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## BALTIC COUNTRIES AND THE BALTIC REGION

**Abstract:** This paper studies social, economic and other developmental trends in the Baltic countries: Estonia, Latvia and Lithuania, after the collapse of the Communist rule in 1991. Attention is paid to some essential changes in the transition from the centrally planned economy towards a market economy. The Baltic Region has been seen from outside as more solid than it is in reality. The Baltic countries differ from each other in many respects. For example, there are differences in privatisation processes. In Estonia the economic development has been faster than in the other two Republics. All three countries have applied for European Union membership. Although the economies of the Baltic countries have come rather close to an industrial structure prevailing in the market economy, the qualification for membership still implies a great amount of catching up.

**Key words:** institutional change, economic transformation, social and demographic transformation, EU integration.

### 1. TOWARDS DEMOCRACY AND MARKET ECONOMY

The Baltic countries, Estonia, Latvia and Lithuania, are former Soviet Republics. They obtained their independence after the collapse of the Communist rule in 1991. The Soviet period connected the Baltic countries with many ties to the Soviet Bloc. A great number of Russians moved to these countries, where they became a large minority. All three Baltic countries were agrarian societies before 1940, Lithuania more than the others. Under the Soviet regime the industrial sectors of the countries were to a great extent developed on the basis of division of labour. Estonia specialised, among other things, in engineering and metal-working, Latvia in electric railroad passenger cars and consumer goods, such as radios and refrigerators, and Lithuania in food processing, shipbuilding, and the

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manufacture of electrical machinery. Disruption of trade ties with the former Soviet republics resulted in a decline in industrial production in 1992. In the 1990s services have grown in importance in absolute and relative terms, and are now a dominating sector in all three Baltic countries.

In sum, the Baltic countries had different economic starting points in their ways to market economy. What is in common in all the countries is that the disruption of ties with the former Soviet republics resulted in a decline of industrial production, as well as in tensions between the native population and the large Russian minority. The first years of the 1990s were characterised by strong industrial changes which were gradually leading to economic growth. For example, in Estonia, the year 1995 showed the first positive figures of GDP. In terms of economic development, Estonia seems to have better conditions for integration with the European Union than the other two Baltic countries. Estonia has, however, experienced serious troubles with handling their minorities. The status of the minorities in the country seems to be a real barrier in Estonia's way towards the European Union. On the other hand, all Baltic countries have restored their democratic constitutional institutions in such a way as needed for making a transition to market economy.

The Baltic countries form a region having a certain strategic importance from the EU's point of view. However, the Baltic countries differ from each other in many respects, both in structural characteristics and developmental trends (table 1). Co-operation between these countries has not always been without problems. Sometimes the Baltic Region has been seen from outside as more solid than it is in reality. For example, the EU is preparing a policy framework for the Baltic entity rather than for individual states.

Table 1. Basic demographic and geographic data on the Baltic Republics

Indicators	Estonia	Latvia	Lithuania
Population, 1 June 1996 (1000)	1 484.1	2 491.5	3 708.5
Area (1000 km <sup>2</sup> )	45.2	64.6	65.3
Frontiers (1000 km) land/sea	0.6/3.8	1.3/0.5	1.7/0.1

The forms of interaction in the area around the Baltic Sea have always involved strategic elements. Even during the last decade of the cold war, Northern Europe and especially the Baltic Region was an important part of the power game of the United States and the Soviet Union (Jonson, 1990; Dawisha and Parrott, 1994, p. 45). Thus the collapse of the Soviet Union in 1991 changed dramatically the Baltic sphere. In a global perspective it practically turned from a politically strategic focus of competing states to an economically strategic residual of competing corporations. This is quite a natural change from the viewpoint of 'post-modern microeconomisation' of various social processes from the core

of political system to the semi-periphery of economic system (Karppi, 1995, p. 18–19).

As a reaction to the threat of this residualisation and peripherisation various public and private actors around the Baltic Sea have initiated processes for promoting an integrated entity of the Baltic Region. These processes include major projects for developing infrastructures in the region, such as the *Via Baltica* highway running from Poland to the Estonian capital, Tallinn, and from there further on, via a ferry link, up to Helsinki in Finland.

It would be somewhat misleading to speak about a totally new birth of the Baltic Region in the form of the state system that has been prevailing since 1991. The three Baltic states existed already in the inter-war period between 1918 and 1940. In many cases, the new independence of the Baltic Republics was interpreted as the continuation of their pre-Second World War existence of independence. This is reflected also in the readiness of the Republics to participate actively in the multilateral decision-making, the activity far beyond a narrowly oriented concentration on the issues defining their relations to Russia.

## 2. KEY ASPECTS OF TRANSFORMATION

### 2.1. Organisational and institutional changes

Changes in public and private systems of governance would be hard to separate from each other. At least partially they have a common origin: fragmentation of the Soviet politico-economic system that used to encompass functions that in market economy are differentiated to either public/governmental or private/economic institutions. Moreover, the historical backgrounds are an inseparable part of the process that was triggered by the August 1991 *coup d'état* in the Soviet Union and the disintegration of the state at the end of the same year (cf. Gorbachev, 1991, p. 67). Instead of signing the treaty on new Union, or what was to become the Commonwealth of Independent States (CIS), Baltic Republics left the USSR during the turmoil of the coup.

Because the Baltic Republics existed as independent nations before the Soviet annexation in 1940, they were in no need to present themselves as new actors of international community. The newly independent Baltic Republics tried, in many respects, to continue developing their legislation and institutions in the 1990s on the grounds they were forced to abandon in 1940. The new status of the Baltic Republics was interpreted as the continuation of the existence of these republics from the 1930s. However, the role of old structures should not be overemphasised.

This fact can be reflected in the readiness of the Republics to actively participate in the multilateral decision-making – an important feature in the preparation of the future EU Baltic Region policy (cf. Christensen, 1995). Thus the development of the external relations of the Baltic Republics has differed substantially from that of some partners of the CIS, such as Belarus and Kazakhstan and Tajikistan. Unlike the CIS countries, the Republics have carried out a much wider range of activities in this field, instead of concentrating mostly on the issues that define their relations to Russia as the successor of the Soviet Union.

The historical backgrounds have other consequences as well. For example in Estonia, the legislation of the 1930s was used as a constitutional instrument when the Republic fought its way towards the restored independence from 1987 to 1991. In 1987–1988 the main aim was economic autonomy, which was promoted in the framework of the Soviet legislation. From 1989 to 1991 the aim was a national independence, and constitutionally it was based on legislation of the 1930s. In this very same example we find also a feature typical to all transition economies: the institutional lag in the transition. However, this institutional lag could be seen as still leaning on the socialist institutions on the one hand and restoring the old institutions from the pre-socialist era on the other. This type of development was more clearly seen in the Baltic Republics than in other transition economies.

The laws that were inherited from the Soviet era were now overruled by the institutional arrangements paving the way for structures of a market economy. However, the process of establishing institutional frameworks is remarkably slower than the flexible changes in micro-economic units: enterprises and households. The effects of the institutional lag are accelerated by privatisation based on both economic and ideological motives. The ideological motives are partially related to nationalistic sentiments in dismantling large economic units as fortresses of Russian influence. The outcome is obviously a turbulent and unpredictable operation environment for actors who are not familiar with such circumstances – particularly for foreign enterprises and investors.

Fuglsang and Pedersen (1995) have classified nine social groups that have different strategies in coping with changes in all transition economies. In this classification quick structural changes and the creation of new institutions are in the interest of so-called revolutionaries. This group consists of members of previous underground oppositions, and it gained political power immediately after the collapse of the old system. The weakness of this group is that it does not always have enough knowledge of the mechanisms of market economy. Moreover, its interests conflict with the more individualistic attitudes of some other influential groups, such as new entrepreneurs.

Unbalanced organisational and institutional changes are a feature common to all societies going through a rapid and profound change (North, 1993, p. 75–76; Kivikari, 1991, p. 2; Huntington, 1975). In fact, in a comparative risk assessment

made in 1994, all Baltic Republics showed a trend quite different from all other transition economies (with the exception of the new German *Länder*). Although foreign investors' risk in the Baltic Republics is still relatively high on the European comparison, it is decreasing. It deviates from the current development in some Central European Visegrad countries where it is increasing rather than decreasing. This gives a picture of the evolution of stabilising legal/institutional frameworks in the Baltic Republics. In Estonia the development has been faster than in the other two Republics. For example, according to Liuhto (1994, p 12), the Estonian markets have now reached a stage where foreign enterprises are ready to operate even without significant participation of local partners. In other words, foreign enterprises do not have to choose a joint venture strategy as a means to cope with insecure and highly unpredictable business environment in the country in question. Especially in Lithuania development in this respect has been remarkably slower.

## 2.2. Local development

The question of institutional change can hardly be distinguished from the trends in local development and administration. In fact in the Baltic Republics the development of local governance is primarily a question of breaking down the command systems and replacing them with democratic local government. However, the lag in legislation already mentioned is a crucial problem in the systematic transformation of local level administration (e.g. Mäeltsemees, 1994, p. 84; Mäeltsemees, 1995, p. 136). Moreover, the lack of resources and knowledge makes the problem even harder to solve. Another important factor making the development of local administration difficult is the primacy which the central state organs have given to privatisation and macro economy, paying less attention to local administrative reforms.

In chapter 2.3 we will take a closer look at the privatisation processes, including municipalisation, which is not only a part of the ownership reform but also closely related to administrative reform and local development. Municipal ownership of property did not exist under the Soviet rule. As far as new democratic systems of local government are concerned, fiscal self-government (revenue and tariff policy) that creates a needed resource base for local policy-making is of great importance. It is worth noting that local administrative units are small according to the North European standards. Thus we expect a drastic reduction in the number of rural municipalities when the Baltic states integrate more closely to the EU-European structures.

Another feature common to all three Republics is the urgent need to acquire competent personnel to work on local as well as regional planning and development. For example in Estonia the Estonian Management Institute has initiated a

range of targeted short courses for local administrators as well as more comprehensive professional development programmes with main emphasis on operations in business environment (cf. Tomson, 1993).

In all Baltic countries a significant feature in local level units is the differences in ethnic structures between the urban and rural areas. For example, at the beginning of the transition period, 87.5% of the population of rural Estonia were native Estonians. In urban areas this percentage was only 50 (Keskspaik *et al.*, 1994, p. 75). This gives us an insight of the dynamics of how urbanisation proceeded in Estonia. This development was significantly a question of security and economic policy. The Soviet military strategy (cf. Jonson, 1990) saw it crucial to secure the strategically important area of a potential bridgehead with 'loyal', native Russian population. This resulted also in modernisation of the Baltic economies, which were agriculturally oriented in the 1940s. Especially Estonia and Latvia became engaged in strategic and often environmentally hazardous production units and power plants to meet the needs of the Soviet empire. One obvious consequence of this policy in Estonia is the fact that the population of Tallinn is today half Russian, and that of Narva almost totally Russian.

In terms of distribution of population between urban and rural areas, the three Baltic Republics form three different patterns. In Estonia, 37% of the population live in two largest cities: Tallinn has 453 000 inhabitants and it is four times of the size of Tartu. In Lithuania the situation is somewhat different, with a clear division of labour between three major centres: Vilnius (capital city, administration), Kaunas (industry, education, commerce) and Klaipeda (seaport). Thus, only 16% of the Lithuanian population live in Vilnius (pop. 590 000). Latvia's capital city Riga (pop. 897 000) is the largest city in the three Baltic Republics. Half of the Latvian population lives in the Riga Metropolitan Area (*Vision ...*, 1994, pp. 22–25).

### **2.3. Economic transformations**

#### **2.3.1. Privatisation processes**

Privatisation is related to restitution or compensation of properties. Moreover, property that has been accumulated during the Soviet era must be redistributed, and property rights must be defined. This concerns private and public, that is state and municipal, ownership. Private ownership is needed for establishing efficiently functioning and evolving market economy. An important prerequisite for this is a just distribution of property. This determines at least partially the forms of privatisation. State and municipal ownership will obviously remain in

some industries (natural monopolies). This is mainly due to the limited size of domestic economies of the Baltic Republics. However, privatisation is a part of the democratic development in the Baltic States, and it plays a vital role while these countries are integrating with the European Union.

Ownership reforms have been cornerstones for implementing market economy in the Baltic States. The aim of these reforms is similar in all three countries: to rearrange ownership relations based on the principles of equality of different ownership forms, on the inviolability of property, and on the compensation of the injustices done in property expropriation. The reforms involve two processes for restructuring property relations. The first one is to restitute or compensate the legal owners or their legal successors for properties which were in private ownership before the Soviet occupation. The second one is to transform properties created during the Soviet regime from public into private ownership or to keep them in state or municipal ownership. Thus, ownership reform involves:

- reprivatisation (restitution and/or compensation);
- clarification of the state's ownership rights;
- privatisation of state-owned assets (land, enterprises and dwellings);
- municipalisation.

Reprivatisation is carried out through restitution, replacement (in the case of lost land property) or compensation. This has led to a great variety of legislative processes and adoption of new regulations in all three countries. The principles of reprivatisation are to a great extent similar in all three countries, although there are some minor differences (*Economic and social changes...*, 1995, p. 3).

In Estonia 'compensation vouchers' are used for compensation of properties. In Latvia they are called 'privatisation vouchers'. In Lithuania 'investment vouchers' are used for the same purpose. The main ways of restitution are privatisation certificates in Estonia and Latvia, whereas in Lithuania money, shares of state capital or a plot for building a private house are being used (*Economic and social changes...*, 1995, p. 4). The principles of distributing vouchers to residents vary significantly between the Baltic states. The principles are based on (*Economic and social changes...*, 1995, p. 8):

- the years of employment in Estonia;
- the length of residency in Latvia;
- the age of residents in Lithuania.

By the end of 1994 municipalisation was mostly completed in Estonia and Latvia, but the process was still going on in Lithuania (*Economic and social changes...*, 1995, p. 16–17).

According to the EBRD *Transition report* in October 1995, Latvia has been slowest in the area of privatisation of large enterprises, only a few state-owned companies have been privatised. In Lithuania more than 25% and in Estonia more than 50% of larger state-owned enterprises have been privatised. Small

companies have all been privatised in all Baltic countries, but the sale of real estate and land remains problematic (Pautola, 1996, p. 24).

Estonia and Latvia have used a privatisation method adopted in Germany: enterprises are sold in a competitive bidding, which is also open to foreign investors. Moreover, important criterion of acceptance of the bid is the competitors' commitment to develop the purchased business (e.g. through investments) and to offer job opportunities. The positive aspect of this privatisation method is the money it brings to the state, although the progress is rather slow.

### 2.3.2. Foreign investments and capital flow

Attracting foreign capital into the Estonian economy has turned out to be one of the most practical ways to develop foreign economic relations necessary to help integration of the Baltic states with the world economy (cf. Vitsur, 1995, p. 217). Foreign investment is usually accompanied by foreign know-how, management culture, and new markets for goods. Foreign investment also contributes to integration, co-operation, and security among countries.

In 1992, Estonia was able to attract 58 million USD of foreign investment, Latvia 43 million USD and Lithuania 27 million USD. From 1992 to 1994 the amount of foreign investment increased in all three countries, most in Estonia and least in Lithuania. In comparison with the other transition countries in Central and Eastern Europe, Estonia held the second place in per capita investment from 1989 to 1994, after Hungary and before the Czech Republic.

Since 1989 several laws have been adopted in all three Baltic countries for promoting entrepreneurship and persuading foreign investors (cf. Lugas and Vistur, 1996, p. 74; Dovladbekova and Karnite, 1996, p. 102; Tamosiunas and Vilkas, 1996, pp. 131–132). It is obvious that foreign investors prefer countries which offer privileges to investors. Opportunities for the expansion of markets are of great importance. Because of the limited size of the population and economies in the Baltic states, it is crucial to ensure further opening of the eastern market. Attention should be paid to the development of economic and political relations with Russia and other CIS countries (cf. Lugas and Vistur, 1996, p. 98). According a survey study (Tamosiunas and Vilkas, 1996, p. 160) in 1995 the Baltic countries were considered as attractive areas for investments as Romania. They came after Poland, the Czech Republic, Hungary and Russia. The three most important motives of the investors concerning the Baltic countries were that they form a potential market, have geographically a favourable location, and have economic potential.

Until 1994 most foreign investors in Estonia were from Finland, Sweden and Russia. Finnish entrepreneurs have been the most active investors. Finnish capital is being invested in more than half of the new firms with the foreign partici-



pation (Lugus and Vistur, 1996, pp. 95–97). In Latvia, the largest foreign partners in terms of invested capital are Denmark, the United States and Germany (Dovladbekova and Karnite, 1996, p. 49) and in Lithuania, the United States, Germany and Great Britain (Tamosiunas and Vilkas, 1996, p. 69).

### 2.3.3. Job creation

The economies of the Baltic countries declined in the years 1991–1993. The development of the economy turned for the better in Lithuania in 1994 and Estonia in 1995. In both countries the economic growth was about 3% in 1995. In Latvia, the economy was still declining. There were differences between industrial sectors in all Baltic countries. Manufacturing production was still on the decrease but the services which were undeveloped under the Soviet rule, kept growing. The following figures describe the growth of the service sector from 1992 to 1994: in Estonia the proportion of the service sector of GDP increased from 57% to 66%, in Latvia from 48 to 58% and in Lithuania from 40 to 60%. Tourism is one of the strongly growing sectors, particularly in Estonia. The distributions of employed persons between the sectors differs to some extent from the proportions of GDP, but illustrates basically the same trends.

Disruption of ties with the former Soviet republics resulted in a drastic decline of industrial production in all three Baltic countries. This decline was reflected also in the number of employed persons. Inflation jumped from about 300% in 1991 to about 1000% in 1992, and the balance of trade became negative after 1–2 years of independence. Inflation has come down to some tens of percents but is still high (table 2). Inflation can also be seen in average monthly gross wages and salaries (table 3). However, in spite of these negative figures and trends, the unemployment has been low in each country during the first years of economic reform. In Estonia and Lithuania it was 5% in the beginning of 1995, and in Latvia – 7% .

There are differences between changes in unemployment rates in the Baltic countries. Economic growth in Estonia resulted in a decrease of the unemployment rate in 1995. Latvia's unemployment rate went down as well, but in Lithuania, irrespective of economic growth, unemployment increased. This is probably due to the structural changes in the agricultural sector, the development which is very likely to continue (Korhonen, 1996, p. 48).

A survey research in Tallinn shows that new jobs are being created in many enterprises. According to the data collected in the summer 1996, about 40% of enterprises which were selected by using stratified random sampling indicated that the amount of employees has grown three to 30% during the previous twelve months. About every tenth enterprise indicated more than 30%

growth<sup>1</sup>. The growth was particularly strong in the field of certain services such as in hotels and restaurants, in trade and in export and import activities.

Table 2. Basic macro-economic data on the Baltic Republics

Indicators	Year	Estonia	Latvia	Lithuania
Inflation from the beginning of the year (%)	1991	303	262	350
	1992	953	959	1163
	1993	35	35	189
	1994	42	26	45
	1995	29	23	36
Balance of trade (millions)	Year	EEK	LVL	LTL
	1991	65	n.a.	n.a.
	1992	421	31	306
	1993	-1211	36	-273
	1994	-4588	-141	-1278
1995	-8096	-236	-1248	
Exchange rates against USD December 1995		11.46	0.54	4.00

Source: Bank of Finland. Unit for Eastern European Economies, 2/1996.

Table 3. Changes in average monthly wages and salaries in the Baltic Republics

Indicator	Year	Estonia	Latvia	Lithuania
Average monthly gross wages and salaries, changes as % of previous year <sup>a</sup>	1993	354	n.a.	n.a.
	1994	157	160	217
	1995	48	27	44
	1996	27	9	30

<sup>a</sup> Estonian changes refer to 1st quarter of the year, Latvian and Lithuanian changes are based on situation in May.

#### 2.3.4. Informal sector

In the Soviet Union, informal<sup>2</sup> (or secondary<sup>3</sup>) sector included illegal elements. According to Grossmann (1989, pp. 151–159) during the second half of 1970s,

<sup>1</sup> Preliminary results of a project on social changes and migration pressure in the transition economies of Estonia, Russia, Czech Republic and Slovakia by Kultalahti, Karppi, Rantala and Sotarauta.

<sup>2</sup> The term informal sector refers to those paid work activities that are hidden from a state for tax, social security or labour law, but which are legal in all other respects (cf. Williams and Windebank, 1994, p. 819).

<sup>3</sup> The term secondary sector refers to all activities which fell outside the official mechanisms of the socialist planning and control system (cf. Sik, 1994, p. 4).

75% or more of the households in the urban areas of the Soviet Union derived over 5% of total personal income from informal sector and 15% or more derived more than a half of their total income in this manner. In the Baltic countries the size of informal sector was relatively small during the Soviet regime because they were officially much better provided with goods than other republics in the Soviet Union.

The transition economies, including the Baltic countries, are a special type of capitalism which is influenced by the earlier secondary sector. The instability and crisis prevailing during the transition period find their expression in and are amplified by the spread of hidden and illegal activities. There are several reasons for it. First, it is due to the persistence and intensification of the old traditions of the socialist period. Second, it is caused by new niches which are not yet rigidly regulated and/or are rather uncontrollable because of the weakness of government organs. Third, it is due to general economic difficulties (EMOR, 1995, p. 5, 9). According to Sik (1994), the current East European transition economies are closer to Latin American states in the following respects: state and/or foreign capital has a significant role, the economies are semi-peripheral, and they are relatively poor. According to Rose (1992), the Eastern and Central European states are analogous to the new industrial states of Asia with their large primary sector and the big share of rural population, important semi-legal and illegal sectors, the absence of a routine tax-paying tradition, and new state structures.

In the present situation it is difficult for workers to understand the relation between social benefits they receive and regular taxes they have to pay. Besides, employees do not always know that their labour is used partly or totally unregistered. If the connections between taxes and social benefits are firmly established in reality, there will be fewer of those who wish to participate in the 'black labour' market. In Estonia, the households which have higher income and spend more money, get more informal income. These households are active, enterprising and relatively young. In 1994, Estonian families had at their disposal about 16.84 billion kroons, of which 2 billion kroons (12%) were informal income (EMOR..., 1995, p. 148).

In Estonian enterprises the use of unregistered labour is a method to pay less taxes (social tax) or offer their workers 26% higher wages (evasion of personal income tax). The use of unregistered labour is a way to reduce labour force costs. It gives also opportunities to hire more workers (EMOR..., 1995, pp. 147–148).

The expanding informal economy of transition states will result in the growth of inequality. For example in Hungary, the Gini coefficient of gross income was 0.3 and approached 0.6 in case of illegal individual activity (Sik, 1994, p. 61). This indicates that the increase of hidden activities aggrandises inequality. Since the gross domestic product declines during the period of crisis, informal economy tends to expand at the cost of legal activity. Consequently,

there will be a rapid growth of material and regional inequality. The increase of the informal economy gives rise to the following negative phenomena (EMOR..., 1995, p. 151):

- the decadence of moral standards and the glorification of financial power;
- the spread of corruption and misfeasance by officials;
- the growth of inequality;
- the spread and organisation of crime;
- the emergence of a wide class of poor people unable to guarantee education to their children;
- the increase of regional differences (centre-periphery).

#### **2.4. Development of physical infrastructure**

The Soviet era provided the three Baltic Republics with transportation infrastructure and a network that served the needs of global power, a central planned economy, with vast energy and other natural resources. The infrastructure was clearly designed to emphasise heavy industry that could take the strategic and to some extent even competitive advantage of these means of production (for descriptions of orientations and scales of the Soviet transportation systems cf. Cole, 1978, pp. 171–179). Generally, railway and pipeline systems were there of much greater importance than in Western European countries. On the other hand, both highway and communication infrastructure were dramatically less developed. Moreover, the Baltic Republics had to start their new independence with badly outdated seaport appliances as well as airports that were used to serve mainly the domestic needs of Soviet passenger flights (cf. Lundquist, 1995, p. 139). Additionally, the military-strategic importance of the Baltic area to the USSR reflected in the intensity by which the Baltic airfields as well as the air space were used by the Soviet Air Force. The same applies to the seaports.

The above information makes it is easy to understand the key aspects of development in transportation infrastructure of the Baltic Republics. In traffic the most urgent need has been to update road and highway systems to match the Western standards. Currently the Baltic states are connected to the neighbouring countries via manifold routes and forms of traffic. This refers to the change in the external traffic environment. However, there are also pressures in the internal traffic environment caused by the domestic economic changes. For example, development of telecommunication and road traffic is most essential. Both of these are closely related to the growing importance of service sector.

During the 1990s, four major links connecting the northernmost parts of the contemporary European Union to the European heartland's have been under discussion. One of them, the E 18, emphasises West-East direction. The E 18 Corridor runs from Denmark (Copenhagen) via southern Sweden and the south-

ern coast of Finland to St. Petersburg region (Leningrad *oblast*). One relies heavily on sea transportation from Helsinki to Gdansk in Poland forming a North-South link. Another starts from St. Petersburg and would thus be directly connected to the E 18 Corridor. This is however on a planning stage but another link, Via Baltica, has already begun to take its shape. This Baltic route has most clearly been in the interest of Finland because it gives possibilities to connect Finnish cities and urban centres to Baltic regions by fast and dense ferry links. The alternative link systems must not be seen only as means of transportation and communication. They also provide the Baltic Region and its urban centres with possibilities for strategic specialisation (cf. Andersson, 1994, pp. 31–33).

By and large, seen from the perspective of national and sub-Baltic needs, one of the most acute problem in the Baltic system of transportation is the question of linking the centres with international importance to the spatial structure of each of the Republics. A question of these hinterland linkages, in the case of both railways and roads, shows also explicitly the problems that are due to the former role of physical infrastructure as a part of highly centralised economy. In terms of volumes of a great number of industrial products the Baltic Republics certainly were by themselves a hinterland of the USSR – even if this is not the case when the Republics were observed in qualitative terms. In a variety of more finished industrial products the volume produced by the Republics exceeded many times their population share in the USSR (Kivikari, 1991, p. 14). However, production was centralised in selected regional centres and these centres were connected to federal centres mainly through railway linkages. Thus, a major challenge for the Republics is to develop both infrastructures that connect them to the Western European networks and to create up-to-date national links to effectively connect growth centres to other parts of the spatial system.

## 2.5. Social and demographic transformations

The Baltic countries were the most Westernised among the former Soviet republics. It could be seen for example in the standard of living in Estonia. In the 1980s the per capita living space in Estonia was larger, the life expectancy longer and the infant mortality lower than the average in the USSR. The Estonian SSR ranked first in the number of private cars per 1000 population and of books published per capita (Park, 1994, p. 70). This has obviously given an advantage in the first phase of transition towards market economy. Indeed, according to the assessment of the European Reconstruction and Development Bank on the success of economic reforms in the Eastern and Central European countries, Estonia has ranked second after the Czech Republic.

The post-war labour force participation trends have been fairly similar in Estonia, Latvia and Lithuania. Comparison with the industrialised market

economies shows that a high level of labour force participation is characteristic. This can particularly be seen in Estonia and Latvia. It seems hardly probable that the improvement of pension benefits would reduce the economic pressure for older workers to postpone retirement in the near future. However, future higher incidence of unemployment is more likely to touch the older workers, thus reducing their market activity. Labour force participation has been relatively unchanged among working-age males but the female labour force participation turned to decline in all Baltic countries in the 1980s. The currently ongoing transition to a market economy involves the emergence of unemployment, differentiation in socio-economic status of individuals, divergence in the modes of employment etc. (Puur, 1993, p. 11)

There are differences in population development between three Baltic countries. Compared to Latvia and Lithuania, the immigration has been the greatest into Estonia during the Soviet period (Katus and Sakkeus, 1993, p. 1). Since 1991, international migration has decreased in all three Baltic countries, emigration, mainly to the East, has been much greater than immigration. It has been estimated that that Estonia might lose about 20–30% of its population because of out-migration (Katus and Sakkeus, 1993, p. 13). Recent results indicate that about 25% of employed workers are willing to emigrate at least temporarily or have already plans to do it (cf. footnote 1). However, there are about 1–1.5 million Estonians in different regions of the former Soviet Union. Their potential return migration would likely counterbalance the population development in Estonia (Katus and Sakkeus, 1993, p. 13).

The proportion of foreign-born population in Estonia is 26.3%, of which about 10% are foreign-born Estonians, and of which Russians account for over 65% (Katus and Sakkeus, 1993, p. 6). If we consider all natives and non-natives, three Baltic countries differ strongly from each other: in Estonia the ratio of Estonians and non-Estonians is 3:2, in Latvia the ratio between Latvians and non-Latvians is 13:12 and in Lithuanian the respective ratio is 4:1. In Lithuania non-natives are national minorities and the competition to influence state structures is less important and the problem is interpreted quite differently in Lithuania compared with Latvia or Estonia (Lakis, 1995, p. 174).

Issues concerning the status of minorities have been far more problematic in Estonia than in the other two Baltic countries. There are obviously many reasons for it. Some explanations have been given. According to Katus and Sakkeus (1993, pp. 10–11) foreign-born non-Estonians demonstrate very low knowledge of the local language, a feature which is independent of age. That could be interpreted in a way that the local population has had to adapt to the behaviour of immigrants. Naturally such a situation has created social tensions which have not yet been overcome. In addition, the unified social organisation practised in the Soviet Union has created tensions between the local Estonians and immigrants. Russian immigrants have experienced some social changes as a special attack on

their rights in Estonia or in other Baltic countries (Katus and Sakkeus, 1993, p. 2). Many other tangible factors seemed to push Estonia towards ethnic violence in 1991–1993 (Park, 1994, p. 69). In addition to an ethnically mixed population, among those factors were: the high social cost of economic transition; the sudden drop in the status of certain ethnically identifiable social groups like the Russian-speaking Soviet bureaucracy, the Soviet Army and KGB veterans; the proximity of Russia, which made it very easy to encourage and supply all types of pro-Russian separatist groups. However, in spite of these tangible factors, Estonia's development has generally been peaceful even if the legal rights of the minority groups have been seen unsatisfactory outside the country.

Geistlinger has studied the legal status of Russians in Estonia in the light of public international law and has come to a conclusion that:

Estonia is granted... a considerable scope of discretion, which ethnic, cultural, religious, linguistic and political rights, to what concrete extent and by which means she guarantees.

He emphasises, however, that according to public international law:

The rights of members of (national) minorities that have to be respected and guaranteed by the country where these people reside for a considerable period of time, do not depend on their citizenship. The policies of the Estonian Government to decree Russians to be either aliens or stateless persons, to force them to apply for Estonian citizenship demanding them to comply with rather rigid conditions, to animate all Russians or even force those who are not willing or able to qualify to remain in Estonia for a limited or unlimited period under exigencies of the Estonian Law on Aliens to leave the country and to offer effective rights of cultural autonomy only to those members of these minorities who are at the same time Estonian citizens therefore has to be qualified a breach of public international law (Geistlinger, 1996, p. 120).

The EU is also concerned about the status of the minorities in Estonia. For example Commissar Hans van den Broek mentioned in an interview (1996) that the status of Russians and Russian-speaking people as a national minority in Estonia seems to be a real barrier in Estonia's way towards the European Union.

## **2.6. Spatial patterns of development**

All three Baltic Republics are neighboured by Russia. Lithuania has common borderline with Russian territory due to the Kaliningrad/Königsberg enclave in the Baltic Sea coast between the coastlines of Lithuania and Poland. Moreover, Lithuania has a common borderline with Poland, Belarus and Latvia. Neighbours of Latvia are from west to east: Lithuania, Belarus, Russia and Estonia. Estonia in turn has land border only with Latvia and Russia, the latter borderline being moreover divided in two rather short stripes by the large Lake Peipus. In terms of physical geography, Estonia and Latvia can be called more maritime countries

than Lithuania. The capital cities and population of Estonia and Latvia are concentrated significantly in the seaside areas, whereas in Lithuania e.g. the historical city of Kaunas and especially the capital city Vilnius are inland centres.

As we are dealing with nations with their independence restored little more than five years ago by the time of writing this text, a natural question to arise is one of security related to arise national borders. In this respect the Baltic republics differ from each other, as could be supposed from the previous country descriptions. In this respect, Lithuania can be said to be in the best position. First, it has a population with around 80% of Lithuanian origin – or considering themselves as Lithuanians (cf. Heurlin, 1995, p. 71). Moreover, Lithuania does not have direct border contact with the Russian mainland. In addition to these factors the Lithuanian area is more homogeneously populated than the other Baltic Republics, which is one part of creating stability. From the institutional point of view the political ties of Lithuania to both Poland and Russia are quite well balanced. As to the social aspects of transformation, Lithuania has chosen a pace of change not so rapid as especially that of Estonia.

Unlike Lithuania, both Latvia and Estonia have direct land borders facing Russia. There are also other factors affecting the security aspects of these two Republics. As already mentioned, in comparison with Lithuania, they are more heterogeneously populated with few major urban centres. However, what is obviously more important cause of potential problems are ethnic relations. In Latvia only 54% of the population are ethnic Latvians, whereas in Estonia some two thirds of the population are 'true' Estonians, i.e. citizens of the first Estonian Republic from the inter-war period or their descendants. Moreover, by mere volume of population, Latvia and Estonia are among the smallest nations in Europe. This means that especially the Estonians as the huge majority of the rural population of Estonia are scattered to significantly more distant locations than the Russian population that is mainly concentrated in urban areas. At first sight, one might well predict such a situation to give an impetus to effective regional policy as a national survival and preservation strategy.

However, this is not the case. Even if in all Baltic Republics there are ministries involved in spatial planning and development (in Estonia – the Ministry of the Environment, in Latvia – the Ministry of Environmental Protection and Regional Development, in Lithuania – the Ministry of Construction and Urban Development), the settings for regional policy are not satisfactory. While the Nordic and EU Member Countries in the Baltic Sea Region had already in 1994 large-scale national spatial development programmes, the Baltic Republics had only some local and regional plans (cf. *Visions...*, 1994, p. 88). In all Baltic Republics governments/ministries are involved in the development of planning programmes. However, the lack of both financial and qualified human resources in the Baltic Republics has been estimated as the main problem blocking effective regional policy as it is implemented in the Nordic/EU countries of the Baltic Sea Region.



### 3. IMPLICATIONS FOR INTEGRATION WITH THE EUROPEAN UNION

The three Baltic countries have experienced rapid structural changes after the annexation by the Soviet Union and then after regaining their independence. During the Soviet period the states industrialised on the basis of division of labour between Soviet republics. In spite of rapid changes, the economies of the three Baltic countries are still based much more on agriculture and forestry than in Western European countries. However, they have come rather close to an industrial structure prevailing in the market economy. The service sector has grown in importance, in both absolute and relative terms. GDP has turned to be positive since 1994 – with an exception of Lithuania's negative trend in 1995.

Table 4. Changes in GDP of the Baltic Republics (in %)

Year	Estonia	Latvia	Lithuania
1991	-11.0	-8.3	-13.4
1992	-21.6	-35.0	-37.7
1993	-6.6	-14.9	-23.7
1994	4.0	0.6	1.0
1995	3.0-4.0 <sup>a</sup>	-1.6	3.0 <sup>a</sup>

<sup>a</sup> Forecast.

Source: Bank of Finland. Unit for Eastern European Economies, 2/1996.

There have been both similarities and differences between the developments of the three Baltic countries in the 1990s. The Baltic Region can be seen as a single entity as well as individual different states. For example, the EU prefers to deal with the region as a single entity, while the Baltic countries themselves wish to be treated individually on their own merits (Pautola, 1996). Since the Baltic countries are still in transition and their economic, political as well as social systems are still in the process of formation, the terms of admission to the EU have become a hot topic. Although there is lack of clear admission criteria, the qualification for membership implies an enormous amount of catching up. The preparation strategy has three parts. First, they will play on terms of the Association Agreements, signed June 1995, which are preferential agreements designed to establish a close, long-term association between the EU and the Baltic states. The Association Agreements fully supplant the Agreements on Free Trade signed between the EU and the Baltic countries. They also include provisions on other matters such as expanding political dialogue, movement of workers and capital, supply of services as well as provisions on economic, cultural and financial co-operation, and co-operation on the prevention of illegal activities.

The European Bank for Reconstruction and Development has published statistics in October 1995 concerning the progress of the Baltic states in transition. The progress is described by several indicators covering the share of private sector, privatisation, enterprise restructuring, price liberalisation, trade and foreign exchange system, competition policy, banking and other financial institutions and legal rules on investment. The statistics indicate that Estonia has made the greatest progress in many aspects of transition among the Baltic states. The following indicators are the best in Estonia: private sector share of GDP, large-scale privatisation, enterprise restructuring, setting up competitive legislation, and the scope and power of legal rules on investment.

Small companies have all been completely privatised in all Baltic countries. All countries have also made substantial progress in price liberalisation and most prices are no longer formally controlled by the government, although comprehensive price liberalisation has not yet to be achieved. All three countries are at the same level as for foreign trade; ministries and state-owned trade companies have little direct involvement in exports and imports. The speed of banking reform and interest rate liberalisation has been about the same in all Baltic states. However, the countries should be able to provide the full range of competitive banking services found elsewhere in Europe (Pautola, 1996). They also should work towards full convergence of banking laws and regulations with BIS (Bank for International Settlements) standards (cf. Korhonen, 1996).

In terms of currencies, the conditions for the Baltic Republics to join the European financial and monetary structures seem to be quite good. The currencies of the Republics are remarkably stable, being connected either to DEM (Estonia), USD (Lithuania) or a SDR, i.e. Special Drawing Right, (Latvia). This monetary stability has some effects on the macro-economy. The inflation rate in all Baltic Republics is still on the two digit level, exceeding those in the Visegrad countries – but being far below the inflation rates in Russia and other CIS countries. The combination of stable currencies and a relatively reasonable inflation rates have resulted in low unemployment levels. Additional reasons for the low unemployment levels are the growing service sectors in the Baltic countries. The EU countries have remarkably higher unemployment rates than the Baltic countries. Also on comparison with most Visegrad countries, the Baltic Republics have a better situation.

The so-called French List of admission criteria for membership includes also stability of institutions, which basically means having a system that supports the rule of law, human rights and protection of minorities (cf. Pautola, 1996). In Estonia this criterion seems to be somewhat problematic. Under the Soviet regime a great number of Russians moved to the country. This large Russian minority group had certain privileges which created tensions between them and the native Estonians. After regaining her independence Estonia has passed laws concerning rights of non-Estonians which have produced reactions from both the

Russian group and outside the country, for example from the EU. Russians form large minority groups in the other two Baltic countries as well, but the similar tensions have not arisen.

More than in the case of other countries dealt with in this publication, the integration of the Baltic Republics is related to the developments between Russia, Western Europe and the United States. The relations of Russia and the Western institutions are important as well. In some areas of interest, co-operation between these countries and institutions already exists. International programmes such as PHARE and TACIS organised by the EU to assist the Baltic Republics and Russia in their transitions, and the Partnership for Peace organised by NATO are examples of this development. These programmes have an important role in decreasing tensions in the whole Baltic Sea area and thus support the integration of the Baltic Republics to the European structures.

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