporate governance, companies are oriented to increase the shareholder value and achieve profitability in short-term. De-regulated and contract-based labour market facilitates attraction of the skilled personnel from the outside. High market pressure does not motivate companies to sustain horizontal industrial relationship and exchange information in the sphere of science and R&D. British companies are governed by relatively independent top management. The CEO does not necessarily has expertise in the field, but certainly has strong personality, is able to speedily make and communicate decisions as well as to flexibly adapt to the rapidly changing market conditions.

[32] Hall P.A. and D. Soskice (2001), Varieties of Capitalism: The Institutional Foundations of Comparative Advantage, Oxford University Press, article by Vitols S. “Varieties of Coporate Governance: Comparing Germany and the U.K.

[33] Hall P.A. and D. Soskice (2001), Varieties of Capitalism: The Institutional Foundations of Comparative Advantage, Oxford University Press

[34] Hall P.A. and D. Soskice (2001), Varieties of Capitalism: The Institutional Foundations of Comparative Advantage, Oxford University Press, article by Vitols S. “Varieties of Coporate Governance: Comparing Germany and the U.K.

3.2.2. Model of Co-ordinated Market Economy

Co-ordinated market economy does not rely entirely on the regulation by the market forces but presupposes the strategic interaction by the government, which takes a more proactive role in shaping a company's external and, to some extent, internal environments.

In the CME, *financial system* provides access to finances, which is not entirely based on the publicly available financial data. The investors usually have access to the "inside information" of a company, therefore, their judgement does not depend only on balance sheet data. Exchange of "inside or private" information stimulates the existence of certain networks between managers and other stakeholders that facilitate provision of reliable primary information. Strong network ties serve as a control tool for ensuring the "reputational monitoring" as companies are concerned about retaining good reputation, which would help them to raise finances in future. German financial system is mainly based on bank credit, and, therefore, stock market remains somehow underdeveloped. Banks retain close links with industry and also own substantial amounts of industrial equity[35]. The corporate governance structure mainly depends on tax provisions, securities regulations and networks of cross-shareholding which nearly eliminates the possibility of hostile take-overs.

Internal structure of a firm in the co-ordinated market economies is much more regulated than one in LME. Top managers rarely have an unilateral control and share the decision-making power with the supervisory board, employee representatives and major shareholders. This situation contrasts the situation in the U.K. where, for example, shareholders have the power to appoint management, but not to participate in day-to-day activities and decision-making process according to national legislation. Difference exists also in the assignation of the top management remuneration package, which in the case of CME is aimed to promote long-term employment.

The specifics of *industrial relations* in the CME is a wide dispersion of the industry-level bargaining between trade unions and employer organisations in relation to wage setting and moderation, dealing with the collective lay-offs and working conditions. Apart from these regulations, employees exercise the power to appoint their representatives in order to participate in the decision-making process along with top management of the company.

Basic distinction between varieties of capitalism in the field of *education and training* is industry-specific vs. general-skills specific orientation in the CME and LME respectively. Germany is known for its highly developed system of vocational training. Some technical colleges in the country are even more prestigious than universities. The engineering educational background is typical to the top management positions. Trade unions also play an active part, as these are assigned to supervise a publicly subsidised training system.

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[35] Whitley R. (1992), European Business Systems: Firms and Markets in their National Contexts, Sage Publications, article by Lane C. "European Business Systems: Britain and Germany compared"

In the sphere of *inter-company relations*, industry associations assisting in technology transfer and R&D activities support companies. Companies and state fund considerable amount of research jointly, and strong ties between university research centres and corresponding industries are established.

Hence, German business system is quite distinctive from the British. In contrast to the latter, it maintains close dialogue with the stakeholders and does not focus that much on the short-term profitability goals. Industrial relations are characterised by close and co-operative management-labour relationship enforced by the powerful trade union network. Top management has generally the engineering background and expert knowledge, and makes decision taking into account the opinion of the employee representatives. Companies enjoy the high level of strategic interaction, particularly in the field of R&D. Capital is raised though the bank credit and companies are concerned to sustain the favourable reputation.

3.2.3. Mediterranean Model

Mediterranean model may be characterised as hierarchy-based, due to historical tradition of centralised state (although it is somewhat confusing to use the word "hierarchy-based" in respect to capitalism system, as this term is often associated with central-planned economy models). France is a classical example of the Mediterranean capitalism model.

The *financial markets* are quite underdeveloped, especially in the field of equity financing. Although the banking sector is generally more developed than the equity market, there is no established firm-bank relationship comparable to the German case.[36]

Intercompany relations are not well developed. R&D projects are mostly state-funded and internal mobility across the companies is quite limited. The relations are mainly maintained through the "old boys" or family networks.

In the sphere of *industrial relations* labour unions do not have the power to influence top management decision – a situation which leads to a high degree of labour-management conflicts. French system is highly politized, lacks management accountability and is associated with de-motivated labour force, but at the same time it is well-planned, precise and manages the risks effectively.[37]

Education and training system is highly influenced by the elite educational system with its *Grandes ecoles*, close "old boys" network and great importance of the social class one belongs to. It enhances the role of reputation and social ties which are not limited to formal business associations. There is also a tradition to start the career in the public sector, which further leads to the extensive ownership of

[36] Jucevicius G. (2003), Developement of the European Socio-Economic System. Increased Divergence of Capitalist Systems Inside the Enlarged EU?, draft article, April
[37] Sorge A., M. Maurice (2000), Embedding Organizations: Societal Analysis of Actors, Organizations and Socio-Economic Context (Advances in Organization Studies, 4)

the large firms by the former civil servants and makes the public companies accountable to politicians and vice-versa.

Concluded from the above, the LME differs from the CME by the extent to which firms rely on market mechanisms to co-ordinate their endeavours, as opposed to forms of strategic interaction supported by non-market institutions[38]. The Mediterranean model occupies somewhat outstanding position, having many similarities with the CME model but not following it entirely. These contrasting models allows to analyse other capitalist systems which do not correspond to the ideal type of a liberal or co-ordinated market economies. Understanding of the model of institutional foundations helps to establish the company's corporate strategy by assessing available institutional support and institutional constraints. The above statement lead us to the issue of comparative institutional advantage. Different institutional framework might lead to the different advantages and incentives provided to the industries. Following this reasoning, one might argue that certain industries might have better development and operating conditions in the CME, while others in the LME. If it appears to be true, the industry might obtain comparative advantage operating in a certain *institutional framework.* What we mean under this concept is explained in the next chapter.

3.3. Institutions and Business systems: A Pattern of Interaction

> "Politicians of all parties are great believers in institutional change as a source of economic improvement – not surprisingly, because that is the sort of change they are well placed to bring about."[39]

Institutions shape the external environment in which companies operate, and directly and indirectly affect their economic performance. The concept of 'institutions' is central to the debate in this paper. Traditionally, an institution is defined as "an organisation or establishment founded for a specific purpose"[40]. This interpretation is too narrow though and does not fully reflect the meaning and the role of institution in the market. Institutions in its wider perspective are rather the rules of the game[41], an established custom, law or relationship in a society or community.[42] In other words, institution represents a set of rules, formal or informal, that actors generally follow, whether for normative, cognitive, or material reasons, and organizations as durable entities with formally recognized members, whose rules also contribute to the institutions of the political economy.[43]

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[38] Hall P.A. and D. Soskice (2001), Varieties of Capitalism: The Institutional Foundations of Comparative Advantage, Oxford University Press
[39] Matthews, R. C. O. (1986), The Economic Institutions and the Sources of Growth, Economic Journal, 96, 903-18
[40] http://www.wordreference.com/English/definition.asp?en=institution
[41] North, D.C. (1997), The Contribution of the New Institutional Economics to an Understanding of the Transition Problem, Wider Annual lectures, March
[42] Ibid.
[43] Hall P.A. and D. Soskice (2001), Varieties of Capitalism: The Institutional Foundations of Comparative Advantage, Oxford University Press

While formal rules include political, judicial, economic regulations and contracts, informal ones deal with routines, customs, traditions and culture, the concepts, which can hardly be defined and tackled[44]. Accordingly, formal rules constitute the immediate business environment, while informal structure general patterns of trust, cooperation, identity and subordination in a society.[45] The entire purpose of those is to ensure stability and continuity of the business system as a whole. Institutions (in the narrow meaning) or organisations usually provide mechanisms for attaining exchange of information, co-ordination, monitoring and the enforcement of formal rules. However, these mechanisms are not sufficient for the effective administrating of the system. Only shared understanding, expressed in a set of informal rules, leads to the development of the "common knowledge" and motivates the participants to co-ordinate and achieve desirable outcome.

Traditional approach suggests that institutional structure follows firm strategy[46]. In the meantime, the modern approach[47] maintains controversial view asserting that the institutional foundations influence firm strategy. The former view may be true in hypothetical conditions when only one or few firms are operating at the market. In reality, a variety of firms have distinct objectives and interests, which makes it impossible for them to agree on methods of institutional co-ordination and influence. As a result, firms are faced with a set of institutions that are not fully under its control.

Institutions within the business system interact with each other and other actors. Moreover, they shape the business system as such. Institutions are perceived as complementary if the presence or efficiency of one increases the returns from (or efficiency of) the other. Conversely, two institutions may be "substitutable" if the absence or inefficiency of one increases the returns of using the other.[48] There are several theories that attempt to tackle the patterns of the institutional behaviour and development. These are presented in more details in the chapter 4.2. I will also return to the issue of institutions in the chapter 3.5. where specifics of the institutional framework in the countries in transition will be discussed.

3.4. The Application of the VoC Model to the Latecoming Countries

The VoC model systematises and analyses the capitalist systems in the developed OECD countries. In the meantime, the countries of Central and Eastern Europe are not covered in the Hall and Soskice model. Apparently, the main reason for that is the ambiguous position of these countries at the international arena. The fall of the Berlin Wall in 1989 and the subsequent dismantling of communism soon after, set the stage for Eastern Europe and Russia shift towards liberal capitalism and a market

[44] North, D.C. (1997), The Contribution of the New Institutional Economics to an Understanding of the Transition Problem, Wider Annual lectures, March

[45] Whitley R. (1992), European Business Systems: Firms and Markets in their National Contexts, Sage Publications

[46] Chandler A.D. (1974), Strategy and Structure Strategy and Structure, the Mit Press, O.E. Williamson (1985), The Economic Institutions of Capitalism, New York, the Free Press, Chandler A.D. and H. Daems (1980), Managerial Hierarchies, Harvard University Press

[47] suggested by P.A.Hall and D.Soskice

[48] Hall P.A., D. Soskice (2001), Varieties of Capitalism: The Institutional Framework of Comparative Advantage, Oxford University Press

economy. The countries faced "triple transition": from communist dictatorship to pluralistic democracy; from centrally administrated to market economies; and from Soviet imperial hegemony to fully independent national statehood.[49] The transformation has not been smooth. Early reform programs were based on strategies initially devised for underdeveloped countries.[50] However, it appeared soon that these programs could not be transferred to transition countries without modification because of the CEE countries specifics.

Indeed, the countries of Eastern and Central Europe constitute a unique class often referred to as *latecoming semi-industrialized countries*[51] (LSCs) or "countries in transition". Unlike the typical developing countries, in which the lack of basic education and infrastructure present fundamental obstacles to economic progress[52], these countries, being a part of central command economy, maintained strong educational basis, developed infrastructure and manufacturing capacities. At the same time, the transition to the liberal capitalism have highlighted a number of serious deficiencies as inadequate productive structures, the lack of advanced organisational skills and knowledge of the free economy market as well as absence of the modern industrial culture. These factors were "the main obstacles that keep the countries from successfully emulating the economic effectiveness of advanced countries"[53].

Is it feasible and reliable to apply VoC model to the countries in transition? Undoubtedly, countries of Central and Eastern Europe do have a capitalist system. However, in contrast to the developed EU countries, it is not that easy to suggest which model of capitalism these countries follow in their development. While model of the Western European capitalism systems has sound historical background and has proved its stability through several economical and political turmoils, it is quite hard to grasp the one of the countries in transition due to their highly turbulent environment. The constantly changing conditions and inconsistency between law and reality suggest that any static model may be applicable in short-term but unpredictable in the long-run. VoC approach though, does not limit capitalist systems to two or three models[54]. This allows suggesting that there can be a model addressing the characteristics specific to the countries in transition – a dynamic model, which reflects the current picture and envisions / highlights the further developments of the system. Before more detailed analysis of the macroeconomic environment of the LSCs, let examine economical view on the transition problematic.

According to Porter, the countries of the central planned economies lack many important elements. Restrictions on buyer choice remove sophisticated demand pressure. The lack of competition

[49] Edited by Bideleux R. and R. Taylor (1996), European Integration and Disintegration, East and West, Routledge, article by Robert Bideleux, Bringing the East back in
[50] Funke, N. (1993), Timing and Sequencing of Reforms: Competing Views and the Role of Credibility, Kyklos, 3/46
[51] The concept was introduced by Storper M., S.B.Thomadakis and L.J. Tsipouri (1998) in their book Latecomers in the Global Economy, Routledge,
[52] Storper M., S.B.Thomadakis and L.J. Tsipouri (1998), Latecomers in the Global Economy, Routledge
[53] Ibid.
[54] The third model is "Mediterranean" one marked by a large agrarian sector and recent histories of extensive state intervention. Typical examples include France, Italy, Spain, Portugal, Greece and Turkey.

eliminates most interchange with related and supporting industries. Lack of motivation and the restricted flow of information need upgrading. Effective domestic rivalry is absent which also lowers the level of countries competitiveness on the global arena.[55] In transition to the market economy, country needs to upgrade all elements of "diamond" and at the same time to change and transform the business culture, organisational structure and also individuals attitude towards work. Changes in former rules may be tackled relatively successfully, but they cannot function without upgraded informal dimension. These informal rules and conventions are deeply rooted and very difficult to change, as doing so requires forging of new social values, individual decisions and behaviours[56].

From the Porter's "diamond" perspective, the central problem for the latecomers is the need to decide what industries to concentrate on in order to gain the competitive advantage. Due to lack of historically formed sectors it is often hard to decide. Nevertheless, it is agreed, that both developing countries and those in transition should concentrate upon value added industries and products and resist the tendency of building advantage on the export of raw materials and natural resources which is the easiest but ineffective approach in the long-run. Another acute issue is whether to build economy largely through indigenous companies or encourage widespread investments in the nation by the foreign multinationals[57]. On the one hand, the growth of national companies is much slower and in many ways riskier process, but on the other, the attraction of foreign multinationals may endanger the formation of home base to any industry. Sometimes entry of multinationals is explained entirely by the cheap labour or other resources availability which makes growth and stability perspectives quite dubious.

At the same time, it is necessary to mention limitations of the Porter diamond model in terms of its applicability to the LSCs. The Porter model have been mainly based on the analysis of the highly developed countries as U.S.A. and Japan, which, among other things, experience a high degree of domestic rivalry due to the size of their local markets. The situation in Europe, and particularly in CEE countries is quite different as domestic rivalry is not that strong[58]. This influences the whole Porter model as its elements are interrelated with each other.

The countries in transition are forced to compete on a global arena with the countries which historically have competitive advantage of operating in a capitalism conditions. Therefore, the extremely high adaptability to the new environment conditions is required for the LSCs especially for those, which are willing to enter the EU as its members in the nearest future. According to Mr. Solbes[59] the European economic integration includes and fosters competition between systems (e.g. fiscal regimes) and between structures (e.g. labour market institutions). This issue relates to the field of political economy, as it studies the relationship between political and economic institutions and

[55] Porter M. (1990), Competitive Advantage of Nations, Palgrave
[56] Storper M., S.B.Thomadakis and L.J. Tsipouri (1998), Latecomers in the Global Economy, Routledge
[57] Porter M. (1990), Competitive Advantage of Nations, Palgrave
[58] Let us mention Western European example of Nokia and Ericsson which main competitors are located abroad and not at their local markets.
[59] EU Economic and Financial Affairs Commissioner, April 19, 2002

processes[60]. From a political economy perspective, the fulfilment of the Copenhagen criteria paves the way for the accession of 10 new Member States. From the economic point of view enlargement brings new challenges to the LSCs countries. Proposed structural reforms need to facilitate annual GDP increase on the level of 6-7% [61] in contrast to actual average of 3% sustained at the moment. The readiness of the accession countries for the EMU and conversely the readiness of the EMU institutions for the enlargement is also questionable.

Introduction provides the rationale for the choice of the country analyzed in the empirical study. Latvia, along with Lithuania and Estonia form the Baltic States region which regained its independent status in 1991 with the breakdown of the Communist Bloc. Therefore, in the first instance, events were shaped by the necessity to confront the problems associated with Latvia's disengagement from the economic and legal structure of the Soviet Union following the partly anticipated and somewhat abrupt resumption of independence in the late summer of 1991[62]. In the subsequent period Latvia has taken on the difficult task of creating a market economy in a newly created country – something for which there was no theoretical or practical model.

3.5. Role of Institutions in the Transition System

> "...analysis of institutions in Eastern European countries is a new field of research, itself developing constantly in response to the experience gained in transition process."[63]

Transition is a complex process from the political, social, legal and economical points of view. There is no comprehensive theory of transition, rather a multitude of theoretical approaches[64]. The previous chapter discussed the general characteristics of the CEEC environment and the relevance of application of VoC model to the highly vulnerable conditions of the LCSs. This chapter pays attention to the role of institutions in the transition process, as they are "the underlying determinants of the long-run performance of economies".[65] An attempt is made to understand what institutional changes were required and how they were implemented in order to ensure smooth transition from the central planned to the market economy in the mentioned region.

As it was mentioned, the CEE countries faced definite problems due to high proportion of heavy industry and an underdeveloped service sector, outdated capital stock and technological backwardness, high energy consumption and pollution, and the priority on CMEA trade rather than international

[60] Moreover, the political economists analyses and explains the ways in which various sorts of government affect the allocation of scarce resources in society through their laws and policies.
http://www.auburn.edu/~johnspm/gloss/index.html?http://www.auburn.edu/~johnspm/gloss/money_stock.html
[61] Lecture of Mr. Göran Lennmarker, Swedish member of the European Convention, IDC course, March 2003
[62]Vanags A., A. Štrupišs (1999), Corporate Governance in Latvia, Organisation for Economic Co-operation and Development
[63] Voigt1 S. and H. Engerer (2002), Institutions and Transition – Possible Policy Implications of the New Institutional Economics
[64] Ibid.
[65] D.C. North (1997), Institututions, Institutional Change and Economic Performance: Political Economy of Institutions and Decision, Cambridge University Press

integration.[66] The macroeconomic problems formed a triangle of utmost importance: with three main dimensions to be addressed - stabilisation, liberalisation and privatisation. Apart from the decline in the economic development common to all CEE countries in the first years of transition, these countries had the different patterns of institutional development, which, according to economists, lead also to different pace of transition[67]. Institutions served as the explanation of efficiency and speed of transition process. The EBRD[68] mentioned that: "However, all countries in the region face a common challenge [...]: the task of developing and providing effective, market-oriented governance. By governance we mean the manner of governing within enterprises and within the economy as a whole, in particular the building and deepening of institutions and behaviour that are at the heart of a well-functioning market economy." Although despite the importance of the institutional factor, at the beginning of transition, institutional change was seen as a precondition for economic transition, rather than the one of the tasks[69].

The Western investors developed “transition indicators”[70] in order to systematise the progress of transition. One of the indicators is a so-called legal transition indicator. It evaluates the success in development of important regulations concerning business law (company law, insolvency law), and is, thus, a measure extensiveness and effectiveness for external institutions since 1997. Extensiveness assessed the extent to which the enacted laws approach the laws of market economies. Effectiveness assessed whether legal rules are enforced judicially, and thus actually implemented. Effectiveness indicator was and still is particularly important in Eastern European countries, where laws often exist only on paper.[71] The distinction between extensiveness and effectiveness reveals that most of the transition countries enacted the necessary laws, but failed to enforce them adequately[72]. One of the possible reasons of that can be the rapid institutional change, which forced governments to copy the Western institutional framework, including legal regulations. Copying legal regulations had an additional advantage of saving resources which could then be used, e.g., to set up the essential legal infrastructure[73]. However, after the transfer of laws from the West and their implementation,[74] further investment outlays were required for generating the new infrastructure and training personnel.[75]

[66] D.C. North (1997), Institututions, Institutional Change and Economic Performance: Political Economy of Institutions and Decision, Cambridge University Press
[67] Stefan Voigt1 and Hella Engerer (2002), Institutions and Transition – Possible Policy Implications of the New Institutional Economics
[68] EBRD (European Bank for Reconstruction and Development), Transition Report, various issues, London, 1997
[69] Stefan Voigt1 and Hella Engerer (2002), Institutions and Transition – Possible Policy Implications of the New Institutional Economics
[70] Indicator was established by EBRD. Each indicator is rated on a range from 1 to 4+, the highest value representing the characteristics of the market economy.
[71] Stefan Voigt1 and Hella Engerer (2002), Institutions and Transition – Possible Policy Implications of the New Institutional Economics
[72] For detailed data please refer to EBRD 1998 research survey Transition Report, various issues, London
[73] "The resources saved by this type of short-cut could then be used for setting up institutions and training the individuals who will be entrusted with applying and interpreting the new laws", ECE (United Nations Economic Commission for Europe), Economic Survey of Europe, various issues, New York.
[74] Western legal systems were indeed copied or used as a point of reference in the early stages of transition. Examples are the Bulgarian and Romanian commercial codes, which were based on German and French law respectively. See Voigtl and Engerer (2002)
[75] Stefan Voigt1 and Hella Engerer (2002), Institutions and Transition – Possible Policy Implications of the New Institutional Economics

Undoubtedly, this strategy have saved the resources and also speeded up the process, although short-cut of the Western laws application was exclusion of the unique characteristics of CEE countries. The "institutional" framework in it narrow sense[76] was adjusted, although the "rules of the game" and particularly informal rules were not. As Murrell noted: "In the large majority of countries, especially in the former republics of the USSR, it will take a generation, or more, for the legal system to buttress capitalism in the manner imagined by the drafters of the many new laws. Although these laws are beginning to affect behaviour, they are presently of no more than marginal significance."[77] The effectiveness of laws is reduced also because of corruption and lengthy judicial procedures that become the actual issues in each transition country. The above-mentioned events are the reasons for the existing gap between formal and informal institutions in the CEE countries.

[76] as referred to laws, the legal infrastructure (courts), as well as organizations such as the central banks, tax authorities, and special agencies (e.g., privatization agencies).
[77] Murrell, P. (1996), How Far Has the Transition Progressed?, The Journal of Economic Perspectives, 10/2

4. LEGAL FRAMEWORK

Enlarging towards the east, the EU and its member states are taking in new neighbour states, which continue to face the challenge of strengthening the institutional and legal frameworks. The interest of the EU and member states to facilitate such an improvement is clear. However, despite the remarkable consensus on key problem areas and objectives, a coherent, well coordinated international strategy has not yet been achieved.[78] Several theories are developed, which try to "look into future" and evaluate what kind of changes in institutional and legal frameworks the countries might face and how the accession will affect existing and new countries of the EU.

4.1. Competition Between Legal Systems

The "legal system" is widely defined as "a complex set of substantive rules, legal processes and legal institutions consisting not only of the formal law implicit in the constitutions, statutes and precedents, but also legal practices by state and non-state agents that may or may not follow the formal law".[79] In the national context, the two dimensions of legal change are distinguished: allocative and procedural ones. They aim to explain the relationship between legal systems and socio-economic change. While the allocative dimension indicates whether the power to make decisions over the allocation of resources is vested with the state or is left to the market forces, the procedural one determines whether decisions are primarily rule-based or discretionary.[80] At the supranational level, the issue of competition between national legal systems becomes actual, particularly in the light of upcoming enlargement.

This theory of "competition between legal systems" was first developed by Easterbrook[81] who made the basic assumption that companies and people are more willing to operate in the legal system which offers them more favourable conditions than another. To simplify, that means that in the long-run people and companies would move to a state with the regulations that they prefer. The analysis of the market in order to establish the degree of competition between jurisdictions is based on the 4 criteria: the mobility of people and resources, the number of jurisdictions, the possibility to jurisdictions select any set of regulations that they desire, and whether all of the consequences of one jurisdiction's laws are felt within that jurisdiction.[82]

The major drawback of this test is, according to Easterbrook, the absence of empirical evidence that would prove/ disprove the existence of the effect of competition among jurisdictions. The attempt to apply this test to the EU though, was made by the several researchers.[83]

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78 Monitoring the Rule of Law, http://www.thehaguelegalcapital.nl/lc/research/cling2
79 Pistor 45, hpair.student.harvard.edu/research/hpair98/legal.RTF
80 Ibid.
81 Easterbrook F.H. (1983), "Antitrust and the Economics of Federalism", The Journal of Law and Economics, Volume 26, No.1
82 Ibid.
83 Neergaard U. B. (1998), Competition and Competences: The tensions between European Competition Law and Anti-Competitive Measures by the Member States, Djof Publishing, Copenhagen

According to the reasoning, the first condition, concerning the mobility of people and companies in the EU is fulfilled only theoretically (framework being defined in the Art. 39 - 48). In practice, the mobility of people is limited.[84] Mainly it is because of the language barriers between the MS unlike in the US, for example. At the same time, the second condition of a large number of jurisdictions appears to be fulfilled, as there are fifteen jurisdictions in the EU at the moment. The third condition is whether the jurisdiction can choose any set of law they desire. This condition is partly fulfilled, as despite autonomy enjoyed by the MS, there are certain rules and regulations applicable to the Member States (both EU primary and secondary legislation) that limits their jurisdiction. Finally, the fourth condition is considered fulfilled as the consequences of regulation may be felt within that state.[85]

Based on the analysis of above mentioned criteria, the author draws the conclusion that competition between jurisdictions in Europe is not high. The absence of the competition between jurisdictions drastically reduces the possibility of the jurisdiction convergence between the MS and also does not support the expectation that national regulations will correct themselves over time and reduce national legislation to the common denominator.

The "competition between legal systems" theory contributes to the discussion about the impact of the institutional structure on the company's strategy and concerns the horizontal competition[86] in contrast of vertical one. The theory indicates on the possibility of that competition would question the successful enlargement process, as the MS would need to estimate the consequences of the upcoming changes and relocations to the "better jurisdictions" by the people and companies. Although it seems that the application of the above criteria to the EU situation seems had not been based on the sound empirical data and is only a product of assumptions and theoretical analysis. Therefore it is difficult to address this situation and measure the potential impact of the enlargement on the EU structure as a whole and relocation of companies and individuals in particular. The soundness of this theory may be tested retrospectively though, after the enlargement round will take place in May 2004. In the chapter 4.3. the soundness of the concept is tested on the example of company law and its harmonisation in the EU.

4.2. Competition Between Institutions: the Theories of Institutional Choice and Institutional Change

Scholars, including legal scholars, social theorists and economists, have long asserted the importance of law and legal institutions for economic development. Hypothetically, the character of the

[84] In contrast to for example, the U.S., where mobility between States is not limited either theoretically or practically.

[85] Neergaard U. B. (1998), Competition and Competences: The tensions between European Competition Law and Anti-Competitive Measures by the Member States, Djof Publishing, Copenhagen

[86] Horizontal competition can be described as economic institutions at the same level of social organisation that compete for economic power and welfare. Vertical one may be defined as the dynamics by which regulatory authority should be allocated among institutions at different levels, i.e. whether the regulator should for example be the state, the EU or the market. Source: Trachtman, J.P. (1993), International regulatory Competition, Externalization and Jurisdiction, Harvard International Law Journal, Volume 34, , No.1.

institutions that make, interpret and enforce law and vice versa can determine the legal framework. In this chapter the discussion about competition between legal systems is followed by the analysis of the notion of competition between institutions. It is necessary to note, though, that vague interpretation of these concepts opens a room for their misinterpretation. Therefore, the theoretical discussion is narrowed down to the national institutional foundations, leaving aside supranational ones. At the same time, the issue of bargaining administration as one of the institutional foundations is considered in this chapter as well as its impact on the decision-making procedures is carried at the Community level.

The purpose of institutional choice theory, introduced by Komesar[87], may be summarised in one phrase "deciding who decides".[88] It is based on the idea that all legal decisions involve a choice among imperfect alternative decision-making institutions.[89] In other words, the institutional choice theory determines that choices regarding implementation of society's social and political goals. They need to be made in accordance with key institutions that are best equipped to implement them: the market, the political process, or the adjudicative process (the court).[90] All three institutions are massive, complex, and *imperfect*. This, however, does not imply that these are necessarily inefficient.[91] However, the theory does not provide simple or single answer on whether competition between these institutions exists and if it does, to what extent the decision-making process is affected by it. It might be interesting to have an in-depth look into the question whether these institutions are complementary or competitive in respect to each other and assess the followed consequences and implications.[92]

The main contribution of this theory is firstly the recognition of the fact that assessment of variations in institutional ability may lead to the development of the most efficient strategy for comparative institutional analysis. Secondly, the American-based theory shows that analysis of a single institution (for example judiciary) from one, say legal perspective, and leave the issue about the institutional efficiency unresolved. Such single institutional analysis, Komesar argues, can tell us nothing about the policy process as a whole.[93] "Intra-system, inter-institutional, comparative analysis"[94] of Komesar complements to the interdisciplinary approach in analysis of institutional framework.

The major drawback of the theory is that Komesar's model does not allow for the possibility that institutional selection may not be a choice after all - at least not in the way in which we commonly understand the term "choice."[95] Neither it recognises the dynamic developmental change in institutions

[87] Neil K. Komesar is a professor of law who in this theory applied the legal knowledge for synthesizes and improvement of the economics-focused approach to politics.
[88] Kersch K. I., critics on the Komesar N. K (1997) book Imperfect Alternatives: Choosing Institutions in Law, Economics, and Public Policy
[89] Komesar N. (1981), In search of a General Approach to Legal Analysis: a Comparative Institutional Alternative, Michigan Law Review
[90] Komesar N. K (1997), Imperfect Alternatives: Choosing Institutions in Law, Economics, and Public Policy
[91] An institution may be inefficient only when it functions less perfectly that an alternative available institution. Source: Komesar N. K. (1997), Imperfect Alternatives: Choosing Institutions in Law, Economics, and Public Policy.
[92] Due to limited extent of this work, author limit herself to this discussion
[93].Kersch K. I., critics on the Komesar N. K (1997) book Imperfect Alternatives: Choosing Institutions in Law, Economics, and Public Policy
[94] Ibid.
[95] Ibid.

over time like Douglass North theory does. It is also criticised by political scholars for the author's inability to balance economic, legal and political perspectives paying insufficient attention to the public policy.

The institutional change theory[96] proposed by Nobel prize laureate Douglass North highlights another aspect of the discussion about institutional interrelations and competitiveness.[97] It forms the basis for the *new institutional theory* (referred also as a new institutional economics) which further reappraises the role of institutions in shaping the political actions. This theory gives more detailed view on possible interaction patterns between institutions. By developing the concept of path dependence, this theory explains the difference between neutral, complementary, substitutive and conflicting institutions.[98] This concept applies both to the vertical and horizontal dimensions. It has also popularised the argument that the reliable functioning of markets depends on institutions, whose significance lies above all in their reduction of the costs of transacting.[99] This notion was also supported by Kompesar, who's participation-centred analysis focuses on the costs and benefits to transacting both within a particular institution and the comparative cost/benefit choices made between institutions.[100]

Discrepancies between institutional change and institutional choice theories may be explained by the fact that authors have different backgrounds (law and economics) and, therefore, different visions on the topic. North emphasises mainly political aspects of the problem, which Komesar economic and legal ones. Nevertheless, both theories agree on interdisciplinary nature of the topic, which should recognize institutional interdependence, and analysed in a broad perspective. None of the theories, however, provide a clear illustration of competition between institutions.

Institutional choice analysis of European integration mainly reveals the strengths and weaknesses[101] of the European constitution[102] as well as interaction between national and supranational institutions. The subsidiarity principle, dealt later in the text, also adds to the debate on which institutions (national or

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[96] D.C. North (1997), Institutions, Institutional Change and Economic Performance, Cambridge University Press

[97] As some of the theory's elements were mentioned in the theoretical framework of the thesis it would not be discussed in details in this part.

[98] Institutions are defined as *neutral* if they regulate different areas of human interaction; *complementary* when the institutions constrain human behavior in an identical or similar fashion and rule-breaking behavior is sanctioned by private individuals as well as by representatives of the state; *substitutive* if they constrain human behavior in a similar fashion, but rulebreaking behavior is sanctioned *either* by private individuals *or* by representatives of the state; and *conflicting* when the institutions constrain human behavior in different ways. Source: Voigt1 S. and H. Engerer (2002), Institutions and Transition – Possible Policy Implications of the New Institutional Economics

[99] Woodruff D.M. (2000), Rules for Followers: Institutional Theory and the New Politics of Economic Backwardness in Russia

[100] Kersch K. I., critics on the Komesar N. K (1997) book Imperfect Alternatives: Choosing Institutions in Law, Economics, and Public Policy

[101] Mentioned weaknesses are the excessive "judicialisation" of Community Law and the related high costs of the system; in certain cases, the economically heavy consequences of some Court decisions (C 362/88, Barber case); and the eventual damage to the legitimacy of the Court and the acceptance of its decisions and authority, created by excessive policy-making by the Court. Esteban M.L.F. (1999), The Rule of Law in the European Constitution, Kluwer Law International

[102] It is considered that the Rome treaty is the basic constitutional charter of the Community.

supranational ones) are more effective in the defining desired social goals and values is determining which institution is best suited to implementing them.

The theoretical discussion on principle of subsidiarity may be complemented by an example of corporatism (for definition see appendix 1) and more specifically the one of "bargained administration". The latter term is defined as "a socio-political process in which interest groups participate institutionally in public policy consultation and/or public policy implementation, either collectively or individually".[103] Interest groups in the definitions are distinguished between those with which public authorities have a "structured" and those with which they have an "unstructured" relationship.[104] These groups may be seen as independent and at the same time interdependent elements of the institutional system.

"Structured interest" groups are those that have a formal role on the decision-making and regulatory process and represented at the Community level by the Economic and Social Commitee. These groups under the EC Treaty Art. 257 (ex.193) includes "representatives of the various categories of economic and social activity, in particularly, representatives of producers, farmers, carriers, workers, dealers, craftsmen, professional occupations and representatives of the general public" and are authorised to assist the EC Council and Commission "in an advisory capacity" [105]. "Unstructured" groups represent those who work in the lobbying sector in Brussels. Being allowed to participate in the decision-making procedure, interest groups illustrate the principle of subsidiarity in practice, as this principle aims to attribute powers to the lowest level of public authorities, thus, assuring that "decisions are taken as closely as possible to the citizen".[106] The EC Treaty Art. 139 confirms these powers (ex. Art. 118b) in regard of dialogue of management and labour and reconfirmed in Article 3 of the Agreement on Social Policy[107]. The above-mentioned implies that special groups as for example organisation of employers (UNICE and CEEP) or labourers (ETUC) may exercise a bargaining power of collective agreements if they are not in breach of Community law provisions. According to the principle of subsidiarity, "only those national powers the exercise of which have important consequences for the economics of the other participating countries should be transferred to institutions of integration".[108]

The above example illustrates the complicated interrelations on Community and national level in the field of social policy. As there is no express policy-coordinating competence for the Community in the social policy field,[109] this matter is left to the regulation of the national legislative authorities to the large extent. The fact that there is no strict division of competencies between Community and national

[103] Van Gerven W (1996), The Legal Dimension: the Constitutional Incentives for and Constrains on Bargained Administration, book: Constitutional Dimensions of European Economic Integration, Kluwer Law International
[104] Ibid.
[105] Art. 7 (ex. Art.4) of the EU Treaty
[106] Van Gerven W (1996), The Legal Dimension: the Constitutional Incentives for and Constrains on Bargained Administration, book: Constitutional Dimensions of European Economic Integration, Kluwer Law International
[107] Ibid.
[108] Kapteyn P.J.G. and P.Ver Loren van Themaat (1998), Introduction to the Law of the European Communities, Third Edition, Kluwer Law International
[109] Ibid.

law (and also between the competencies of institutions dealing with it) increases the complexity of the issue (see chapter 4.4.).

4.3. The Contribution of Harmonisation to the Competition Between the Different Jurisdictions

Varieties of capitalism model, which shapes the theoretical part of the work, places company needs in the centre of the model. In the meantime, in spite of numerous attempts, the company law in the EU appears to be the least harmonised issue of all. Hypothetically, in the perfect harmonisation conditions, when all jurisdictions have the same “rules of the game” the issue of competition would not arise. But what is the situation in the EU? It is clear that company law is not harmonised yet at the Community level, but does it imply the existence of competition between jurisdictions? This chapter discusses these questions.

The hypothesis considered in the previous chapter states that the right to choose the most favourable jurisdiction within the Community leads to competition between different jurisdictions of the Member States. The Company may be attracted to locate the primary or secondary establishment in another Member State because of attractive local job market in terms of skills and cost of hiring staff, or because of financial inducements for inward investment issued by local agencies. A company may also seek to evade laws that would otherwise apply to it in its home territory and to operate in a more favourable legal or tax regime or a less bureaucratic regulatory regime.[110] The attractive environment is shaped by provisions governing the raising and maintenance of capital, accounting, audit and disclosure, employment and work security, constitutional law and corporate governance, stock exchange and capital markets law, competition and subsidies law and existence of tax burden of the enterprises.[111]

Theoretically, the freedom of establishment gives entrepreneurs the right to choose the most favourable jurisdiction and thus the place of establishment for their business venture.[112] Freedom of capital and the above-mentioned freedom of persons, aiming for abolition of barriers to the market entrance and facilitation of free capital flow, also contribute to the free movement of companies between the respective Member States. But does the theoretical framework reflect reality? There are still major differences in the company laws of Member States, such as the absence of a minimum capital requirement for UK private companies limited by shares, in contrast to all other Member States except Ireland, and the fact that as yet the UK among others does not have mandatory employee participation in its public companies, as well as continuing differences in taxation.[113] Another restriction on freedom of choice and movement is the lack of different theories on company establishment used by the MS. As the majority of the MS adhere to the “real seat” or some variation of

[110] Bisacre J., The Migration of Companies Within the European Union and the Proposed Fourteenth Company Law Directive
[111] Ebert S., The European Company on the Level Playing Field of the Community
[112] By freedom proclaimed in Art.43 (ex. 52) of the EC Treaty
[113] Bisacre J., The Migration of Companies Within the European Union and the Proposed Fourteenth Company Law Directive

"real seat" theory[114] it to the large extent prevents competition between jurisdictions.[115] The ECJ though, obviously does not view the coexistence of two theories as incompatible with the freedom of establishment as "real seat" theory was validated in the Daily Mail judgement.[116]

With regard to the necessity of company law harmonisation, two controversial views exist. On one hand, it is argued that "substantial parts of company law need to be harmonised so that companies can reap benefits of the unified European market and the euro to the full". On the other hand, there is a view that "company law rules can be enacted and adapted to new developments more efficiently at the national level, and that a certain competition between legal rules is healthy for the single market".[117] Another argument posed by economists is that European harmonisation is no longer an option due to internationalisation of business and financial markets regulations. It is particularly true for the field of corporate governance, whose principles are actively developed by the OECD.[118]

It is a known fact that almost 30 years were required to establish a pan-European form of company, which can be used throughout the EU, irrespective of national borders.[119] There is a view that the harmonisation of these corporate governance issues on the European level has thus far failed due to disagreement over the most suitable institutional framework[120] (refer to the discussion on convergence in 5.4.2. chapter). The influence of national law to the SE Statutes[121] may lead to "a very complex legal framework, which may lack legal certainty in many cases".[122] However, considering that these Statutes are not in force yet, it is quite hard to predict the consequences and estimate the impact of harmonisation on national company law. Presently, the EU power of competencies is being merely discussed by the scholars in relation to harmonisation activities, together with the complementary issue of MS loyalty regarding the implementation of the new Community legislation.

In summary of above-mentioned, the important challenge for the Community seems to take the one strict stance in respect to company law harmonisation, at the same time tackling issues of europeanisation vs. internationalisation, and assessing economical consequences of EMU and introduction of euro in respect to European companies.

[114] Wouters J. (2000), European Company Law: Quo Vadis?, Common Market Lae Review 37, Kluwer Law International
[115] Under "real seat theory" companies are obliged to be (re-)incorporated under the legal system of the State where they have their actual headquarters (their "real seat").
[116] Case 81/87, Daily Mail, 1998, ECR 5483
[117] Wouters J. (2000), European Company Law: Quo Vadis?, Common Market Lae Review 37, Kluwer Law International
[118] See OECD Principles of Corporate Governance, http://www.oecd.org/daf/governance/principles.htm
[119] Schulz A., Eicker K. (2001), The European Company Statute – the German View, Delloite&Touche, Munich, INTERTAZ, Vol. 29, Issue 10, Kluwer Law Internaitonal
[120] Grundmann S., Mulbert P.O. (2001), Corporate Governance: European Perspectives, International and Comparative Corporate Law Journal, Vol.2 Issue 4, Kluwer Law International
[121] Due to limited extent of this work neither development nor structure of Societas Europaea (SE) companies is not discussed.
[122] Grundmann S., Mulbert P.O. (2001), Corporate Governance: European Perspectives, International and Comparative Corporate Law Journal, Vol.2 Issue 4, Kluwer Law International

4.4. Distribution of Competencies

The concept of division of competencies has been already mentioned several times in the above debate. In this chapter is will be discussed in more details. The underlying concept which shapes the discussion is that "it is fundamental to the federal or transnational system of government that governmental competencies shall be shared or divided among a central federal or transnational authority and the governments of the Member States."[123] In other words, the problem in question is how the competencies or areas of responsibility between the MS and Community must be and are divided. It is acknowledged[124], that there is quite little guidance regarding this issue. This issue concerns the concept of vertical competition[125] and relates to the interaction of articles 3(g), 5(2) and 81 of the EC Treaty. The two following statements demonstrate the lack of clarity in regards the circumstances the Community may apply their competencies. European Council in Edinburgh stated that "The requirement of and attribution of powers under the Treaties had always been a basic feature of the Community legal order; the powers of the individual States have always been the rule, those of the Community, the exception."[126] Somewhat controversial point of view is the one of Witte[127] who mentioned that "…there is no clear division of competencies between the Union and the Member States, but rather an open-ended authorisation to the Council to do whatever it thinks fit within broadly defined areas." At the same time, it is quite important to realise how the competencies are distributed in order to ease regulation and communication with the accession countries in the upcoming enlargement process.

The relationship between the Community and its Member States with regard to competencies is governed by several principles, all closely interrelated, and which mainly have been established by the ECJ rather than expressed in the Treaty itself.[128] These principles may be applied in order to decide whether it is the MS or the EU which has the competence to legislate in the field in question.[129] Let us briefly outline these principles.

Principle of enumerated competence means according to Bradley that "the Community enjoys only those powers which are expressly set out in its constituent treaties."[130] It was further included in the EC Treaty as an article 5 (1) (ex.art. 3b(1))[131]. It explicitly states that the competencies of the Community are in fact limited by the primary source of law – the EU Treaty. At the same time,

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[123] Neergaard U. B. (1998), Competition and Competences: The tensions between European Competition Law and Anti-Competitive Measures by the Member States, Djof Publishing, Copenhagen
[124] Ibid.
[125] for definition see footnote 98
[126] Manfred Brunner and others v. The European Union Treaty (cases 2BvR2134/92 and 2159/92)
[127] Witte B. (1996), International Agreement on European Constitution?, Reforming the Treaty on European Union, The Legal Debate, The Hague,
[128] Neergaard U. B. (1998), Competition and Competences: The tensions between European Competition Law and Anti-Competitive Measures by the Member States, Djof Publishing, Copenhagen
[129] Neergaard U. B. (1998), Competition and Competences: The tensions between European Competition Law and Anti-Competitive Measures by the Member States, Djof Publishing, Copenhagen
[130] Bradley, Kieran St.C. (1998), "The European Court and the Legal Basis of Community Legislation", European Law Review, Volume 13
[131] "The Community shall act within the limits of the powers conferred upon it by this Treaty and of the objectives assigned to it therein".

secondary sources also cannot be neglected in assessing the scope of the EU competencies. One might notice that only three situation are possible under principle of enumerated competencies[132]:

- Exclusive MS competencies, implying that the Community does not have competence over the field in question;[133]
- Exclusive Community competencies, implying that the MS does not have competence over the field in question;[134]
- And, finally, shared competencies where both parties have competencies which may overlap or complement each other.[135]

The classification of the field in question helps to decide on which legal grounds issue in question need to be considered.

The *principle of implied competencies* is somewhat controversial to the one described above. It is based on the ERTA case[136] and provides the Community with a great deal of flexibility and at the same time reduces the degree of competencies retained by the MS.[137]

The principle of supremacy was established in the secondary legislation in Van Gend en Loss and Costa v. ENEL cases.[138] In the first case, the conflict between the Community law and the earlier Dutch law was solved in the favour of the Community law. [139] In the latter case the principle of the supremacy was confirmed once more.[140] Clearly this principle somewhat diminishes the competencies of the MS. Another case, which supports this principle, is Simmenthal SpA.[141] It was ruled that national judges facing a conflict between national law, whatever its nature, and Community law, must ignore the national law.[142] Any law, incompatible to the EU legislation, is automatically

[132] Neergaard U. B. (1998), Competition and Competences: The tensions between European Competition Law and Anti-Competitive Measures by the Member States, Djof Publishing, Copenhagen
[133] As an example may be mentioned issues of taxation, family law and regional planning.
[134] As an example may be mentioned the establishment of the internal market.
[135] An example is certain social, environmental and consumer protection measures.
[136] "If (ex Art. 3(f) and 5) are read in conjunction, it follows that to the extent to which Community rules are promulgated for the attainment of the objectives of the Treaty, the MS cannot, outside the framework of the Community institutions, assume obligations which might affect those rules or alter their scope", ruled ECJ in ERTA case, Case 22/70, Commission of the European Communities v. Council of the European Communities, Judgement of 31 March 1971
[137] Neergaard U. B. (1998), Competition and Competences: The tensions between European Competition Law and Anti-Competitive Measures by the Member States, Djof Publishing, Copenhagen
[138] Case 26/62 NV Algemene Transport- en Expeditie Onderneming v. Nederlandse Administratie der Belastingen, 1963 and Case 6/64, Flaminio Costa v. ENEL, Judgement 15 July 1964
[139] "…The Community constitutes a new legal order in international law, for whose benefit the States have limited their sovereign rights, albeit within limited fields", Judgement of the Court, case 26/62
[140] "The transfer, by Member States, from their national orders in favour of the Community order of the rights and obligations arising from the Treaty, carries with it a clear limitation of their sovereign right upon which a subsequent unilateral law, incompatible with the aims of the Community, cannot prevail." Case 6/64.
[141] Case 106/77 "Amministrazione delle Finanze dello Stato v Simmenthal SpA ,1978
[142] "... a national court which is called upon... to apply provisions of Community law is under a duty to give full effect to those provisions, if necessary refusing... to apply any conflicting provision of national legislation, even if adopted subsequently, and it is not necessarily for the court to request or await the prior setting aside of such provision by legislative or other constitutional means." Case 106/77

inapplicable.[143] Here, question of competencies comes into light again as it is necessary to decide which organ or institution (national or European one) is competent in the field in question.

The principle of pre-emption is linked to the principle of supremacy and to the concept of exclusive competencies. It is described as ".... the (principle of pre-emption) will be treated as going beyond the principle of primacy of Community law over MS law; it will be taken to refer to cases where the MS are precluded from legislating, not because the legislation would conflict with Community law but because the competence in question is exclusively a Community competence."[144] As it follows from definition, this principle applies only to exclusive Community competencies, as opposed to the shared ones. However, this principle was developed later also in respect of the shared competencies. Its essence is that the MS are not completely precluded from legislating and if Community have not yet acted, MS are free to exercise their competencies, as long as they do not damage the Community's interests[145]. At the same time, it is quite hard to judge about the relative power of this principle, as it was never applied by the ECJ although it being recognised by scholars.[146]

The principle of subsidiarity is agreed to be a general norm for the practical allocation of tasks in cases in which concurrent or parallel competence of the Community and its Member States exists.[147] It is also argued that in its essence this principle (expressed in Art. 5 (2)[148] (ex. Art. 3b (2)) is "a political maxim, not a legal one",[149] which indicates that it can be invoked either as a justification for Community action or the opposition to it.[150] Developed from the provision of the EC Treaty, the comparative efficiency test suggests that the Community shall only act if the MS cannot more efficiently achieve the objectives of the proposed action. Also the Amsterdam Protocol on Subsidiarity[151] confirmed that the Community measure shall "leave as much scope for national decisions as possible", should "respect well established national arrangements and the organization and working of Member States' legal systems" and should "provide Member States with alternative ways to achieve the objectives of the measures"[152] while, of course, respecting the Community law.

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[143] Steiner J. (1992), Textbook on EEC law, 3rd edition, Blackstone Press Limited
[144] Jacobs F. G.& Karst K. L. (1986)„The Federal Legal Order, the U.S.A and Europe Compared: A Juridicial Perspective", Integration Through Law, Volume 1, Book 1
[145] Neergaard U. B. (1998), Competition and Competences: The tensions between European Competition Law and Anti-Competitive Measures by the Member States, Djof Publishing, Copenhagen
[146] Ibid.
[147] P.J.C. Kapteyn, P. VerLoren van Themaat (1998), Introduction to the Law of the European Communities, Third Edition, Kluwer Law International
[148] "In areas which do not fall within its exclusive competence, the Community shall take action in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale of effects of the proposed action, be better achieved by the Community."
[149] said Mackenzie Stuart, P.J.C. Kapteyn, P. VerLoren van Themaat (1998), Introduction to the Law of the European Communities, Third Edition, Kluwer Law International
[150] Ibid.
[151] Wouters J. (2000), European Company Law: Quo Vadis?, Common Market Lae Review 37, Kluwer Law International
[152] Points 6 and 7 of the Amsterdam protocol on Subsidiarity, Protocol no. 30 of the European Community Treaty

One might notice, that if the principle of enumerated competencies is applied, the MS almost completely retain their right to economic intervention. On the other hand, if the principle of implied competencies prevails, the Community competencies prevail over MS ones.[153] From the political perspective, the first principle is linked with the theory of federalism with its statement that the MS tend to retain the power to legislate and being self-governed units. Nevertheless, this approach does not facilitate the economic integration of the Union as does the other principles that recognise the centralised power of the EU competencies at the centralised level. If the degree of Europeanisation will be assessed through such aspects as emergence of formal EU legal structure and development of EU policies, transfer of decision making/policy competencies to the European level, constructing systems of meaning and collective understandings[154] , it might be noticed, indeed, that progress in Europeanising the fundamental elements that describe national capitalist systems– corporate law and governance, industrial relations, educational system – is very limited.[155] MS still govern every element and sphere of competence of the VoC model.

There is also another, rather controversial point of view, the one of Leibfried and Pierson.[156] It argues that the national sovereignty in the above-mentioned areas has been dramatically eroded by the market integration processes as well as by global developments, for example, in the field of social policy. Indeed, the greatest concern of the accession countries is the individual state sovereignty and the degree of its loss after 1st May 2004. Another economical and political issue that potentially would diminish the States sovereignty is the enlargement of the EMU accompanying by the abolition of capital controls[157]. Besides, the rules of the EMU entry require not only budgetary discipline but also inflation (and interest rate) convergence and exchange rate stability, In the case of the accession countries, a tension might emerge between the achievement of these two variables.[158] The difference in the liberalisation status of the newcomers joining EMU raises concern that it might destabilise the common monetary policy.[159] Accordingly, there is a risk of control dilution by the MS as the supranational institutions gradually accumulate competencies. There is also a view that Member States still play a central part in policy development within the Community, but they do so in a context that they do not fully control.[160] It is still unclear, if the European institutional framework may lead to some kind of convergence across the systems, especially in the light of future enlargement that is likely to add to the socio-economic diversity in the Union.

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[153] Neergaard U. B. (1998), Competition and Competences: The tensions between European Competition Law and Anti-Competitive Measures by the Member States, Djof Publishing, Copenhagen

[154] Risse T., Cowles G. and M., Caporaso J. (2001), Transforming Europe. Europeanization and Domestic Change, IIthaka and London: Cornell University Press, article by Risse T., Cowles G. and M., Caporaso J., Europeanization and Domestic Change: Introduction

[155] Jucevicius G. (2003), Developement of the European Socio-Economic System. Increased Divergence of Capitalist Systems Inside the Enlarged EU?

[156] Leibfried, S and P. Pierson (1996) 'Social policy' in Wallace H. and W. , eds. (1996) 'Policy-making in the EU', Oxford University Press: Oxford

[157] At the moment, four countries removed practically all exchange controls (Estonia, Latvia, Lithuania, Czech Republic), others still retain definite restrictions. Ems. E. (2000), Capital Controls in the View of Accession, mimeo, Brussels: European Commission (DG ECFIN)

[158] T.Fosdal, A. Kolliker, L.R.Pench (2001), Euro Economic Governance, Report on a Workshop

[159] Economic Governance in the EU: Towards Closer Economic Policy Coordination, remarks by P.Solbes, EU Economic and Financial Affairs Commissioner

[160] Pierson P. (1996), The Path to European Integration. A Historical Institutionalist Analysis, Comparative Political Studies, Vol. 29, Number 2

The question of convergence across the systems in its vertical context is also a broad political issue. Let only briefly mention the theories which complement to the discussion about MS and Community competencies. *Federalism* theory argues that it is the most relevant form of domestic governance to the EU[161] that achieves maximum efficiency through decentralization and autonomy maximization.[162] Indeed, we have seen, that a broad range of economic policies is still assigned to the MS level of competence. The *neo-functionalist* ideology, popular at the start of integration, assumed that a nation state gradually cedes its competences to the supranational structures through the policy spill-overs.[163] The representatives of *liberal intergovernmentalists* also argue that the Europeanisation is considered to be only the outcome of converging member states' preferences rather than vice-versa. As it is highlighted in this work though, the level of convergence between different systems is not as high as it was forecasted decades ago. European integration is driven by bargains among member state governments and supranational actors exist merely to aid member states in signing the agreements by providing necessary information.[164] The modern "*multi-level governance*" theory challenges this by incorporating its notions into a much larger and more complex policymaking model.[165] This theory explains the European integration as "a policy creating process in which authority and policy-making influence are shared across multiple levels of government – subnational, national and supranational".[166] It emphasizes the importance of interlinks between national and supranational arenas facilitated by subnational actors and pictures the complex European system of interrelations. The above theories have their strong points and limitations and try to explain the issues of integration and sovereignty, outcome of which is as yet uncertain.

[161] Schrapf, F. (1999), Governing in Europe: Effective and Democratic, Great Britain: Oxford University Press
[162] Rosamond B. (2000), Theories of European Integration, The European Series, Palgrave
[163] Jucevicius G. (2003), Developement of the European Socio-Economic System. Increased Divergence of Capitalist Systems Inside the Enlarged EU?
[164] Marks G., L. Hooghe, K. Blank (1996), European Integration from the 1980s: State-centric v. Multi-Level Government, Journal of Common Market Studies 34(3)
[165] Ibid.
[166] Ibid.

5. EMPIRICAL FRAMEWORK

The following chapters lead the reader to answer the key question of this paper: “Which of the varieties of capitalism does Latvian system represent and how does it relate to other European capitalistic systems?” By analysis of current situation in LSCs and particularly Latvia, the changes and developments of the system of institutional frameworks in the countries of transition become visible. In order to tackle all elements of VoC model, the empirical part is divided into 5 parts, each of it is assigned to specific element.

5.1. Element I: Education and Training System

It is acknowledged[167] that the field of education and training in Europe is not only the one of relatively great government intervention, but also the one where level of provisions varies considerably between countries. This system encompasses such issues as vocational system and training; management education; scientific research and role of trade unions in education and training. According to Hall and Soskice the main difference between the two models is that CME system motivates labour to acquire industry-specific or firm-specific knowledge, while vocational training in the LME emphasises general skills of individuals.

In order to analyse Latvian training and employment systems let us concentrate mainly on a few questions. Does the present Latvian system stimulates acquisition of industry-specific or general skills? How high is prestige of vocational training? Are managers mainly have high level of technical competence or “generalist” training?

5.1.1. Assessment of Latvian Vocational Education and Training System

As at the end of 2001, national standards for secondary vocational education have been established but standards for basic vocational education had still to be developed in Latvia[168]. There are several levels of vocational education in Latvia (see appendix 5). At the national level, four institutions have the most significant impact on the VET policy: Ministry of Education and Science, the Ministry of Agriculture, the Ministry of Culture and the Ministry of Welfare (see appendix 6). Involvement of a number of ministries in the administration of VET system and division of competencies between them though, lead to certain disparities between Ministries in terms of policy implementation. The level of funding of VET continues to be low (0.7% of GDP in 2000) which does not foster the promotion and development of the system.

The relative share of VET among alternative educational systems in Latvia is not high.[169] Breakdown of education level of employed and unemployed persons also shows that the proportion of vocational

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[167] Veersma (1995), MNCs and industrial relations, both excerpts chapter 4 and 15 in Harzing & Van Ruysselveldt, International Human Resource Management, London: Sage, ISHRM compendium

[168] International Labour Organization, Review of Progress in Vocational Education and Training Reform (2002)

[169] The results of the survey in November 1997 have shown that 12.4% of the labour force in Latvia (total labour force of Latvia at the date of the report composed 1,987.5 thousand) have higher education, 54.0% secondary education (23.7%- general secondary, 19.9%- specialised secondary and 10.5% *vocational secondary*

training is very low compared to other types of education that indicates its underestimation by the state (see appendix 7). For example, the rate of the unemployed forwarded for training or re-qualification, composed only 9,3% of the total unemployed population.[170] Meanwhile, the breakdown of the unemployed by professions shows that the greatest part of the registered unemployed has simple professions, which clearly indicates the need for vocational training. This controversial situation has been observed in Latvia few years ago but reasonable solution was not found since then.

VET legal framework is already stabilised and aligned to the Community requirements. In 1992 when the law "On Employment" came into force. Alongside with passive activities of employment promotion, there were foreseen wide active measures, such as vocational training or retraining and temporary paid social work[171]. These measures were enforced by regulations "On unemployed vocational training and retraining" in 1994. Saeima of Latvia had adopted the "Law on Vocational Education" in the middle of 1999. The government emphasised the necessity to create regionally administered vocational education. The Vocational Education and Employment Tripartite Council, established in 1999, fostered the involvement of social partners in definition of occupational and vocational education and training strategy on regional level[172]. Measures included professional consulting, education and retraining, creating of temporary jobs, establishment of job seekers clubs etc.

The EC Treaty provides that the Community among other things shall implement a vocational training policy whose purpose is to support and supplement the action of the Member States (Article 150, ex Art. 127) and shall aim to facilitate adaptation to industrial changes and increase employability. These provisions were implemented mainly through three major action programmes Socrates, Leonardo da Vinci and Youth of Europe in Latvia. According to the EU report,[173] Latvia has fulfilled the Community criteria's in regards to vocational training policy. In the meantime, it must be repeated that regulations at the *de jure* level do not provide sound grounds for assessment of the *de facto* situation in the countries in transition.

According to the National report[174], co-operation between VET schools and enterprises is weak. There are no incentives for employers to offer practical training placements for students in vocational education establishments. This leads to imbalance between theoretical knowledge and practical skills of the graduates. Due to this fact the prestige of VET also suffers, as individuals fail observe the direct correlation between education and employment. The low prestige of VET leads also to lack of highly skilled human resources responsible for training and retraining programs. Decision to deliver all

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education), 21.2% have basic education only. The education level of women is slightly higher than that of men- 13.5% of women have higher education compared with 11.0% of men, 25.2% of women have general secondary education compared with 21.8% of men, 20.4% of women have specialised secondary education compared with 19.3% of men, but only 7.6% of women have *vocational education* compared with 14.0% of men. Ministry of Economy, Semi-Annual Report on the Development of Economic of Latvia (2002) Ministry of Economy

[170] Although slight increasing tendency is noted: 1993 – 3,7%, 1994 – 6,2%, 1995 – 7,6%, 1996 – 9,7%, 1997 – 9,3%, www.izm.lv, 15/04/2003

[171] National report to the European Training Foundation: Vocational Education in Latvia (1999)

[172] http://europa.eu.int/scadplus/leg/en/lvb/e19104.htm

[173] Commission of the EU (2002), Regular Report on Latvia´s Progress Towards Accession

[174] National report to the European Training Foundation: Vocational Education in Latvia (1999)

vocational education in public schools solely in the national language, Latvian, starting with 1st September 2004, raises the concern about the quality of the education, particularly in the first few years due to obvious lack of the qualified personnel and also about the future of the Russian-speaking teachers who have not fully acquired the knowledge of language in the due time.[175] Due to low remuneration, VET system is generally under-staffed and therefore can barely meet its commitments to the unemployed. The particularly vulnerable groups (in particular non-citizens, school leavers without qualifications, long-term unemployed, etc.) do not receive sufficient attention and their integration to the economically active society is proved as week.

Regarding specific and general skills provision, the situation in Latvia is controversial. While first level vocational programs provide individuals mainly with general skills, the programs in the second level, and particularly those for unemployed, focuses on the acquisition of the specific professional skills. This situation is in contrast with management education, which, due to demands of the business environment, has an accent on generalist training and tends to copy the liberal market economy model in this respect.

5.1.2. Management Education

Management education is an important subject of study not only for its obvious impact on levels and nature of technical competence but also for its influence on managerial identity and value orientations.[176] In Germany and Britain management education on the one hand becomes increasingly "professionalised" but on the other, follows the different paths in its development. While managers with engineering education dominate in Germany, more general education in management and business administration is typical for Britain. Which of these models is followed by Latvia? I will base the conclusions on the interview with the former employee of recruitment company "Fontes" Jury Kondratenko[177] and on the secondary data from the higher education establishments.

All post-Soviet candidate countries carry a certain legacy of the centralised planning system, which traditionally favoured the hierarchy-based relationship.[178] Transition to market economy presupposes conversion of the "top-bottom" approach and drastic change of management and administration methods. Soviet system managers faced the challenge of obtaining updated knowledge about specifics of the operations in the market economy conditions. The situation was even more complicated as reorientation to the Western market required also extensive language knowledge. Nevertheless, young people had the comparative advantage in the transition period, despite the fact that the system of higher education was not able rapidly adjust to changing conditions. They formed the unique class of managers, being promoted to the top position in their yearly 30s, which is rather untypical to the

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[175] The Latvian government though apparently realized the drawbacks and ambiguity of this law. On 14th May 2003 changes were accepted and it was allowed to conduct 40% of subjects in native language in Russian minority schools. www.delfi.lv , 14/05/2003

[176] Whitley R. (1992), European Business Systems: Firms and Markets in their National Contexts, Sage Publications, article by Lane C. "European Business Systems: Britain and Germany compared"

[177] Interview held on 29 April, 2003

[178] Jucevicius G. (2003), Developement of the European Socio-Economic System. Increased Divergence of Capitalist Systems Inside the Enlarged EU?

developed countries. According to the data of the "Big 4" consulting company in Latvia, age of the 5 managers in the audit division was between 23 (!) – 32 years in 2002.[179] Based on the experience of Mr. Kondratenko, the average age of top management is about 30-40 years old in Latvia. They typically have specific knowledge and previous experience in the industry that is backed up by recently acquired MBA. The popularity of the programs in Social Science among young people may give us an indication to the educational trends in the society. Statistics of the year 2001 (see appendix 9) shows that the social science studies (which include management, law, business administration and economics) have the highest correlation coefficient. That means that these studies are the most popular among Latvian future professionals and have the highest rate of entry competition in the higher education establishments. As this tendency has been continuously observed during last 5-6 years,[180] that also indirectly proves that the managers in Latvia possess *generalist education*. That does not exclude the case, though, that individuals may have previously acquired specific skills.

There is also one indicator which was not mentioned in the VoC literature, but which can also, in the author's opinion assist in distinguishing liberal and coordinated market economies. That indicator is the level of prestige of public vs. private schools. In the U.K. private schools have traditionally been of higher prestige than public ones, while in Germany public schools and colleges are considered of better quality. Meditteranean model is famous for the existence of *Grand ecoles* and close ties of the "old boys" network. For example, reputation of a school determines to a great extent the further prestige of employment of an individual in France. In Latvia there are few private schools that have a history of longer than 10 years. During this short period of time though they managed to change the public opinion from the strongly negative (as private schools primarily were seen as a schools where you "buy" your grades) to somewhat positive (as some were able to attract highly qualified personnel and ensure strong knowledge base for students). According to statistics, the highest growth in student number was observed in private schools in 2002.[181] It is possible that the only factor that refrains students to obtain education in private schools besides the financial one, is the problem with the recognition of private school diploma by the state due to incomplete school accreditation process.

5.1.3. VET Interconnection with Other VoC Elements

The system of education and training in Latvia has not been stabilised yet. It has experienced transfer from the hierarchy-based relationship to a sort of mix between liberal and co-ordinated market relationships. Relatively low prestige of VET facilitated by the government policy, required transformation of higher education programs. Summarising all above mentioned, one may conclude that Latvia have the following features of VET, compared to CME and LME countries:

[179] Empirical data provided by Andersen HR manager Dita Duka in 2002.
[180] www.izm.lv/lv/statistika/parskats2001/saturs.htm
[181] Comparing to previous year (2001/2002) the number of students increased by 62%, comparing to 4% in the state higher education insituttions, source: http://www.izm.gov.lv/en/default.htm

Comparison of VET System in Latvia with CME and LME Countries

The system of education and training	Britain	Germany	Latvia
(a) *Vocational education and training*			
Prestige of VET*	Low	High	Low
Availability of highly skilled, flexibly deployable human resources*	Low	High	Low
(b) *Management education*			
Availability of managers with high level of technical competence*	Low	High	Low (due to necessity of specific market economy skills)
Availability of managers with high level of “generalist” training*	Medium	Low	Medium (“due to new generation”)
Prestige of public schools	Low	High	Medium
(c) *Trade unions*			
Co-ordination of VET policy implementation by trade unions	Low	High	Low

* Sample characteristics are taken from Whitley R. (1992), article by Lane C. “European Business Systems: Britain and Germany compared”

Education and training element impacts all factors of the VoC model as it directly deals with individuals. This topic will be continued in the chapter 5.2 where discussion on science and innovation will uncover problems of academic education and development. Trade unions, which are part of the industrial relations element actively participate in planning and executing VET programs especially in the CME economies. Finally, both shareholder and stakeholders models of corporate governance assign different but equally important roles to managers which will be considered in chapter 5.4.

5.2. Element II: Inter- Company Relations

Inter-company relations in the VoC model deals mainly with the technology transfer and assessment of the general degree of horizontal co-operation between companies. Hierarchy-based centrally planned system did not foster extensive horizontal inter-company co-operation, relying mainly on the “from above” regulations. The socialist manager was not a decision-maker, but rather a decision-implementer, following the hierarchically produced orders.[182] The informal rules deeply rooted by the Soviet system were not easy to break. The lack of co-operation culture among firms did not strengthen the mutual trust of the companies either. Another issue for the countries in transition was co-operation between industries and universities and R&D departments. The lack of co-operation possible may be overcome through the introduction of certain bureaucratic mechanisms, which however would do little to promote the collective learning.[183] The extensive co-operation may be mutually beneficial to the both parties and also other market actors (government, customers, etc.). It

[182] Jucevicius G. (2003), Developement of the European Socio-Economic System. Increased Divergence of Capitalist Systems Inside the Enlarged EU?
[183] Storper M., S.B.Thomadakis and L.J. Tsipouri (1998), Latecomers in the Global Economy, Routledge

may provide synergy effect and lead to facilitation of the innovation, and, thus, to increased competitiveness.

Innovation also plays an important role in the VoC model. This model draws the distinction between radical and incremental innovation. Radical innovation entails the substantial shifts in product lines, the development of entirely new goods and therefore is typical for the dynamic liberal market economies.[184] Incremental innovation is marked by continuous but small-scale improvements to existing product lines and production processes.[185] None of these types is better than another, and both have been operating successfully within their models. Undoubtedly, innovation is one of the sources of competitive advantage. It is one of to the advanced factors in the Porter diamond model, who stresses that nearly every country may develop it as it does not require specific natural resources.

The science in its “pure” view is useless to the country. What makes science and research so precious is the possibility to improve production processes through application of the modern technology. Therefore, there should be a match between technology and science policies and the latter needs to concentrate on the technologies that would affect national industries or industry clusters. Research with direct relevance to industry has particularly strong leverage in an economy[186]. Consequently, it is mutually beneficial for the science and industry to emphasize commercially relevant technologies. Innovation is one of the areas, where the position of government is crucial. The R&D institutions, either public or private ones, facilitate innovation. R&D may not be left solely to the firms because the benefits to the national economy exceed those to individual firms due to spillovers[187].

The main characteristics in the field of science and innovation that distinguish liberal and coordinated market economies are the following. Primary, CMEs enjoy high degree of industry-university cooperation. The results of research are available for the whole industry through the centralized associations and therefore the effect of spillover is ensured. The prestige of doctoral degree and academic career is high. While science in LME focuses mainly on the current profitability issues, the science in CME emphasizes continuous improvement and high quality. Science and innovation in this respect are in accordance with the concept of corporate governance. Also in the field of R&D orientation on either shareholders model (ROI) or stakeholders model (quality and improvement) is observed.

Being aware of the basic differences between two models let us discuss what type (or mix) of models is applicable to Latvia. It should be stressed though, that evaluating the current situation it is vital to realize that circumstances of the country in transition are not the static ones, therefore one needs to be aware of what was behind, what is now and what can be expected in the future.

[184] Hall P.A. and D. Soskice (2001), Varieties of Capitalism: The Institutional Foundations of Comparative Advantage, Oxford University Press
[185] Ibid.
[186] Porter M. (1990), Competitive Advantage of Nations, Palgrave
[187] Ibid.

5.2.1. Science and Innovation in Transition

Scientists in Latvia have expected a lot from the regained independence. However, they were disappointed just with respect to development of scientific research: the dramatic fall in funding and in the number of scientists, young people moving away to other spheres of life or going abroad, and ageing of scientists. The fall was very fast in 1992-1994 and the following bank crisis in 1995 shattered hopes for the increase in funding[188]. The new role of the state in a market economy has also resulted in the need to make changes and adjustments to the science and research policy. As a result, many research institutions and universities have become autonomous administrative structures. At the same time, the great number of independently operating institutions has raised the problem of co-ordination of activities in the realisation of state policy with regard to research and development.[189] Organic chemistry, biomedicine, pharmacy, materials sciences, information technologies, forestry and wood sciences and Lettonics (Latvian studies) become the priority fields in Latvia.[190] In these fields Latvia's scientists have achieved noteworthy results and have proved themselves at the international scale. At the moment, there are 20 university research institutes with independent legal status, 12 state research institutes and 15 other state research organisations from which the Ministry of Education and Science[191] in Latvia supervise 25. Research is conducted also in the universities and technology centres (see appendix 12 for details).

During the period of transition the number of research and development personnel decreased seven-fold in Latvia.[192] This reduction in the number of personnel is characteristic to all post-Soviet countries.[193] Presently, the relative number of research and development personnel in Latvia per 1000 inhabitants is approximately 2.5 times less than the average in the European Union (appendix 13). The financial resources allocated to research and development from the Latvian State budget over the last few years have gradually decreased[194] and consequently the allocation of funding by the state is now one of the lowest among the Central and Eastern European countries (appendix 14). The loss of the so-called industrial science was probably the greatest loss after 1990s. Soviet scientific research basis although centrally planned but in many respects well designed was damaged,[195] some facilities were moved to Russia.[196] Only several centres of high technologies have survived up to now.[197] Analysing

[188] Stradins J. (2001), Guidelines of Science in Latvia: Historical Development and Contemporary Real Facts
[189] http://www.izm.gov.lv/en/default.htm
[190] Bērziņš A. (2001), excerpts from speech at the General Meeting of the Latvian Academy of Sciences of Prime Minister of the Republic of Latvia, 22 February
[191] Ibid.
[192] It should be noted that during the Soviet years the number of scientists in Latvia was enormously high. The proportion of these experts per 1000 inhabitants in Latvia was twice as much as in such developed countries as Germany and Great Britain and 1.5 times greater than in the USA and Japan, source: http://www.izm.gov.lv/en/default.htm
[193] The number of research personnel has decreased drastically in Latvia: from 31,274 per 1000 inhabitants in 1989, to 4,301 in 1999, (almost 8 times), http://www.izm.gov.lv/en/default.htm
[194] comparing from 2,5% of total budget in 1991 to 1,3% in 1999, www.izm.gov.lv
[195] For example VEF factory, leader in radioelectronics in the former USSR located in Riga
[196] For example the Institute for design of electric fast trains was moved to the neighbourhood of Moscow or marine geology which secret investigations were conducted in Latvia during Soviet times.
[197] For example joint stock company Sidrabe - design of vacuum surfaces (belongs to the capital of the USA); Baltic Scientific Instruments - a small part of the large Institute of Radio Isotopes (Ge crystals for the detection

this data, one may notice that in respect to Latvian science, main discussion in which scholars are involved is about *survival* of science and in much less extent about its development and innovation. It is also true, that there is generally a low-level of innovation in CEESs as most companies (both locally run and MNCs) are engaged in low/medium value-added parts of the value chain or industrial sectors.[198] There are two contradictory opinions about the situation of science in Latvia.[199] While some argue that "education and science are the national wealth of Latvia[200]" others predict that "the current science policy in Latvia cannot prevent its collapse and the ensuing rapid decline of the quality of higher education. Moreover, it eliminates a real possibility for science to influence the processes of Latvia's human development and national economy".[201] Apparently, the truth lies somewhere in the middle between these extreme opinions.

5.2.2. Characteristics of the Science and Innovation System

According to the investigation requested by the European Commission (Directorate General XII Science, Research and Development) as a major study on "The impact of the enlargement of the European Union towards the associated Central and Eastern European Countries (CEEC) on Research and Development Innovation and Structural Policies",[202] decrease in practical capacity of scientific research has been noted. The government is reproaching scientists that in Latvia science has "alienated itself from public needs, and that it lives and works *per se".*[203]

At the moment, integration of institutes within the University of Latvia is quite formal. Research is not linked with the training of students (except for individual cases). And apparently, Latvia still does not maintain a high level for university education in all natural, engineering and social sciences and more importantly, does not ensure attractive working conditions for the scientists. The gifted ones continue to leave the country to study and work abroad. The low prestige of the scientific career and the academic degree is proved also by the striking fact that in 2000 only 22 (!) people in Latvia received doctoral degree (meanwhile 200-300 such people per year are needed according to Mr. Ekmanis).[204]

Until now, the local national economy offered no demand for science. "The state has failed in cultivating successful business environment and in creating preconditions for the development of innovative science - that is the sad conclusion to be drawn. The state feels no necessity for science, therefore from among the candidate states of EU Latvia is the last but one as to the funding of science and the number of scientists, in one case - before Cyprus, in another - before Romania" acknowledged

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of radioactive materials) (Finnish capital); individual limited liability companies within the Technological Centre.

198 Jucevicius G. (2003), Developement of the European Socio-Economic System. Increased Divergence of Capitalist Systems Inside the Enlarged EU?

199 Ekmanis J. (2001), The Present Situation of Science in Latvia

200 Ekmanis J. (2001), The Present Situation of Science in Latvia , speech by Anonymous (1999), Society of Latvian Intellectuals and the meeting of LAS, November

201 Ibid.

202 http://www.izm.gov.lv/en/default.htm

203 Stradins J. (2001), Guidelines of Science in Latvia: Historical Development and Contemporary Real Facts

204 Ekmanis J. (2001), The Present Situation of Science in Latvia

President of the Latvian Academy of Science.[205] The same view was supported by Andris Bērziņš,[206] who mentioned that "interrelation of science and concrete life, and the emerging demands of the economic area we are progressing to - the EU, is the question to be considered first". The government is aware of the problem, but does not suggest stimulating measures for improvement of the situation. Therefore, at the moment, the weak development of innovative science and, consequently, the absence of industry-science mutually beneficial cooperation are obvious.

The *weak* link *between industry and science* is also proved by the fact that from total R&D budget only 15% are financed by the business sector (see appendix 11), comparing to 57% which are financed by the state.[207] This is clearly seen observing the national budget allocations for science[208] in 2000. The main portion of the state science budget (77,2%) goes to the *support scientific activity*, which is earmarked for academic and applied research, and for the maintenance of the requisite infrastructure. Market oriented research that promotes the co-operation between science and small-scale science-intensive enterprises comprise only 10%. In the meantime, this area serves as "a bridge" between science and industry and is associated with attraction of private capital for the needs of applied science[209]. This leads to the conclusion that industries either are not interested in the research conducted by the R&D institutions or does not have sufficient information about this services. The other reasons may be lack of trust or disagreement about financial side of the question.

Transition from the dependence to interdependence-based relationships has never been an easy one.[210] Above facts indicate at the low degree of industry-university cooperation. Technology transfer mainly originates in the external rather than internal environment as companies are keener to hire people with necessary competencies or copy the processes from the rival companies. Neither government nor industrial sector is interested in R&D investments. Consequently, there is a low prestige of the doctoral degree and an academic career as such among young people. Regarding the assessment of the type of innovation typical to Latvia, the conclusion is hard to draw due to the absence of data about recent scientific findings. Nevertheless, in author's opinion, the tendency of incremental innovation is observed, as in the given state of science and funds available it is not likely that there is a room for entirely new, revolutionary products creation. Summarizing above mentioned, one may find out the following regularities in the Latvian inter-company relation system.

[205] Speech at the Baltic Conference on Intellectual Co-operation in Tallinn in 2001
[206] Bērziņš A. (2001), excerpts from speech at the General Meeting of the Latvian Academy of Sciences of Prime Minister of the Republic of Latvia, 22 February
[207] Data of year 1999
[208] per Ekmanis J. (2001), data for the year 2000
[209] Other parts of the state science budget comprise of payment for Latvia's participation in EU 5th Framework programme (5.3 % from the total budgetary funding of science) and research ordered by state institutions (6.9 % and these are the funds which are allotted to ministries for solving local scientific problems).
[210] Jucevicius G. (2003), Developement of the European Socio-Economic System. Increased Divergence of Capitalist Systems Inside the Enlarged EU?

Comparison of Inter – Company System in Latvia with CME and LME Systems

Inter-company relations	*Britain*	*Germany*	*Latvia*
(a) ***Scientific research***			
Degree of industry-university co-operation*	Low	High	Low (lack of trust)
Degree of industrial self-organisation of R&D*	Low	High	Low (lack of interest, low value added products)
Degree of formalisation of inter-firm relations*	Low	High	Low (lack of regulating mechanisms)
State support of the R&D activities	Medium	High	Low/Medium (lack of funds)
(b) Prestige of academic career			
Prestige of academic career	Medium	High	Low (lack of all above factors)

* Sample characteristics are taken from Whitley R. (1992), article by Lane C. "European Business Systems: Britain and Germany compared"

5.3. Element III: Industrial Relations System

Industrial relations system concentrates on issues of wage setting and moderation and industry-level bargaining between trade unions and employer. The principal distinction between CME and LME in the sphere of industrial relations is the relative power of trade unions. CME generally have powerful trade unions. This implies the high effectiveness of conflict resolution between employer associations and trade union conflicts. Power of trade unions also includes the recognition of the "right to manage" and the ability to negotiate nationally homogeneous bargains.

Compared to most of the world, Europe is heavily unionised especially in the CME countries, such as Nordic countries and Germany. The former countries are characterised by the important position of the labour market organisations and the industrial relations structure based on national, industry-wide collective agreements.[211] For example, in Germany, employees, through the employee organisations, have considerable influence at the enterprise strategy as they are allowed to participate in decision-making. It is reported that union influence has even increased during the past decade.[212] In contrast, in the U.K., trade union system has been regulated mainly by tradition and custom until 1980s.[213] Multi-unionism, characteristic for Anglo-Saxon countries, prevents the trade unions to achieve homogenous decisions in the national bargaining and therefore weakens its role in the institutional foundations system. It is a known fact that existence and relative power of trade unions usually is not a matter of organisational choice but rather it is a product of government system, which entrusts it the function of

[211] Speech by Lauri Ihalainen at the Northern Dimension Labour Market Forum (11.2.2003), The Northern Dimension - The role of trade unions in the promotion of the labour market
[212] Veersma (1995), MNCs and industrial relations, both excerpts chapter 4 and 15 in Harzing & Van Ruysselveldt, International Human Resource Management, London: Sage, ISHRM compendium
[213] Whitley R. (1992), European Business Systems: Firms and Markets in their National Contexts, Sage Publications, article by Lane C. "European Business Systems: Britain and Germany compared"

constraining of managerial actions. Knowing the mechanism of the bargaining system in Latvia it is possible to find out the specifics of the third element in the VoC model.

5.3.1. Overview of Latvian Institutional Framework of Collective Bargaining System

Restructuring of the Baltic States socio-economic model has involved fundamental changes in the institutional structure of the labour market including elaboration of relevant laws and the formation of relevant institutions, such as government agencies, independent trade unions and employers' organisations.[214] Nevertheless, the institutional foundations of the labour market are still in transition. Employer organisations are, to a great extent, only about to develop, and many trade unions are still building up to become genuine representatives of employee interests. The same picture applies to the bargaining structure[215] of the above players.

The trade union power in the Baltics has decreased considerably after the collapse of the Soviet system. Union membership, which constituted approximately 50 percent of the work force in 1993, fell as workers left the Soviet-era unions or were laid-off from the Soviet-style factories. Membership rate in the trade unions decreased till around 30% in 2000 in Latvia.[216]

Since 1992 numerous and rapid legislative changes have occurred in the industrial relations system with a strong commitment to European Union membership. Latvia has ratified the ILO Conventions No. 98 on Collective Bargaining, and No 87 on Freedom of Association in 1992, recognizing the role of independent social partners and laying the groundwork for the establishment of the social dialogue process. Autonomous organizations representing workers and employers were acknowledged and acquired legal status.[217]

The main legal basis for trade union activities laid down the Law of 13 December 1990 “On Trade Unions”. The Constitution of Latvia guarantees the right to strike and the Law on Trade Unions mandates that workers, other than the uniformed military, have the right to form and join labour unions of their own choosing. The legislation also provides a legal basis for social dialogue, regulating negotiations between the social partners and labour disputes (the law on dispute settlement is under preparation). Unions are free to affiliate internationally and to develop contacts with European and international labour unions. The law bans dismissal of workers who choose to go on strike, although it is acknowledged that the government has not effectively enforced the law.[218]

[214] Anonymous (1995), Institutional structure of labour market, http://www.ibs.ee/ibs/economics/esc/part-3.2.html
[215] Speech by Lauri Ihalainen at the Northern Dimension Labour Market Forum (11.2.2003), The Northern Dimension - The role of trade unions in the promotion of the labour market
[216] However, the lack of the comprehensive register makes it difficult to estimate what proportion of the workforce have membership in trade unions , www.gla.ac.uk/ecohse/latvia.pdf
[217] Strengthening social dialogue in Latvia (2001), Project Proposal by Flemish Community in Belgium and International Training Centre
[218] Freedom House (2000), www.gla.ac.uk/ecohse/latvia.pdf

The "Law on Public Organizations and their Associations" as of 15 December 1992 regulates employers' organizations. The methods and procedures of collective bargaining are defined in the Law on Collective Agreements as of 26 March 1991. A new Labour Code, adopted by Parliament on 20 June 2000 that entered into force on 1 June 2002, further updates the collective bargaining process and labour disputes settlement mechanisms.

The present institutional framework in Latvia aims to bring the trade union activities under one umbrella while employer's ventures under another thus ensuring centralised resolution of conflicts and homogenous nature of bargaining. The above strategy allows to increase the relative power of the both parts with hope to achieve speedy and easy resolution of negotiations. Despite a decrease in membership after independence Free Trade Union Federation of Latvia (LBAS)[219], with 230,000 members retains the unionisation rate (30%) remains high compared to the average in Western European countries.[220]

On the employers' side, an umbrella organisation representing private and state owned enterprises in almost all sectors was created in 1993. The Latvian Employers' Confederation (hereinafter LDDK) represents the business community's interests on the National Tripartite Collaboration Council (hereinafter NTCC) and in tripartite/bipartite negotiations. There are about 70 direct members and 20 members in the Association who are representatives of the leading Latvian companies. Organization aims to assist its members in various fields, ranging from information dissemination to legal advice and economic/financial consultancy and preparation for successful accession to the single market. Employers' organizations are a new phenomenon of the transition period. It is the least organized social group, and this causes some problems in tripartite negotiations.[221]

The institutional framework is completed by the NTCC founded on 25 February 1999. This tripartite council operates as a consultative body where the social partners meet on a regular basis to discuss social and economic matters. The council examines draft laws and put forward proposals and suggestions to the Government. It does not have decision-making power but serves as a forum for social partners composed of 21 members (7 Government representatives, 7 employers' representatives and 7 trade unionists). Four other tripartite institutions, the Social Insurance Council, the tripartite Co-operation Sub-Council on Vocational and Education and Employment, the tripartite Co-operation Sub-Council on Labour Affairs and the tripartite Co-operation Sub-Council on Health Care, are involved by the Government and the social partners on specific issues.[222]

[219] LBAS, established on 25th May 1990, is responsible for the implementation of common tasks, economic and social rights and interests of trade union members protection, and more generally taking part in the development of legal state and the democratic society.
[220] Strengthening social dialogue in Latvia (2001), Project Proposal by Flemish Community in Belgium and International Training Centre
[221] Ibid.
[222] Ibid.

5.3.2. The Specifics of the System

5.3.2.1. Union Recognition of the "Right to Manage"

Despite the developed institutional (in its narrow, organisational meaning) framework, the actual power of trade unions is not that high. According to Commerce round table,[223] trade union rights and social dialogue are still problems in Latvia. *De jure,* Latvian employers recognise that workers have the right to join the trade union. However, *de facto* exercise of this right is far from reality. Managers try to keep the commerce union out at the workplaces[224] particularly in the privately owned sector. Weak actual trade union power also affects the signing of the collective agreements[225] that is another indicator of effectiveness of the trade union operations.

According to Ms. Romanova[226] since *perestroika*, relative power of trade union has considerably decreased along with elimination of compulsory membership fees. This fact is supported also by other sources. At the moment, trade unions have a declining rate of membership in all types of enterprises and 80% of the new enterprises have no unions. Employee influence through unions is the most significant in state owned enterprises.

The research conducted by the Finnish Ministry of Labour[227] provides somewhat controversial view on the above problem. During this research, more than 900 men and women, who are currently employed, were interviewed in each of the Baltic countries and it was concluded that the working conditions and protection of social rights has been most evenly balanced in Latvia. Among other things, it was noted that "The trade union membership rate is clearly the highest of the three in Latvia, the workers there being able to exert a greater (underlined by the author) degree of influence at the workplace, particularly in the more recently established enterprises, than are their counterparts in Lithuania or Estonia". Not questioning the results of the research, one must pay attention that comparing with two other Baltic States the relative power of trade unions in Latvia may be stronger although it is not a reliable indicator that trade unions are strong as such. At the same time, referring to the above findings, one may notice that the main problem is not that trade union does not have the sufficient power allocated by law, but is in limited way in which they can exercise the power in the real market conditions.

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[223] Commerce round table prepared for EU membership, 20th July 2002, http://www.union-network.org/unisite/sectors/commerce/Activities/Riga_round_table_June_2002.htm
[224] Ibid.
[225] The number of collective agreements, covering a small percentage of the labour force, has no significantly risen 2001. In 2001, 2 287 collective agreements were concluded, compared to 2 057 in 2000. The collective agreements concluded in 2001 cover 203 374 employees (approximately 20% of the total workforce) (203 725 in 2000). 2 167 of the collective agreements were concluded at company level, while the number of collective agreements at branch level (17) was lower than in previous years. Source: Commission of European Communities (2002), Regular Report on Latvia´s Progress Towards Accession
[226] Interview with Galina Romanova
[227] Commerce round table prepared for EU membership, 20th July 2002, http://www.union-network.org/unisite/sectors/commerce/Activities/Riga_round_table_June_2002.htm

5.3.2.2. Effectiveness of Conflict Resolution

According to the current legislation[228] employees have the right to strike if it is not possible to reach consensus in the peaceful way. The regular strikes of teachers, nurses and medical personnel and farmers are a common occasion in Latvia.

The main reasons for the strikes in Latvia are economical rather than professional issues. The typical requirements of teaching and medical personnel are increase of the average salary and demands to the timely transfer of social security contributions to the state. Farmers force government to protect internal market of the agriculture production. They also express protests against EU expansion to the east, being afraid of competition caused by it.

On the one hand, the expressed freedom to strike and the ability to exercise this right by the different groups of the society indicates growing democracy and power of the trade unions. On the other hand, it also points to the government inability of the peaceful conflict resolution. The repeating strikes by the same categories of people show that problems in question are not resolved but merely suppressed temporarily. It is also noticed, that although labour unions have the right to bargain collectively, they are largely free of government interference in their negotiations with employers and the law prohibits discrimination against union members and organisers, some emerging private sector businesses have threatened to fire union members.[229] Indeed, these businesses usually provide better salaries and benefits than the ones available elsewhere, and in return expect unconditional obeyance of the employees. Extended working hours, salary “in the envelope” and avoidance of paying social security contributions are Latvian reality which state institutions are unable to control.

5.3.2.3. National Homogeneity of Negotiated Bargains

National homogeneity of negotiated bargains appears to be rather high due to Free Trade Union Federation of Latvia which co-ordinates 28 branches of trade union with more than 250 thousand members[230] and is responsible for implementation of common tasks, economic and social rights and interests of trade union members.

5.3.3. Concluding Remarks

Independent trade union organisations, which are inevitable labour market institutions, represent and protect the economic and social interests of employees and pursue the establishment of legal order, using democratic methods. Employers' organisations are also looking for their place and role in CEE

[228] The “Act on Strikes” was adopted in 23rd April 1998, which, however, excludes certain categories of the employees who are not allowed to strike, for example judges, prosecutors, police officials, fire fighters, border guards, officials of the state security service, guards of confinement institutions, and persons serving in the National Armed Forces.
[229] www.gla.ac.uk/ecohse/latvia.pdf
[230] http://www.randburg.com/lv/lbas.html

society. However, the differences in relative power of trade union across the countries are great due to the dissimilar starting points and labour market and political cultures.[231]

Along with the reform process concerning the future of the EU, the so-called social dimension issues, labour market and social policy, will be ever more significant factors in the integration process. Social policy, economic policy and employment policy constitute an interacting triangle. The social dimension is vital for the development of country as a whole. At the end, let us summarize the above finding regardin Latvian system in the following table:

Comparison of Industrial Relations System in Latvia with CME and LME

The system of industrial relations	**Britain**	**Germany**	**Latvia**
(a) Power of trade unions			
Effectiveness of conflict resolution*	Low	High	Low
Union recognition of "the right to manage"*	Medium	High	Low
National homogeneity of negotiated bargains*	Low	High	High

* Sample characteristics are taken from Whitley R. (1992), article by Lane C. "European Business Systems: Britain and Germany compared"

5.4. Element IV: Corporate Governance System

The aspect of corporate governance is probably the most important in the VoC model. However, before going into analysis of the element's position and significance in the Latvian institutional framework, it is necessary to clarify the meaning of the "corporate governance" concept. This concept potentially covers a large number of issues and its ambiguity is enforced by a variety of interpretations. Some scholars provide reader with the narrow definition claiming that "corporate governance is the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment"[232] thus focusing on the institutionalized management-ownership relationship. Others perceive corporate governance as a "triangular interaction between a company's shareholders, board of directors and management and also with employees, creditors, the local community and other parties with whom the company has a relationship."[233] Third suggests such a vague and wide definition as "corporate governance is about promoting corporate fairness, transparency and accountability"[234]. To sum up, one may say that corporate governance may be defined narrowly as the relationship of a company to its shareholders and more broadly, as its relationship to society[235].

[231] Speech by Lauri Ihalainen at the Northern Dimension Labour Market Forum (11.2.2003), The Northern Dimension - The role of trade unions in the promotion of the labour market
[232] Shleifer and Vishny (1997), A Survey of Corporate Governance, The Journal of Finance
[233] "What is corporate governance?", definition of the Norway Stock Exchange, www.ose.no
[234] Speech of Wolfensohn J., president of the Word bank, as quoted by an article in *Financial Times*, June 21, 1999, http://www.encycogov.com/WhatIsGorpGov.asp
[235] The Financial Times, 1997, http://www.encycogov.com/WhatIsGorpGov.asp

5.4.1. Theoretical Framework

The diversity of corporate governance systems in the EU which will be enforced even further with the upcoming enlargement, do not prevent scholars in their attempts to classify these systems. Traditionally, there is a distinction between shareholder and stakeholder model of corporate governance. The former model suggests that the primary goal of the company is the maximisation of the shareholder value. Profit and shareholders wealth maximisation approach is widespread in the Anglo-Saxon countries, where other stakeholders retain relatively week power of control. Some authors share the view that the shareholder model is the best one and it will prevail due to the increasing dominance of institutional investors on international capital markets.[236] They provide historical, efficiency or even human rights arguments in order to justify their preference.[237] At the same time, the agency theory criticises this model due to the high risk of manager-shareholder conflict.[238] Others also question shareholder's profit being the sole overriding purpose of corporate activities[239] as it is not always lead to overall societal wealth maximisation.[240] Alternative, stakeholder model, introduced in 70s, incorporated the above criticism and took more society-oriented stance. It views the role of corporate governance as balancing tool of the different, sometimes competing claims of various stakeholders and accepts the stakeholders active participation in the decision-making procedure. This model draws on the distinction between primary (shareholders and investors, employees and managers, customers and suppliers and local communities) and secondary (government and regulators, civic and social groups, competitors and media) stakeholders and is typical for Germany and Scandinavian countries where the relative power of "non-market" institutions is quite high.

However, for the VoC model analysis, another classification of corporate governance systems seems to be more applicable. It distinguishes three prototypes of corporate governance in Anglo-Saxon countries, Germany and Scandinavia and Southern Europe (defined accordingly as outsider, insider bank oriented and insider state and bank oriented systems[241]), thus drawing a parallel with a VoC model. The characteristics of the systems are highlighted in the table below[242]

[236] Lazonick W. and O'Sullivan M. (2000), Maximizing Shareholder Value: A New Ideology of Corporate Governance," Economy and Society, 29, 1**,** Schmidt R.H. and G.Spindler (1998), Path Dependence, Corporate Governance and Complementarity

[237] Dragneva R.O., W.B. Simons (2001), Corporate Governance Revisited: Can The Stakeholder Paradigm Provide a Way Out of "Vulture" Capitalism in Eastern Europe?

[238] European Shadow Financial Regulatory Commitee, Corporate Governance In Europé, Statement No.15, London, December 2002

[239] Ibid.

[240] Parkinson J., M.Blair (1995), Ownership and Control, Washington DC

[241] Lecture by Clas Wihlborg on February 4th, 2003, Corporate governance systems in the EU

[242] Lecture notes by Clas Wihlborg on February 4th, 2003, Corporate governance systems in the EU

Prototype Systems of Corporate Governance

Outsider system	Insider bank oriented system	Insider state and bank oriented system
• Important role of stock market valuation, allocation, and managerial incentives; • Dispersed ownership, diversified owners; • Shareholder wealth max through threat of hostile take-over; • Possibility of managerial entrenchment; • Arm's length banking (lender's liability); • Restrictions on cross-holdings, interlocking directors; • Strong investor protection, strict accounting standards.	• Bank-industry group members determine allocation and managerial incentives; • Strong role of block shareholders closely related to management; • No hostile take-overs, "corporate wealth max"; • Banks have strong links to corporations through share ownership or persons on boards; • Corporations within group have shares in each other, directors in common and each others' boards; • Less investor protection, more secrecy.	As in insider bank oriented system but strong influence of state, partly through ownership.

Apparently, the first corporate governance type is attributable to the LME conditions, while second to the CME and third to the Mediterranean market economy. These distinctive paths of corporate governance can be explained by different historical, economical, political and social events which countries have been encountered. The systems are supported by the countries socio-economic models and have their pros and cons. In the light of European integration, the question of convergence between models becomes actual. Are the existing systems viable, stable and sustainable in the long-run? Is the one system more efficient than another? And finally, is the convergence between corporate governance systems desirable?

5.4.2. Is Convergence an Option?

Before answering the last question, it is necessary to understand whether there is a tendency towards convergence of corporate governance system and whether these systems converge, diverge or remains neutral in respect to each other. This will also allow to assess whether countries in transition may expect the restructuring and structural adjustment of their systems in the light of expecting enlargement.

EU corporate governance focuses mainly on two issues, firstly seeking to assess whether self-regulation by firms is adequate to ensure sound corporate governance, and secondly aiming to assess whether EU-wide legal harmonisation or the existence of national rules are the best regulatory frameworks.[243] European Shadow Committee holds the view that harmonisation efforts need to be focused on elimination of explicit hindrances to mobility and government-sanctioned discrimination of non-resident firms and individuals. Although it is acknowledged that the EU legal framework includes

[243] European Shadow Financial regulatory Committee, Corporate Governance In Europe, Statement No.15, London, December 2002

proclamation of the four freedoms, in practice these freedoms are often restrained (for example language barriers restrain labour mobility within the EU). European Shadow Committee considers that "Mobility and non-discrimination lead to competition among national institutional structures and thereby may over time lead to a degree of harmonisation by market forces" (for the competition between the EU legal systems see chapter 3.1).

The support towards positive integration and convergence is proved by the development of codes of good corporate governance and number of disclosures[244] that regulate corporate government in the whole EU space.[245] Another argument in favour of convergence between systems is the EMU convergence criteria, which equally affects EMU members and put pressures on national economic governance systems.

There is a strong criticism though regarding the issue of European corporate governance systems convergence. Hall and Soskice develop the first set of arguments claiming that certain institutional framework renders certain comparative advantage that country seeks and should be able to preserve.[246] As long as VoC approach recognises the barriers to fundamental institutional change as very high and informal rules deeply rooted the convergence arguments may seem not be sufficiently supported. Moreover, studies show[247] that Germany and the U.K. do not appear to "converge" towards one best model of corporate governance. The notion of path dependence also supports this view by arguing that welfare of changing institutional arrangement might not be justified and sufficient to cover the switching costs of the adjustment [248] and claiming the complicated mix of legal rules and practices developed over time in specific cultural environment cannot be redesigned rapidly.[249] The cultural aspect is truly one of the most significant barriers on the way of change (convergence). It is accepted that cultures may change, but this change is very slow and takes many years.[250] Moreover, change does not always imply convergence as it is more common to the systems to change along their distinctive value-defined systems.

It is also rather hard to draw the line between Europeanisation and globalisation tendencies which both affect the EU countries corporate governance systems. For example convergence of the U.K. and German system may be seen as Americanisation effect, as the U.S. has the same corporate government strategy as other Anglo-Saxon countries.

The discussion of convergence therefore has not yet reached its final conclusion. It is impossible to provide single and simple answer on the EU corporate governance systems converging / diverging

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[244] Disclosures of corporate governance rules and executive compensation schemes in firms, concerning the roles of independent directors, auditors, compensation committees, institutional investors and so on.
[245] Lecture by Clas Wihlborg on February 4th, 2003, Corporate governance systems in the EU
[246] Jucevicius G. (2003), Developement of the European Socio-Economic System. Increased Divergence of Capitalist Systems Inside the Enlarged EU?
[247] Hall P.A. and D. Soskice (2001), Varieties of Capitalism: The Institutional Foundations of Comparative Advantage, Oxford University Press, article by S. Vitols "Varieties of Corporate Governance: Comparing Germany and the UK"
[248] Schmidt R.H. and G.Spindler (1998), Path Dependence, Corporate Governance and Complementarity
[249] Lecture by Clas Wihlborg on February 4th, 2003, Corporate governance systems in the EU
[250] Hofstede G. (1991), Cultures and Organizations: Software of the Minds. London: McGraw-Hill

tendencies and the final outcome. It is commonly agreed though, that the EU needs a stable, simple to achieve and maintaining the confidence system, which respects national traditions while also permits systems to evolve under the influence of market forces. Those, who support the idea of "stateless market", [251] positively evaluate the convergence tendency and creation of unite European space. It is considered as negative by those trying to preserve national sovereignty and identity within the Community. It can be added though, that in this respect countries in transition represent flexible, yet immature system vulnerable to adjustments and with the high degree of adaptability. It may help to drive their systems to the common denominator or at least to classify them in a period of time as representatives of the one of three types of corporate governance systems. It may also appear that these countries form unique fourth "countries in transition" model. Nevertheless, it may be concluded that the most pressure on national systems is likely to come in the form of policy spillover and structural adjustments.[252]

5.4.3. Corporate Governance in Transition

In transition countries, and in the Eastern Europe in particular, corporate governance was introduced within the policy framework of privatisation, that is, the transfer of state equity into the private sector.[253] Privatisation was seen as a rapid means to reduce the state's influence on enterprises and to change the ownership regime. Consequently, the countries were mainly concerned with the principle rather than substance of privatisation. In order to speed up the process, Western privatisation methods have been adopted and success has been measured in quantitative rather than qualitative terms. There were applied different methods of privatisation in CEE countries including voucher privatisation and management/employee buy-out.[254] The application of different methods led to different ownership structures and different dominating stakeholders groups.[255] For example, voucher privatization has resulted in fragmented ownership that was later consolidated by the large investment groups. The direct sales privatization was relatively more favorable to the participation of foreign investors. Meanwhile, the management-employee buyouts mainly resulted in the ownership concentration with the insiders, typically top-managers of the company.[256] In the light of privatization the concept of institutional impact on the process was realized as a precondition for successful companies transformation.

N.Miegynd distinguishes between five types of stakeholders that own companies in the transition economies: state, employee, managers, domestic insiders and foreign investors.[257] During transition the significance and relative weight of the parties in the decision-making has changed considerably.

[251] Jucevicius G. (2003), Developement of the European Socio-Economic System. Increased Divergence of Capitalist Systems Inside the Enlarged EU?
[252] Jucevicius G. (2003), Developement of the European Socio-Economic System. Increased Divergence of Capitalist Systems Inside the Enlarged EU?
[253] Voigt1 S. and H. Engerer (2002), Institutions and Transition – Possible Policy Implications of the New Institutional Economics
[254] Ibid.
[255] In Latvia primary privatization relied on direct sales and secondary on vouchers. Jucevicius G. (2003)
[256] Ibid.
[257] Mygind N. (2002), Ownership, control, compensation and restructuring f Latvian enterprises- preliminary results from a manager survey

The role of state has continuously diminished due to privatization and changing pattern of ownership. At the same time, the role of managers has drastically increased due to the absence of regulating mechanism and relative weakness of other parties. Lack of legal environment, underdeveloped stock market, weak saturation of the labour market with qualified professionals, the fragmented shareholders, transformed manager from the decision-implementator to decision-maker with nearly absolute power. The problem of absence of the legal framework regarding employees protection rights has been eliminated during 90s, but it did not facilitated drastic increase in its power of control due to existence of informal barriers. Domestic insiders play an important part in the SMEs financing due to the specifics of the SME structure when the owners are simultaneously managers of the company. Foreign investors have decision-making power but it is not supported by the proper institutional arrangements.

The proponents of the stakeholder model and insider bank oriented system rightly notice that mechanisms for the allowing the stakeholders participation are gradually legally enforced in the CEE countries. Nevertheless, stricter legal framework does not necessarily mean the immediate adoption of the stated principles in the real market situation. The argument that "socially responsible business activity opens pathways to competitiveness in emerging markets"[258] just starting to evolve in the circle of consideration of the policy makers. It mainly reflects future than present reality as it is too ambiguous to presume that companies operating in unstable changing conditions of the transition countries would pay too much attention to the spheres of corporate social responsibility, ethical management and environmental issues. Undoubtedly, these questions receive growing recognition although they does not enjoy yet the "full membership rights" in the corporate governance model. But do the above-mentioned dynamic changes in the corporate governance structure follow any of three generally accepted models, or introduce a mixture of them?

An argument of social tradition is more solid for justifying the shift towards network-based model. Collective modes of working are not new for the former countries of planned economy with its strong trade unions and supervision networks. Therefore, the acceptance of the stakeholder model is quite natural to the CEEC where "co-operation" and "society" are the key operating words for 50 years.

The central issue for companies is rising of capital. Capital may be obtained either by usage of the retained earnings or interaction with the external providers of finance. Due to rather underdeveloped stock markets, companies in transition economies rely more on debt capital than on equity financing/raising the capital throught the emissions which also is a characteristic of the network-based system.

The final argument in favour of insider bank-oriented model is the one of learning effect. Germany and Scandinavian countries, being the major investors for the Baltic States, may bring they corporatist

[258] Dragneva R.O., W.B. Simons (2001), Corporate Governance Revisited: Can The Stakeholder Paradigm Provide a Way Out of "Vulture" Capitalism in Eastern Europe?,

traditions into the Latvian markets, therefore, influencing the convergence of the system towards network-based model.[259]

However, other factors do not allow to accept the insider bank oriented model as the basic one for CEEC. In favour of outsider model of corporate governance speak companies' short-term orientation and focus on immediate results.[260] This is mainly explained by market instability where long-term investments are highly risky due to changing and unpredictable nature of the external environment. Moreover, foreign investors who have the primary concern on profitability that long-term development usually promote high demand on capital return. The main reasons of their interest is attractiveness of cheap labor market, availability of cheap natural resources and their concentration on low value added output, which also pressures achievement of high return on investments. Rapidly decreasing level of state intervention due to the privatisation process and dramatically increased role of managers, with dominating Anglo-Saxon style (MBA) education discussed in more details in the "Education and training" element, are also the characteristics of outsider model. Finally, the strength of the outsider model is supported by the very definition of the transition process, commonly formulated as "transition from centrally planned to *market* economy".

The characteristics of hierarchy-based system can also be found in the corporate governance system of the transition countries. The main reason for this undoubtedly is the historically formed command economy with its strictly defined hierarchical structure and bureaucracy. The hierarchical organisational structure was enforced by informal institutions that made this system quite hard to change in respect of informal rules and conventions. Another argument in favour of hierarchy-based elements existence can be found in culture. Hofstede[261] explained the differences in national socio-economic systems through the own model where transition economies in the research scope are defined by high power distance (need for hierarchy) and high uncertainty avoidance (need for regulation) that places them in the "French/Latin socio-economic cluster".[262]

It can be seen that transition economies follow their own path in developing corporate governance and form the unique model containing characteristics of three corporate governance/ VoC systems:

[259] Jucevicius G. (2003), Developement of the European Socio-Economic System. Increased Divergence of Capitalist Systems Inside the Enlarged EU?
[260] Polonsky, G. and Z. Iviozia, Z. (1999) 'Restructuring of Russian Industries – is it Really Possible?', in Edwards V. (ed.), Proceedings of the Fifth Annual Conference on The Impact of Transformation on Individuals, Organizations, Society, Chalfont St. Gilles: CREEB, vol. 1
[261] Hofstede G. (1991), Cultures and Organizations: Software of the Minds. London: McGraw-Hill
[262] Jucevicius G. (2003), Developement of the European Socio-Economic System. Increased Divergence of Capitalist Systems Inside the Enlarged EU?

Factors Favouring the Emergence of Certain Socio-Economic Systems in the EU Candidate Countries

Network-based, CME, Insider bank oriented system	Market-based, LME, outsider system	Hierarchy-based, Mediterranean, Insider state and bank oriented system
Underdeveloped stock market Learning economy Social traditions (Slow) tendency to social responsibility	Neo-liberal nature of transition and globalisation[263] Decreased role of state due to privatization Short-term focus on profitability Power of executive and specifics of the educational system	Hierarchical traditions maintained from centrally planned economy Informal rules unadaptability in the short-term Specifics of the culture

Another element of corporate governance system is the existence or possibility of hostile take-overs. Vanags (1999) argues that due to not very well developed stock market, and the absence of dispersed shareholding, take-over mergers are not common in the Baltics states. In the meantime, there are several examples that may be defined as "hostile"[264]. Due to its ambiguous position no conclusion on this issue can be made.

The characteristics of the corporate governance systems in the transition economies apply to the large extent to the Latvian situation. Let us elaborate on the characteristics of corporate governance system in Latvia in the next subchapter.

5.4.4. Characteristics of the Corporate Governance System in Latvia

In the first years of independence, Latvia have faced the challenging task of disengagement from the economic and legal structure of the Soviet Union and creation of new market economy, including transformation and restructuring of the political, economical and social institutions. Privatization process was the central one also for Latvia, along with the reorientation of trade from the East to the West, which started in 1991 and was painfully fostered by the Russian financial crisis in 1998. It is quite complex to characterize the system of corporate governance in Latvia. Latvian model of corporate governance cannot be directly related to the one of the models and it development paths uncover features characteristic to the three models.

For evaluation of the current situation, let us refer to Vitols[265] model. He analyses the distinction of the corporate governance institutions on example of Germany (CME) and the U.K. (LME). I, in turn, will draw another column to the table for the comparable comparison of Latvian system of corporate governance.

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[263] Ibid.
[264] For example, Swedbank acquisition of Hansabank or building a majority holding in Unibanka by SEB. Vanags A., A. Štrupišs (1999)
[265] Hall P.A. and D. Soskice (2001), Varieties of Capitalism: The Institutional Foundations of Comparative Advantage, Oxford University Press, article by S. Vitols "Varieties of Corporate Governance: Comparing Germany and the UK"

Corporate Governance Institutions and Firm Strategies in the UK and Germany

	LME (UK)	CME (Germany)	LSC (Latvia)
Dominant ownership structure	Small shareholding by portfolio investors	Large shareholding by strategic investors	Large shareholding by foreign strategic investors
Employee representation institutions	Voluntarist	Corporatist (board-level co-determination)	Does not possess sufficient enforcement rights
Top management institutions	Single board dominated by CEO	Dual board Multiple power centres	Single board, high relative power of top management
Primary corporate goals	Profitability	Multiple goals: profitability, market share, and employment security	Profitability, market share
Competitive strategy	Radical innovation in new sectors Price competition in established sectors	Non-price competition through incremental innovation	Innovation is close to none Price competition among MNC

According to this model, focus needs to be made at the following issues: dominant ownership structure, employee representation institutions, top management institutions, primary corporate goals and competitive strategy.

In analogy with the CEE countries, the process of privatisation formed ownership structure of the Latvian companies. Latvian Privatization Agency (LPA) in the second phase of privatisation made an emphasis on attracting a "strategic investor" as part of the Public Offering Scheme.[266] That resulted in concentrated corporate ownership with a very few listed companies without a major shareholder.[267] This also may be explained by the investors' willingness to maintain an actual control over enterprise possessing the "control packet" of shares. Despite the obvious similarity of this element to the German stakeholder model, Latvian one has its specifics. The important role in the ownership structure is assigned to foreign investors, which owns nearly half of Latvian shares.[268] Another peculiarity is that due to uncompleted privatisation process, few largest Latvian enterprises are still state owned or are in the uncompleted process of privatisation. Besides, in contrast with the CME model, banking sector is not heavily involved in direct ownership of enterprises.[269] However, during past years the observed is the growing significance of financial intermediaries as leasing companies and pension funds slowly start to participate in the financing activities.

[266] Vanags A., A. Strupiss (1999), Corporate governance in Latvia, Seminar on the corporate governance in the Baltics
[267] Shareholder is considered to be major when its shares excess 30%.
[268] Vanags A., A. Strupiss (1999), Corporate governance in Latvia, Seminar on the corporate governance in the Baltics
[269] In 1997 only 3% of banks' assets were held in the form of equity and this has fallen to 1% by the end of 1998, Vanags A., A. Strupiss (1999)

Top management institutions in Latvia in contrast with the previous element have more similar features to the LME model. Due to the fact that managers are considered to have the highest influence on decisions in all areas, the role of the other stakeholders appear to be secondary. As this issue already has been covered in this paper further elaboration is not considered necessary. Employee representation institutions were already covered in the element I along with the issue of science and innovation in the element II. Therefore, the discussion will not be continued in this chapter. The same regards the discussion about company's primary corporate goals.

5.5. The Fifth Element – Company and It Internal Needs in the Countries in Transition. Case of Latvia

Traditionally, it was suggested that inducement of economic actors to cooperate with government will enforce the viability and efficiency of market system.[270] The Porter's model of competitive advantage of nations[271] recognizes government power to influence all four elements of the diamond.[272] Government may encourage companies to raise their performance, for example by enforcing strict product standards or vice versa, stimulate early demand for advanced products, enforce focus on specialised factor creation and stimulate local rivalry by limiting direct co-operation and enforcing antitrust regulations.[273]

The VoC approach though sees the principal problem in inducing economic actors to cooperate more effectively with each other. Securing better forms of coordination among private-sector actors is seen as a way of improving national economic performance. Paradoxically, it appears that both traditional and VoC ways are equally inefficient in the transition countries at a given period of time. (!) Historically, government-business relations in the LCS were characterized by little trust between the state institutions and private firms. Because of the lack of confidence in the governments, the population of the countries in transition mainly is politically passive. Issue of corruption, tax evasion and revenue concealment exacerbate the situation. On the other hand, inter-company relations are undermined by the challenging competitive environment and fear to loose the competitive advantage in market as well as absence of the coordinating industry associations, which would assist to overcome this problem.

As a solution, Culpetter (1998)[274] advises securing of "decentralized cooperation", which entails persuading private-sector actors to share information, improving their ability to make credible

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[270] P.A. Hall, D. Soskice (2001), Varieties of Capitalism: The Institutional Framework of Comparative Advantage, Oxford University Press

[271] Porter M. (1990), Competitive Advantage of Nations, Palgrave

[272] These are Factor conditions, Demand conditions, Related and supporting industries, Firm strategy, structure, and rivalry

[273] http://www.quickmba.com/strategy/global/diamond/Web

[274] P.A. Hall, D. Soskice (2001), Varieties of Capitalism: The Institutional Framework of Comparative Advantage, Oxford University Press

commitments, and altering their expectation about what other will do.[275] However, this approach causes immediate critiques, as it is unclear which mechanisms (both formal and informal) may enforce firms to fulfill the above actions. As the concept of “decentralized cooperation” to the large extent concerns informal conventions and more specifically the notion of *trust* , it makes nearly impossible to change in the short period of time. In the meantime, it is obvious, how the lack of this key component complicates the relations between economic actors and governmental institutions.[276]

It is generally possible to distinguish four main types of companies in the transition economies: (1) traditional state-owned enterprises owned/governed by members of nomenklatura clan, (2) new small and medium enterprises headed by young entrepreneurs, (3) multinational enterprises ruled by foreign capital owners and appointed managers, and (4) joint ventures co-owned by local and foreign capital and usually run by local managers.[277] All these types of companies are present in Latvia. Avoiding going too deep to the environment microlevel, it is possible to analyze companies from the position of ownership: state, employees, managers, domestic outsiders and foreign investors referred also in chapter 5.4.[278]

Privatization process of the state enterprises has been detailed in chapter 5.4. I need only to mention here, that probably the most troubles in the privatization process caused strategic enterprises with a strong market position and relatively high profitability which privatization was postponed over and over.[279] As at 2002, most of remaining large state enterprises were privatized, leaving state-owned just few. The central problem of the state enterprises is one of the corporate governance. Managers are accountable to the state (in the state controlling representatives person) and managers-owners conflicts may arise. There are also often soft budget constraints for strategically advantageous state enterprises. Awareness of possible subsidies and soft loans covering losses as well as acceptance of tax arrears may reduce financial discipline, undermine efficiency and slower restructurization process.[280]

Employee-owned enterprises were very popular in the early stages of transition but lost their importance in the later time. A more typical form of companies is management-owned enterprises widespread in the Baltic States. Being the classical form of entrepreneurship, where new companies are started by owners directly involved in the management, these companies do not have typical agency problem, as there is no separation of control and financial owner rights.[281] This type is characteristic to the Latvian small and medium size enterprises. As in 2001, the number of economically active small and medium-sized enterprises (SME) equals to approximately 99% of the total number of Latvian enterprises. In total terms, SME accumulates 70% of labour and produce more

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275 Ibid.
276 North (1990) notices that ”without minimal level of trust and confidence that commitments will be honoured, markets cannot function”.
277 Jucevicius G. (2003), Developement of the European Socio-Economic System. Increased Divergence of Capitalist Systems Inside the Enlarged EU?
278 Mygind N. (2002), The Role of Different Ownership Structures for Restructuring – Evidence form Baltic and Other Transitional Economies, CEES, Working paper No.45
279 Ibid.
280 Boycko M., A. Schleifer, R.Vishny (1996): A Theory of Privatisation
281 Mygind N. (2002), The Role of Different Ownership Structures for Restructuring – Evidence form Baltic and Other Transitional Economies

than 65% of GDP.[282] Being the one of the most important actors at the market, SME often lacks capital and qualified human resources and does not receive considerable attention and support from the government. However, in terms of privatisation small and medium-sized enterprises have been more successful than the big ones as the process was basically completed already in the middle of 1998.[283]

It is difficult to assess the current state and the patterns of development of SME sector in Latvia as there are dual positions: one of government and another of the enterprise representatives. The government measures on facilitating SME activities include National Program for Development, being updated right now in order to "incorporate the main principles of the European Charter of Small Enterprises and the EU Multi-annual Program for Enterprises and Business (2001-2005) alongside with the new state support measures to SME to enhance the competitiveness of SME in the European Union"; joining the European Charter of Small Enterprises (April 23rd, 2002) and reorganisation of business support funds.[284] From the enterprise point of view, the government regulations *do not* facilitate SME development, the influence and pressure from the large companies and MNC is oppressed as well as the high tax burdens and bureaucracy level. The truth as usual lies somewhere in between these two poles.

As the third category of the companies, having significant impact at the Latvian market, we have mentioned companies with a significant share of foreign ownership. At the moment, there is a tendency that large and capital-intensive firms are much more likely to be owned by outsiders while insiders own low capital intensity and low size companies.[285] This fact can be explained by the availability of financial resources, management skills, international network and "know-how" technologies by the former investors. Undoubtedly, foreign investors key interests were potentially profitable, strategically important companies that partly were acquired through direct sales of sales enterprises.[286] The most attractive sectors therefore appeared to be infrastructure, including transportation and transit sectors (including oil and oil product transit from CIS to Western Europe), communication and trade (wood and other natural resources with low value added) ones. Due to high share of foreign-owned companies at the local market, the whole corporate governance structure is highly sensitive and vulnerable to influence from the abroad both in terms of culture, formal and informal rules. Despite critiques, evidence confirms the strong performance and restructuring abilities of foreign ownership. The positive effects include high capital supply, industrial upgrading, increased competition (linking local production into advanced international production networks) and achieved stabilization and liberalization of the market as a whole.[287]

282 Ministry of Economy (2002), Semi-Annual Report on the Development of Economic of Latvia, December
283 Ibid.
284 such as Latvian Guarantee Agency (LGA) (offering guarantees needed for credits) and Latvijas Eksportkredīts (Latvian Export Credit) (insurance of export payments and issuance of export guarantees). Regional Fund, Rural Development Fund (credit guarantees to farmers, rural businesses) and Environment Protection Fund (funding of environment protection oriented projects), etc.
285 Jones D. and Mygind N. (1999), The Nature and Determinants of Ownership Changes after PrivatizationL Evidence from Estonia
286 Mygind N. (2002), The Role of Different Ownership Structures for Restructuring – Evidence form Baltic and Other Transitional Economies
287 Ibid.

However, one must not forget the outside domestic owned enterprises, which do not dominate at the Latvian market arena at the moment, but hopefully have a potential to become an important and may be even dictating force. The most typical form of this type of firms is joint ventures, which have share of foreign capital in the form of the initial injection or base for restructuring.

Research conducted by different scholars have shown that there is no single answer what kind of ownership structure is the most preferable and provide the best resource allocation and potential for restructuring. Most likely, the balanced integration of the four types of the companies is the most desirable. Being the core of the transition in Eastern Europe, change of company's governance is affected by the other 4 elements of the institutional structure, which, in turn, are influenced by the dynamic restructuring of companies from the centrally planned to market economy.

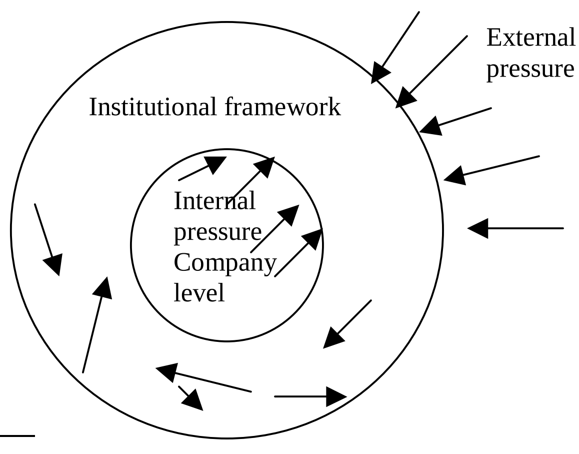
6. DISCUSSION AND CONCLUDING REMARKS

In the complex institutional framework four interconnected elements (education and training, intercompany relations, industrial relations and corporate governance system) shape a company's external environment, and formally and informally dictate its "position" in market. The company, an economic agent, which actively participates in distribution of material and human resources in order to reach its objectives (both profit and non-profit oriented goals), is a key element of the VoC model.

As the central actors of economy, firms are engaged in the multiple spheres of political economy. They need to raise finance (on financial markets), to regulate wages and working conditions (industrial relations), to ensure workers to have the requisite skills (education and training), to secure access to input and technology (via inter-firm relations), to compete for customers (in product markets), and to secure co-operation of their workforce (firm-employee relations).[288] In short, firms' success depends substantially on its ability to co-ordinate effectively with a wide range of actors.[289]

Traditional approach suggests that institutional structure follows firm strategy.[290] In the meantime, the modern approach[291] maintains controversial view asserting that the institutional foundations influence firm strategy. The former view may be true in a hypothetical condition when only one or few firms are operating at the market. In reality, a variety of firms have distinct objectives and interests and consequently it is not possible for them to agree on methods of institutional co-ordination and influence. As a result, firms are faced with a set of institutions that are not fully under their control.

A company's obedience to, or, in contrast, avoidance of the imposed constrains, influences the further development of institutional framework and modification of the current rules. In fact, institutional framework is exposed to the internal (company), external (foreign and international institutional environment) system pressures and also to the continuous intersystem pressures.



[288] D.Hall, D.W. Gingerich (2001), Varieties of capitalism and Institutional complementarities in the macroeconomy: an empirical analysis, Harvard University
[289] P.A. Hall, D. Soskice (2001), Varieties of Capitalism: The Institutional Framework of Comparative Advantage, Oxford University Press
[290] Chandler A.D. (1974), Strategy and Structure Strategy and Structure, the Mit Press, Chandler A.D. and H. Daems (1980), Managerial Hierarchies, Harvard University Press, Williamson O.E. (1985), The Economic Institutions of Capitalism, New York, the Free Press
[291] suggested by P.A.Hall and D.Soskice (2001)

It leads the discussion to the comparative institutional theory, whose basic notion is that the institutional structure of a particular economy provides firms with advantages for engaging in specific types of activities there.[292] Companies may operate in one field more efficiently than in another because they receive appropriate institutional support. This theory is supported by the fact, that it was noted that “national growth of rates cannot be explained fully by incremental additions to the stock of capital and labor and fixed rates of technical change”.[293] As this approach lack some variables that could justify the national growth, may be institutional factor is the one that is missing?

The choice of an appropriate corporate strategy is a prerequisite for a company’s comparative advantage within the highly competitive environment of the modern market. The formal and informal institutions have significant impact on operations and competitiveness of firms and industries[294] although the factors influencing the firm’s strategy are much more diverse. Varieties of capitalism assume that firms´ behaviour aggregate into national economic performance[295] and argue that nations can derive comparative advantage from their institutional infrastructure[296].

It is obvious that in a distinguishing institutional frameworks company’s strategy will differ. However, it is not always clear what kind of differences there will be. Also the correlation between a firm’s adaptability to the specific institutional conditions and its overall success have not been studied in depth as may be concluded after the conducted research.

The VoC argues that coordination of firms´ endeavors is dependant on what kind of support institutions of the political economy provide for different kinds of coordination.[297] In general, one may state that firms operating in LME rely mainly on market mechanisms to coordinate their operations, while the ones in CME rely on non-market institutions that have the power of strategic interaction in the activities of the companies. This conclusion though may be considered reliable only in the theoretical model. In practice, the situation is much more ambiguous and forces which influence planning and decision-making operations of the company are not that easy to grasp. Each economy displays specific capacities for coordination that would affect the actions of the firms and governments.

Nevertheless, Knetter (1989)[298] argues that there is “substantial evidence that firms in different types of economies react differently to similar challenges. Moreover, firms also derive comparative advantage from the home country institutional framework that supports specific types of inter- and

[292] Hall P.A. and D. Soskice (2001), Varieties of Capitalism: The Institutional Foundations of Comparative Advantage, Oxford University Press
[293] Ibid.
[294] Solvell O., I. Zander, M.E. Porter (1991) , Advantage Sweden, Norstedts
[295] D.Hall, D.W. Gingerich (2001), Varieties of capitalism and Institutional complementarities in the macroeconomy: an empirical analysis, Harvard University
[296] P.A. Hall, D. Soskice (2001), Varieties of Capitalism: The Institutional Framework of Comparative Advantage, Oxford University Press
[297] Ibid.
[298] Hall P.A. and D. Soskice (2001), Varieties of Capitalism: The Institutional Foundations of Comparative Advantage, Oxford University Press

intra-firm relationship.[299] For example, the countries are characterized by unique “management ideologies”[300]. Important national differences in management practices and approaches occur in such areas as training, background and orientation of leaders, group versus hierarchical style, the strength of individual initiative, the tools for decision making, the nature of the relationships with customers, the ability to co-ordinate across functions, the attitudes toward international activities, and the relationship between labour and management.[301] The different patterns of management culture’ development within organisations affect the creation of national competitive advantage. In Germany, the predominance of engineers on top management position is noted, while in Anglo-Saxon countries the background of top management is mainly financial. This fact may explain the focus on incremental innovation and production process in the former country and the emphasis of maximising short-term financial returns in the latter. Liberal market economies may be attractive to companies seeking the support for radical innovation, while CME for ones, searching for long-term investments. Secondly, there is a link between vigorous domestic rivalry and sustaining the competitive advantage in the industry. Clearly, in the intense domestic rivalry conditions, the companies are forced to innovate, to improve quality, to reduce costs, and to invest in upgrading advanced factors[302]. Coping with domestic competition allows companies to strengthen their competitive position on the international arena. The derivation of comparative institutional advantage may also affect companies´ mobility and willingness to change jurisdictions both in positively and negatively. As a result, the impact of institutional foundations is another indicator that needs to be considered in analysis of convergence and free movement of the firms.

6.1. Concluding remarks

The purpose of the thesis was to analyse “Which of the varieties of capitalism does Latvian system represent and how does it relate to other European capitalistic systems?” from both the theoretical and empirical perspectives, thus deepening the understanding of the role of institutional foundations in Latvia and discovering the similarities and discrepancies with the classic VoC model. The analysis of the research problem leads to the answer to the general research question “How institutional framework affects the formation of capitalism in countries of transition: following the path or finding new ways?”

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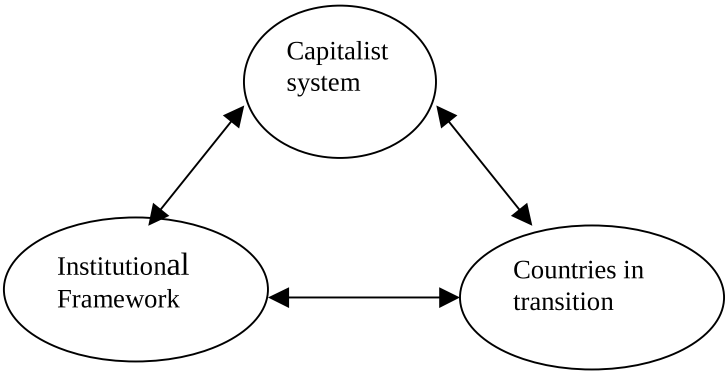
[299] P.A. Hall, D. Soskice (2001), Varieties of Capitalism: The Institutional Framework of Comparative Advantage, Oxford University Press
[300] Ibid.
[301] Specific aspects highlighted by Porter include: attitudes toward authority, norms of interpersonal interaction, attitudes of workers toward management and vice versa, social norms of individualistic or group behaviour, professional standards, attitudes toward travel, language skills and attitudes toward learning new languages, Acts of pure invention, Major technological discontinuities (for example, biotechnology, microelectronics), government policy regarding foreign exchange controls and neutrality, nature of company ownership, corporate governance, and company goals, nature of capital markets and capital formation, Individual goals and reward systems, attitude towards individual wealth, Individual attitudes toward skill development and toward company activities, immigration policies, attitudes toward risk taking, influence on national prestige/priorities on goals, willingness to maintain a sustained commitment.
http://members.tripod.com/hewoodward/Global%20Competitive%20Advantage.htm
[302] Hill, Charles W.L. (2002), International Business: Competing in the Global Marketplace: Postscript 2002, third edition, McGrawHill Irwin

Theoretical study uncovered variety of possible classifications of capitalist system in Europe. The long history of capitalism have been ground for scholars diverse research and analysis. This paper though focused on quite recently developed VoC model, which classifies countries into three groups - ones with liberal market economy, co-ordinated market economy and Mediterranean one. The classical VoC model though, whose primary goal was to classify capitalist systems of developed countries, did not cover countries in transition which occupy significant part of Europe and whose coverage is vital to evaluation of the overall European situation. Three elements: capitalist system, institutional framework and countries in transitions formed the basis for the work.



The specifics of the countries in transitions have been underlined many times in the work. The one expected question would be “Is the VoC framework built for developed European countries good to study CEE countries?” In the introduction, rationale for the application of VoC model to LCSs was given. However, there are still many uncertainties regarding the feasibility of application of this model to this type of countries. Rapid transitional changes may negatively impact the credibility of the proposed model. The distinction between economical and judicial *de facto* and *de jure* situations does not help in clarifying the situation as well. Nevertheless, it was considered viable to apply this model to the countries in transition as theses countries are also capitalist countries; their institutional framework is more or less the same despite some left rudiments of centrally-planned system; at the moment, they take active measures to become members of the EU and make considerable progress on the way of economic development and integration. Apparently, the transition from centrally planned to market economy in the Eastern Europe and the transformation of West European capitalism may not be as incomparable as they appear at the first sight.

One of the conditions for the formation of capitalist system is the establishment of institutional framework. Their development, in turn, affects the creation of the socio-economic system. This reciprocical interrelation in regards of LCSs reminds the everlasting dilemma “Who was first – egg or chicken?” In other words, is institutional change a prerequisite for shaping capitalist system, or do institutions just follow changes in a society? It appears, that there is no simple answer to this rhetorical question.

The structure and operations of the institutional foundations are a matter of national government. In the meantime, the EU has the competence to legislate in the certain fields and under principle of the supremacy Community law shall prevail upon national law[303]. In increasing integration and globalisation conditions, institutions and regulatory instruments retain their national competencies and differ from country to country so that no united model can be identified. But does the lack of harmonisation constitute a problem? Is there a need for convergence or the above situation does not preclude successful integration process? These questions become the central ones for the legal part of the thesis. Legal part contributed to the study in two major ways. Firstly, it highlighted the interdisciplinary nature of the topic, which encompasses political, legal and economical elements. Secondly, it raised the issue of convergence between socio-economic systems. In the legal part it was done through assessment of the notion of harmonisation between jurisdictions, which received its development in empirical part of the thesis (see chapter 3.3.).

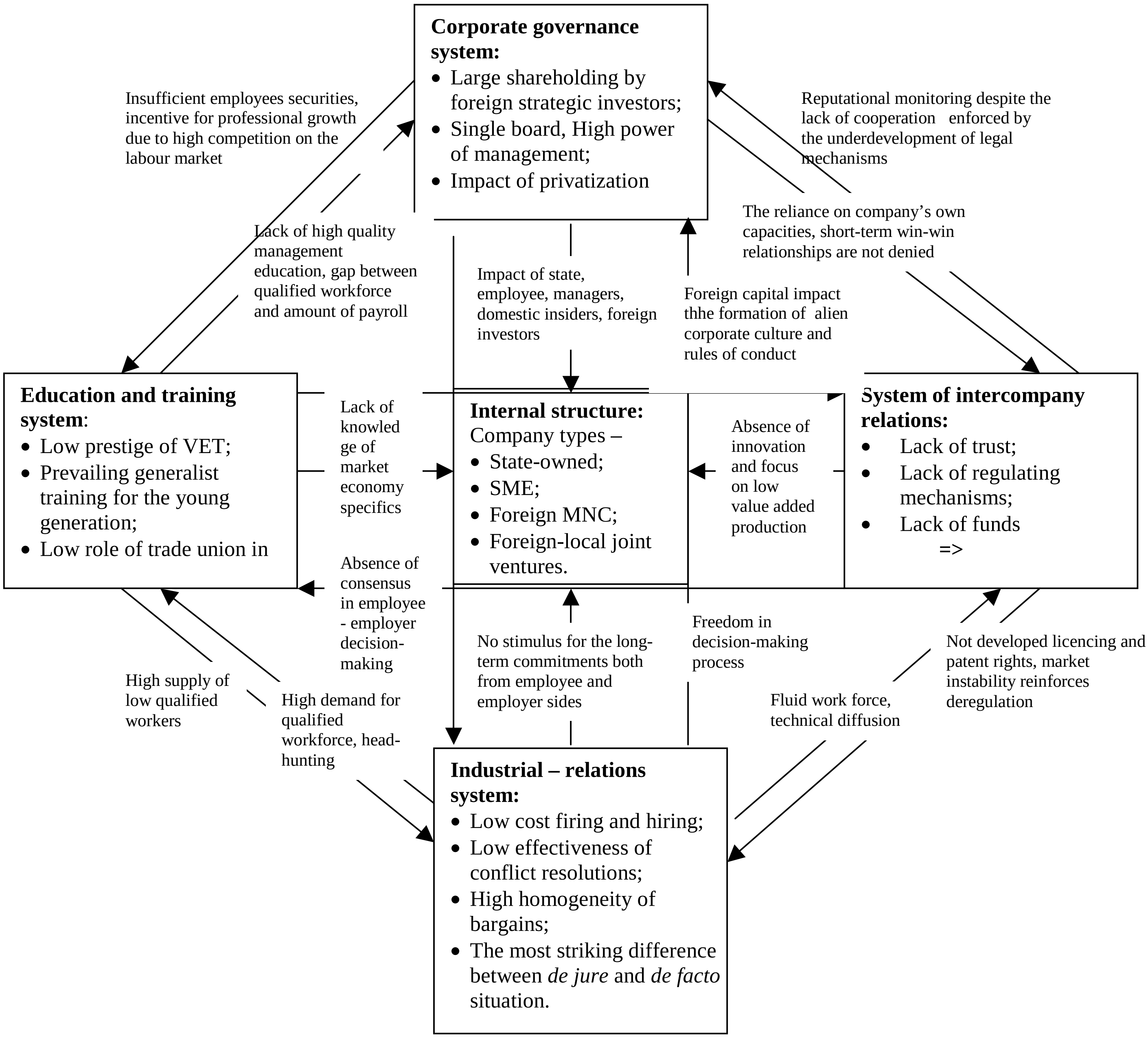
The upcoming enlargement will increase diversity of member states not only in terms of level of economic development, but also in terms of economic governance structures and also cultural contexts. There is a view, that "although the Commission's impact on candidate countries was far reaching, its actual outcome was more the *consolidation* of new market economies than *convergence* of their governance structures. The EU's converging impact on the substance of corporate governance, industrial relations or education policy in the candidate countries did not go much further than in the case of the current member states". [304] Indeed, national governments are not intended to give up their power and competencies in the traditionally MS governed fields as taxation, company law etc. The tiny possibility of competence between legal systems also is viewed as a positive phenomenon, particularly by the followers of liberal market model. The last point in this controversial debate is the author´s belief that despite the non-harmonized, diversified space of European Union socio-economic systems it need stability, safety and development as three main whales on which its prosperity will be based in the future.

Empirical analysis was presented in the form of case study of Latvia. The empirical part explored the specifics of the five element s of VoC model in its application to the countries in transition and attempts to identify the country's institutional framework and modifications caused by local environment to the variety of capitalist model. It is the part, where the answer on the key question "Which of the varieties of capitalism does Latvian system represent and how does it relate to other European capitalistic systems?" hides. It was highlighted, that, the open transition economies can be characterized by both a variety of institutional influences and the cohabitation of old and new forms of economic organization. The study of Latvia presents the unique model of capitalism, which has similarities and discrepancies with all three basic models. Apparently, it is impossible to suggest one model of developed capitalist countries that Latvia would follow. Despite providing an evident answer to the posed research question, the study uncovered the complexity and interrelation of the elements of CEE countries institutional frameworks and also its impact on the company, a central actor of the VoC model. Summary at the end of each VoC element sketched a comparative picture of Latvian and LME

[303] Principle of supremacy was first developed in the case 6/64, Costa v. ENEL
[304] Jucevicius G. (2003), Developement of the European Socio-Economic System. Increased Divergence of Capitalist Systems Inside the Enlarged EU?

and CME models. As a final remark, the graphical model relevant to the countries in transition and more specifically, Latvia, is suggested.

Complementarities Across Subsystems in the Economy of the Countries in Transition (Latvia)



6.2. Proposals For Future Research

The subject of this thesis is very extensive and reveals a lot of related issues and actual problems that could be studied further in more depth and width.

First of all, EU's influence on the national institutional frameworks may be studied in more depth, particularly in respect of countries in transition. To what extent the European institutions affect a country's institutional framework? Will the EU membership bring changes to the institutional framework of the accession countries? And if yes, when and what kind of changes? Are there still any institutions in the countries in transition which may be regarded as controversial to the EU in the enlargement perspective, and what would a change of these institutions mean to the overall country's capitalist system?

Still another interesting field for further research might be the implications and variations in company strategies caused by the changing context of membership and complete incorporation of "*acquis communataire*". Impact of a country's institutional framework on a company's corporate strategy also may be studied in more depth. The institutional structure does not fully determines the choice of corporate strategy but rather conditions it.[305] It is obvious, that institutional framework and legislation in force impose certain limitations on a company's operations. They also create preconditions for certain industries comparative advantage or disadvantage, more favourable treatment for some than for others. Therefore, corporate strategy of a company is influenced by regulations imposed by government and institutional foundations. How and to what extent – these might be the questions.

[305] P.A. Hall, D. Soskice (2001), Varieties of Capitalism: The Institutional Framework of Comparative Advantage, Oxford University Press

APPENDIX 1: Major Definitions Used in the Study

The major concepts used in the work have quite broad range of interpretations. Therefore below are given definitions used by the author.

"firm"

Any business, such as a sole proprietorship, partnership or corporation[306]. This concept is broadly applied to the companies, business entities and undertakings. Firms are the economic agents that possess the significant influence over distribution of material and human resources of the company. In the meantime, in this work the concept of firm is limited to some extent. It generally do not include natural persons, and companies incorporated under Company law[307].

"undertaking"

One of the drawbacks of the EC Treaty is that it does not provide the definitions of the basic concepts leaving the job of interpretation to the ECJ. For example there is no definition of "goods" in the EC Treaty as well as there is no definition of what the "undertaking" is. The position of the ECJ though is to interpret the word "undertaking" as widely as possible. The Commission follows this concept. The "undertaking" falling under scope of EC Competition Law may be:

- either legal[308] or natural[309] persons engaged in some sort of economic or commercial activity;
- operating both in public[310] and private[311] sphere;
- non-for-profit organisations – NGO´s[312], pension funds[313], etc.;
- they even does not have to be incorporated under Company law[314].

"business system"

Business systems are particular arrangements of hierarchy-market relations that become institutionalised and relatively successful in particular contexts[315]. In other words, business systems are the sum of general practices and value orientations that characterise both the internal organisation of business units and their relations with their external environment.

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306 http://www.investorwords.com/cgi-bin/getword.cgi?1967
307 In case of Latvia the companies are regulated by "The Commercial Law" dated 14.02.2002 (with amendments)
308 As an example there can be mentioned basically every case under scope of the EC competition law, concerning companies incorporated under Company law, and performing economic activities with the view to gain profit.
309 The Commission even held in the Commission Decision 78/516/EEC Re UNITEL that an opera singer is an "undertaking" under the scope of Art. 81, 82.
310 Case 95/99, Satellimages TV 5 SA v Commission of the European Communities
311 Case 453/99, Courage Ltd v Bernard Crehan and Bernard Crehan v Courage Ltd and Others
312 Case 7/82, GVL v Commission
313 Joined Cases 180/98 and 184/98 Pavel Pavlov and Others v Stichting Pensioenfonds Medische Specialisten
314 Faull J. and Nikpay A. (1999), The EC Law of Competition, Oxford University Press
315 Whitley R. (1992), European Business Systems: Firms and Markets in their National Contexts, SAGE Publications,

“institution”

The wide definition of institutions is used in the work. It is considered that institutions are the set of rules, formal or informal, that actors generally follow, whether for normative, cognitive, or material reasons, and organizations as durable entities with formally recognized members, whose rules also contribute to the institutions of the political economy[316].

“corporatism”

A specific socio-political process in which organizations representing monopolistic functional interests engage in political exchange with state agencies over public policy outputs which involves those organizations in a role that combines interest representation and policy implementation through delegated self-enforcement.[317]

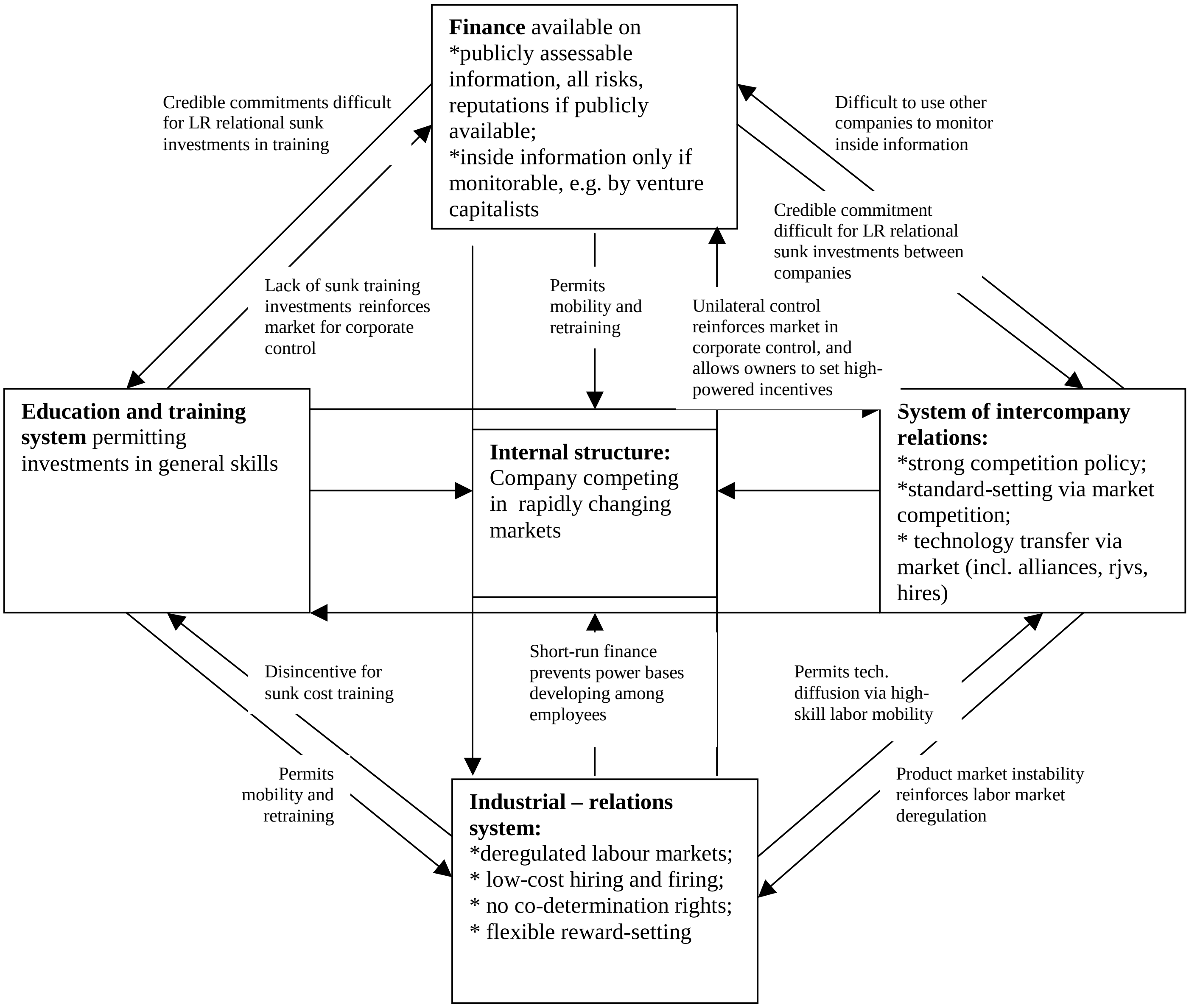
APPENDIX 2: The Distribution of Capitalist Systems in the Europe

LME	CME	Mediterranean	CEEC
Great Britain	Germany	France	Hungary
Ireland	Austria	Italy	Poland
	Finland	Spain	Slovakia
	Denmark	Portugal	Romania
	Sweden	Greece	Slovakia
	Norway	Turkey	Latvia
	Switzerland		Estonia
	Belgium		Lithuania
	The Netherlands		Bulgaria
	Luxembourg		Czech Republic
			Malta

Source: based on data by Hall and Soskice (2001), Varieties of Capitalism: The Institutional Foundations of Comparative Advantage

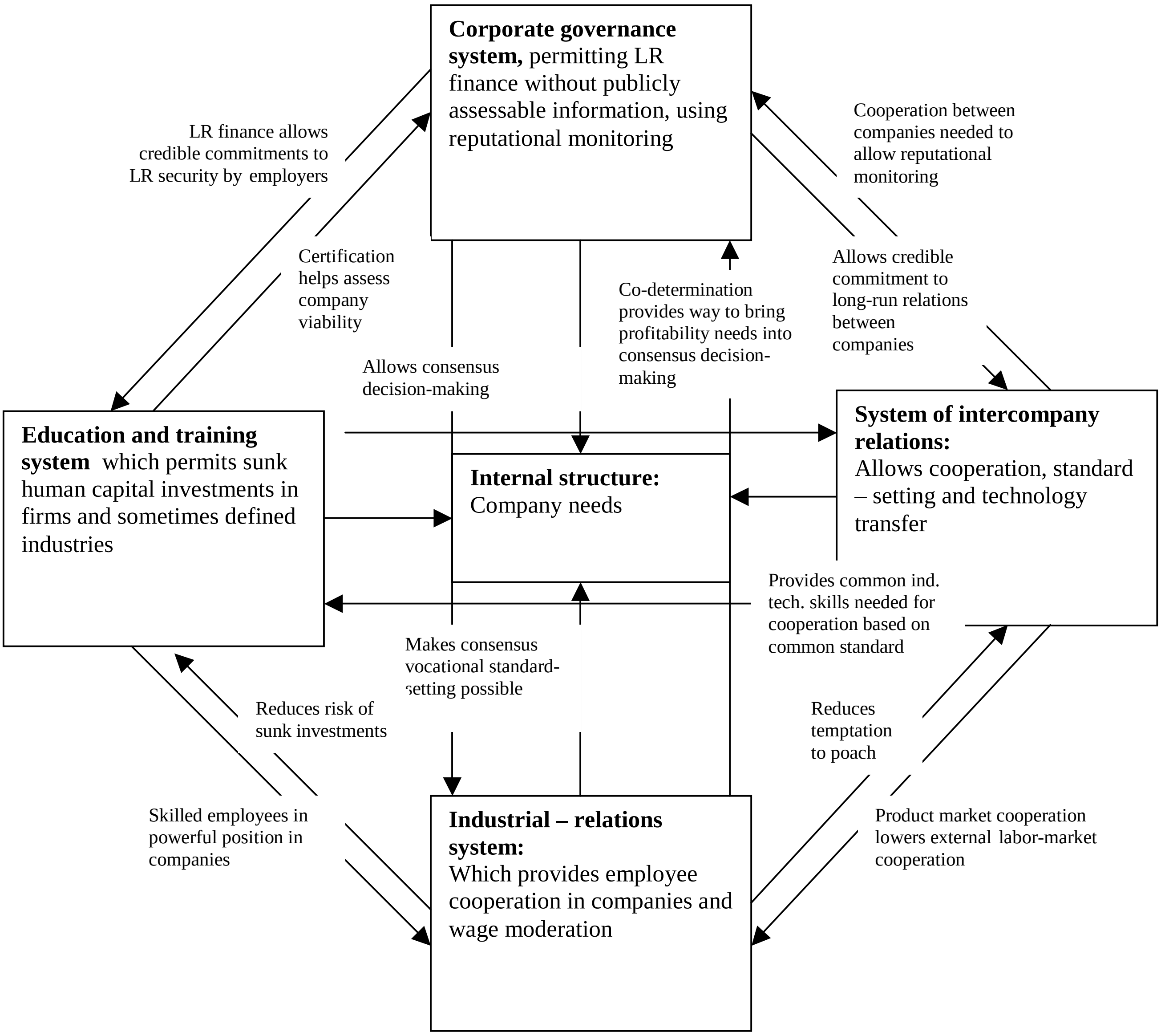
[316] P.A. Hall, D. Soskice (2001), Varieties of Capitalism: The Institutional Framework of Comparative Advantage, Oxford University Press
[317] Van Gerven W. (1996), the Legal Dimension: the Constitutional Incentives for and Constrains on Bargained Administration, book: Constitutional Dimensions of European Economic Integration, Kluwer Law International

APPENDIX 3: Complementarities Across Subsystems in the American Liberal Market Economy



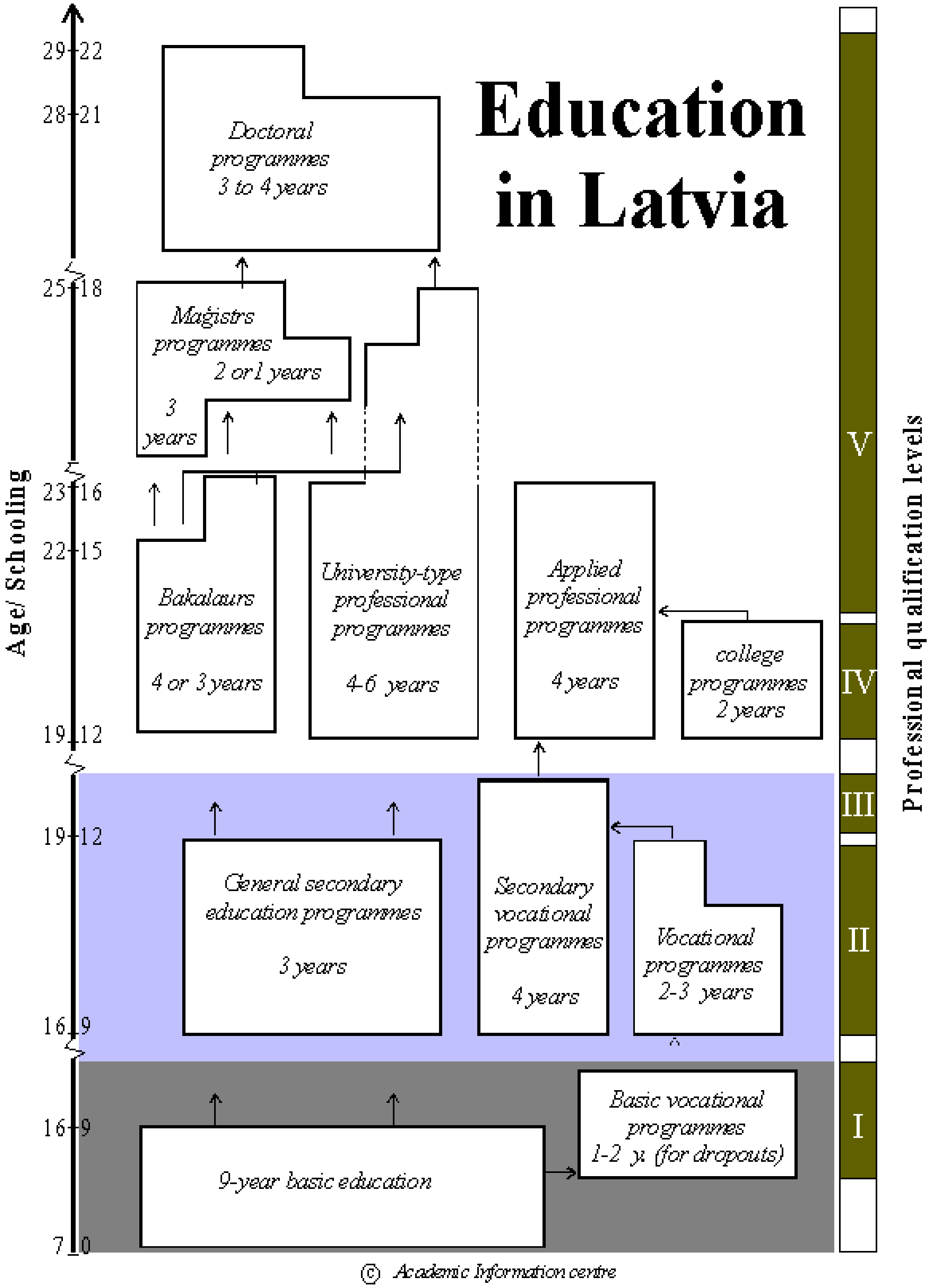
Source: Hall and Soskice (2001), Varieties of Capitalism: The Institutional Foundations of Comparative Advantage

APPENDIX 4: Complementarities Across subsystems in the German coordinated market economy



Source: Hall and Soskice (2001), Varieties of Capitalism: The Institutional Foundations of Comparative Advantage

APPENDIX 5: The Structure of Educational System in Latvia



Source: Academic Informaiton Centre

APPENDIX 6: Institutional Framework of Education System in Latvia

The key players for the implementation of employment policy in Latvia are:

The Ministry of Economy – the institution co-ordinating the implementation of the National Employment Plan.

The Ministry of Welfare - responsible for the labour market policy with a focus on combating unemployment.

Ministry of Education and Science – national authority for the human resource development policy, including all levels and types of education and training.

Latvian State Employment Service – a state non-profit joint stock company under supervision of the Ministry of Welfare, carries out labour market activities in the form of active labour market measures (i.e. retraining of unemployed, job-seekers clubs and temporary social works). LSES has 28 regional centres and 34 local offices.

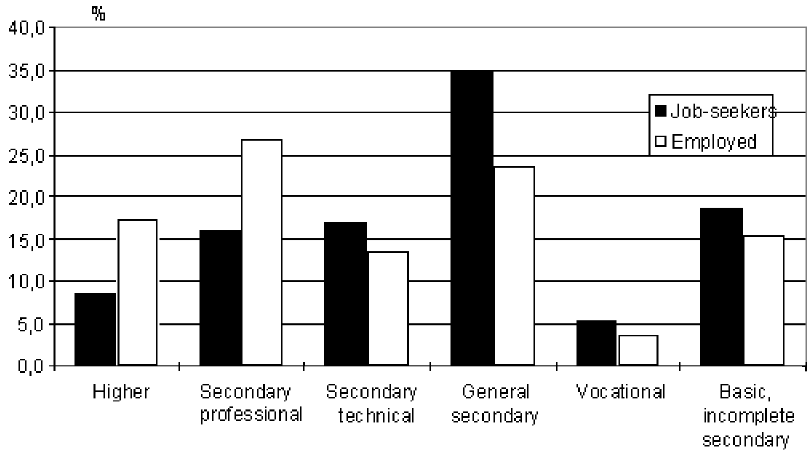
The Professional Career Counselling Centre (PCCC) is a state non-profit organisation under supervision of the Ministry of Welfare, providing advice on education and career choice issues to students and adults, the latter – mainly unemployed ones.

Centre of Professional Education (CPT) is the national authority in the matters of content and provision of Vocational Education and Training (VET) in Latvia, acting as the main education and training support institution in curricula, methodology and VET teacher training issues.

Vocational Education Development Programmes Agency is a state non-profit organisation promoting vocational education and training policy implementation and strategy development[318].

[318] National report to the European Training Foundation: Vocational Education in Latvia Academic information centre - Latvian National Observatory, Riga, 1999

APPENDIX 7: Education level of employed persons and job seekers (percentage out of total amount)



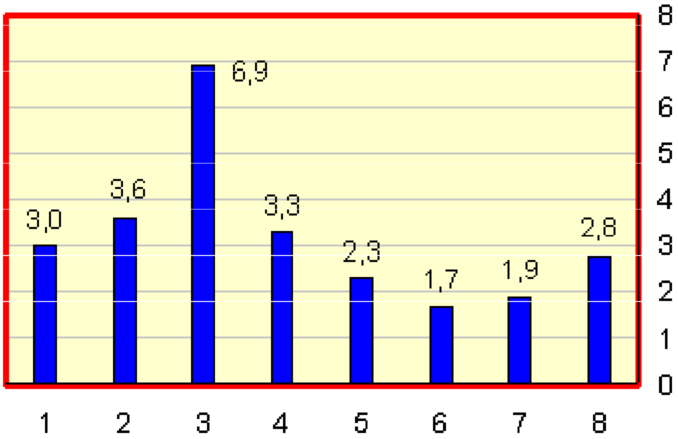
Source: www.izm.lv

APPENDIX 8: Number of PhD Students Who Received Academic Degree in Europe in 2000

State	Number of PhD Students	% of Total Number of Students	Number of Received Degrees	% of Total Received Degrees
Europe Total	**250 000**		**45 000**	
Sweden	18 000	5,30 %	3 100	7,50 %
Finland			1 165	6,80 %
Checz Republic	11 500	6,60 %		
Slovenia			206	2,40 %
Estonia	1 251	2,70 %	135	2,70 %
Lithuania	2 023	2,40 %		
Latvia	**1 301**	**1,20 %**	**37**	**0,20 %**

Source: http://www.izm.lv/lv/Statistika/parskats2001/8.5nod.htm

APPENDIX 9: Correlation Coefficient of Applications According to the Educational Fields

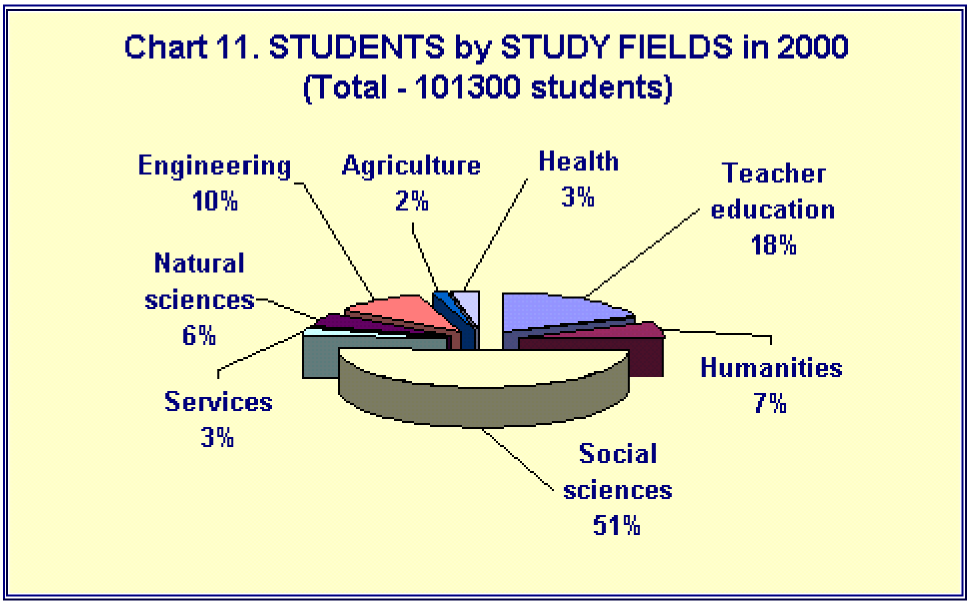


Educational fields:

1. Teachers´ education and educational sciences
2. Humanitarian sciences and arts
3. Social sciences, entrepreneurship, legal sciences
4. Natural and environmental sciences and mathematics
5. Engineering sciences and technology
6. Agriculture
7. Health and social care
8. Services

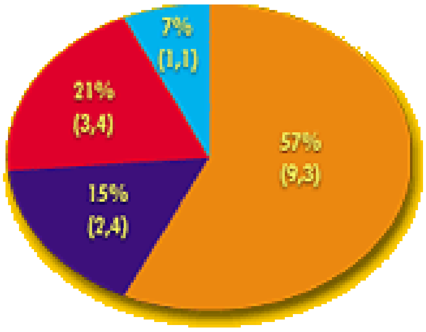
Source: Ministry of Education and Science of Latvia

APPENDIX 10: Students by Study Fields in Latvia in 2000



Source: Ministry of Education and Science of Latvia

APPENDIX 11: Sources of Finance for R&D in Latvia



State Budget	57%
Other Sources	7%
Foreign Sources	21%
Business Enterprise Sector	15%

Source: www.izu.lv

APPENDIX 12: Main Types of R&D Institutions in Latvia

Institution Type	**Number of Institutions**	
	1996	**1999**
State research institutes	26	12
Other state research organizations	16	15
Higher Educational Establishment	11	12
University research institutes	7	20
Research units in the business enterprise sector	35	30
TOTAL	**95**	**89**

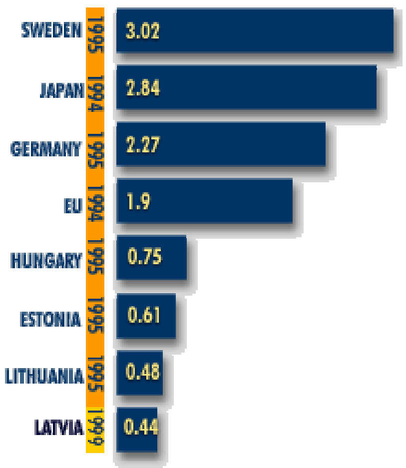
Source: www.izu.lv web page

APPENDIX 13: The Number of Scientists per 10 000 Residents in European Countries

Country	Year	%
Latvia	**1998**	18.6
Estonia	1998	34.8
Lithuania	1998	24.0
Hungary	1995	26.0
Poland	1995	29.0
Denmark	1995	57.0
Finland	1995	67.0
Sweden	1995	78.0
EU	**1995**	**49.0**

Source: The yearly statistics books of Estonia, Lithuania and Latvia; OECD (1998)

APPENDIX 14: Percentage of The State Budget, Allocated to R&D in European Countries



Source: www.izm.lv

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