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Economic Adaptability in the Absence of Democratic Corporatism: Explaining Lithuania's Export Performance*

Ekonomikos prisitaikymas be demokratinio korporatyvizmo institucijų: Lietuvos eksporto tendencijų analizė

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Abstract: Viewed in light of democratic corporatism literature, Lithuania is a deviant case. Although it lacks essential institutional prerequisites deemed important for export success and flexible adaptation to external shocks, the small Baltic country has been among the best performers in the European Union on these dimensions. Lithuania has become very internationally integrated and has managed to quickly adjust to numerous shocks, such as the Russian financial crisis of 1998–99, the Global Financial Crisis of 2008–2009, and the COVID-19 pandemic. In this article, we analyse Lithuania's export specialization and show how particular institutional elements have supported flexible adaptation and competitiveness improvements: we cover the labour market, state's involvement in terms of domestic compensation and public goods provision, education and skills, and the role of political legitimacy. Lithuania's case has implications for the literature on the political economy of small states and the debate regarding the middle-income trap.

Keywords: small states, democratic corporatism, external shocks, export competitiveness, institutions, Lithuania.

Summary: Vertinant iš demokratinio korporatyvizmo perspektyvos, Lietuva yra sunkiai paaiškinamas atvejis. Nors jai nebūdingi instituciniai bruožai, kuriuos kaip svarbius eksporto augimui ir prisitaikymui prie išorės šokų vertina demokratinis korporatyvizmas, ši maža Baltijos ekonomika yra tarp geriausiai šiuo požiūriu vertinamų Europos Sąjungos valstybių. Pastaraisiais dešimtmečiais Lietuva tapo viena iš labiausiai ekonominiiais ryšiais su išore integruotų šalių ir sugebėjo sėkmingai prisitaikyti prie reikšmingų skirtingo pobūdžio išorės šokų – Rusijos finansų krizės 1998–1999 m., Didžiosios recesijos 2008–2009 m. ir COVID-19 pandemijos. Šiame straipsnyje analizuojame, kaip skirtingi instituciniai Lietuvai būdingi bruožai veikia jos ekonomikos prisitaikymą bei eksporto ir konkurencingumo dinamiką. Tiriame tokius institucinius veiksnius kaip darbo rinka, valstybės vaidmuo kompensuojant praradimus bei teikiant viešąsias gėrybes, švietimas ir įgūdžių lavinimas bei politinis legitimumas. Lietuvos atvejo analizė gali suteikti vertingų įžvalgų mažų valstybių politinės ekonomijos tyrimams bei diskusijoms apie vidutinių pajamų spąstus.

Keywords: mažos valstybės, demokratinis korporatyvizmas, išorės šokai, eksporto konkurencingumas, institucijos, Lietuva.

Introduction

Lithuania has turned out to be a remarkable export success story. In terms of exports share in value-added, the country is fourth in the European

Union (EU), only surpassed by Luxembourg and Malta as well as Ireland.

¹ Exports' growth was also crucial when, defying pessimistic predictions, the country recovered from the Global Financial Crisis (GFC) – from 2009 to 2013, Lithuania's exports-to-GDP ratio grew fastest in the EU. Besides, Lithuania was successful in adjusting to the Russian trade embargo of 2014 and the Covid-19 crisis, as in 2020 the country's economy contracted the second least in the EU after Ireland.

Lithuania's secular growth in exports and its exceptional ability to adjust quickly to shocks are not only interesting empirical phenomena but additionally present an important theoretical puzzle viewed from the perspective of comparative and international political economy. An influential strand in the literature – arguably starting with the seminal contribution by Katzenstein – posits that small European states tend to adopt models of democratic corporatism, which helps support political legitimacy and bolsters their international competitiveness.²

Lithuania is a deviant case for this line of argument.³ In many ways, Lithuania is the opposite of a democratic corporatist model – it lacks corporatist consultations, has adopted comparatively limited mechanisms of domestic compensation, and features a decentralized and uncoordinated wage bargaining regime.⁴ Despite this, Lithuania's economy has been very successful in adjusting to short-term shocks as well as building up its general export orientation. Lithuania also does not fit well with the approach categorising countries into exports-led and demand-led growth regimes,⁵ as the country has managed to switch from the latter to the former very quickly in the wake of the GFC.

Solving this riddle is the principal aim of this paper. Our argument is essentially institutionalist, as we show how Lithuanian export competitiveness has stemmed from the particular institutional elements that have developed in the country since the beginning of the political and economic transition in the early 1990s. The dependent variable in this article is adaptation, which can be defined as the ability of a country's economy, in terms of particular exports, to quickly recover from external shocks.

This article is structured as follows. First, we provide an overview of previous attempts in the literature to address Lithuania's export competitiveness. We then discuss our research design and methodological approach. Next, a theoretical framework underpinning the democratic corporatist model is presented. The subsequent sections discuss different parts of the Lithuanian political-economic model. After providing a detailed overview of Lithuania's exports' growth and adjustments, we scrutinize the country's export profile, its wage bargaining system, the state's role in providing “domestic compensation” and public goods, the country's education system, and, last but not least, political legitimacy. In the concluding section, we address the significance of Lithuania's case for arguments regarding the small state democratic corporatist model, as well as the state's role in the economy, especially concerning the prospects of escaping the middle-income trap.⁶

1. Literature review and methodological approach

While the economics literature has addressed the growth and adjustments of Lithuania's exports, it has so far either focused on simply describing these phenomena or suggested what could be considered as their "proximate" causes (like fast adjustment in unit labour costs (ULC)), rather than more fundamental determinants of Lithuanian adjustment capacity.⁷ At the same time, it has generated insights that we build upon. A case in point is Notten's finding that Lithuanian companies tend to be price-takers on global markets.⁸

Meanwhile, authors in the field of political economy have sought to provide explanations for Lithuanian (or, more generally, Baltic) adjustments. This is particularly true of their adjustment to the Global Financial crisis (GFC), which has garnered a lot of attention due to how extremely vulnerable the Baltic countries were before the crisis and how surprisingly fast and successful they were in adjusting to it, as their case raises possible implications regarding adjustment in broader debates on the internal devaluation of countries within the Eurozone. Conversely, adjustment to other shocks – namely the Russian trade embargo and the COVID-19 crisis – have so far been largely neglected in academic literature.

With regards to GFC, the literature can be divided into several groups. In the wake of the crisis, several scholars emphasized the very severe impact of the crisis in the Baltic countries, which resulted from their financialized, debt-driven growth models.⁹ It has been argued that the crisis exposed the fragile nature of Baltic politico-economic models, which had come to depend on unsustainable external borrowing.¹⁰

After Lithuania, and other Baltic states, had defied the dire predictions issued during the economic downturn in 2009, scholars started looking for answers to this recovery. One explanation was that Baltic countries were saved by exogenous external developments, namely the substantial inflows of EU funds as well as support from Scandinavian banks.¹¹ Another account was provided by those claiming that Lithuanian export recovery was driven by favourable external developments in international markets, as prices of goods exported by Lithuanian firms increased substantially at the time.¹² These explanations point to "luck" (or at least exogenous external circumstances) as the reason behind the fast rebound of Lithuania's economy.

We do not deny that such factors were important. However, we contend that important endogenous causes were at play as well, especially since we observe a similar adaptability in response not just to one external shock but also others (i.e., the COVID-19 pandemic), which have been different in their nature from the GFC. We specifically focus on the domestic institutional constellation of Lithuania's politico-economic model. In Herman Schwartz's terms, we suggest that "stuck" factors were as (or even more) important as those assigned to "luck."¹³ Our argument is closest to that of Kuokštis, specifically with its focus on

the type of capitalist variety in the Baltic countries resembling liberal market economies or perhaps even embodying a distinct “flexible market economy” category.¹⁴ This type of capitalism was more compatible with the internal devaluation required to adjust during the GFC as compared to the varieties of capitalism in Southern Eurozone members.

As we build on these insights on “capitalist variety,” we go beyond and extend them in several ways. First, we frame Lithuania’s case as a deviant one in the context of democratic corporatist small state literature. Second, by covering not just the GFC but other episodes of adjustment, as well as the broader historical trajectory of Lithuanian exports’ developments, we can better demonstrate the continuous pattern of Lithuanian institutional responses, which allows us to argue that there is a pattern in the country’s adaptability that goes beyond “luck” and contingent external circumstances. Third, in addition to providing a deeper analysis of Lithuanian exports’ specialization, we go further in unpacking the phenomenon of the “exceptional flexibility” of the Lithuanian economy.¹⁵ Fourth, we do not merely rely on functional economic explanations but also address the issue of political legitimacy.

We treat Lithuania as a “deviant” case in relation to the democratic corporatist small state literature.¹⁶ Lithuania does not have the prerequisites deemed crucial in sustaining exports’ competitiveness (as well as political legitimacy) in small democratic capitalist countries. Furthermore, we can view Lithuania as a typical case representing the Baltic model, because it shares many similarities with Latvia and Estonia. Lithuania’s case is arguably the most interesting, as its export growth has been the fastest among the three and surpassed the respective figure of Latvia and Estonia, despite the fact that the latter two are markedly smaller economies. In 2019, the exports-to-GDP ratio in Lithuania, Latvia, and Estonia stood at 78%, 60%, and 73%, respectively (Eurostat data); Lithuanian exports’ share in value added was also higher – in 2014, the respective figures were 45%, 40%, and 35%.¹⁷

Our analytical strategy consists of explicitly formulating the mechanisms via which the literature considers that democratic corporatist countries can successfully achieve and sustain export success. The independent variables and their interrelationships discussed in the literature on small European democratic corporatist states provide us with a coherent analytical framework to start from. We then turn to Lithuania’s case and trace what explains Lithuania’s exports’ results in the absence of the key elements of democratic corporatism. We rely on statistical data (both Lithuanian and comparative), reports, and secondary sources.

2. Democratic corporatism and Lithuania’s deviance

Starting with the seminal contribution by Katzenstein,¹⁸ a significant number of scholars have maintained that small Western and Northern European countries are able to combine “democratic corporatism” with

high economic efficiency, in particular export competitiveness.¹⁹ In fact, the argument has been that successful economic performance was not despite but due to certain non-market institutional features.

To begin with, as suggests the label itself, these countries are corporatist. This means that they have strong traditions – although with varying degrees of formality – of consulting with the main social groups in the country. Both employers’ and employees’ organizations are strong and influential. Decision-making tends to be consensual. This is closely related to the nature of their labour market institutions. The democratic corporatist model features high wage bargaining centralization, which refers to “the level at which wages are bargained or set,”²⁰ and coordination, which can be understood as “the degree of intentional harmony in the wage-setting process-or, put another way, the degree to which minor players deliberately follow along with what the major players decide.”²¹

Furthermore, democratic corporatism is characterized by a high degree of “domestic compensation.” This means that these countries have extensive welfare and retraining programs to help adjust to the “losers” of globalization and other forms of creative destruction. As a corollary, such countries redistribute relatively large amounts of their economic output, which also implies a high level of taxation. This redistribution, together with the peculiarities of their wage bargaining systems (via wage compression), results in low levels of wage and income inequality.

These features – most notably domestic compensation, low level of inequality, consensual politics, and involvement of major societal groups into the decision-making process – are deemed to be essential in sustaining high levels of political legitimacy, which manifests itself in elevated political as well as interpersonal trust. Furthermore, democratic corporatist countries are characterized by a high quality of governance, which in turn helps to bolster legitimacy and support for redistribution as well as extensive public goods provision, especially in the form of retraining and education.

Importantly, it is often argued that democratic corporatism not only ensures legitimacy but also enhances economic efficiency, particularly international competitiveness. First, centralized and coordinated wage bargaining, which tends to be dominated by representatives of the exposed (i.e., exporting) sector, helps achieve cost competitiveness by avoiding situations of wage growth exceeding productivity gains.²² Second, wage compression expands the pool of highly-skilled workers who can be hired by the exporting sector at lower wages.²³ Third, generous and efficient public investment into education and retraining helps boost productivity, especially when it comes to sustaining success in high value-added sectors that require a highly skilled workforce and innovation.²⁴ Fourth, democratic corporatist countries have not only demonstrated their capacity to support incremental innovation in high value-added industries but also displayed remarkable ability to flexibly adjust to competitiveness challenges by enacting a rapid

transformation of their industrial structure – they have engaged in acts of “creative corporatism.”²⁵ Fifth, a high level of political legitimacy helps to bolster support for outward economic orientation and limit populist anti-globalization backlash. Finally, high levels of political as well as interpersonal trust are important assets in reducing the resolution of collective action problems and lowering transaction costs, further fostering competitiveness. In general, the democratic corporatist model seems to be able to combine significant economic openness with an extensive permeation of non-market, organized forms of coordination.

Having laid out the key features and logic of the democratic corporatist model, it is clear why Lithuania does not fit the theory well. The paucity of corporatist elements in Lithuania has been covered quite extensively in the literature.²⁶ This paper's Appendix provides details on various important dimensions of democratic corporatism – or lack thereof – in Lithuania along with the Western and Northern European small states²⁷ as well as small Central Eastern European (CEE) countries that joined the EU together with Lithuania in 2004.²⁸

It can be seen that Lithuania has very low (and declining) union density and coverage, fragmented employers' and employees' organizations, and its wage bargaining is extremely uncoordinated. Furthermore, Lithuania has one of the lowest tax-to-GDP ratios and social protection expenditure in the EU, as well as one of the highest levels of income and wage inequality. Moreover, these are persistent phenomena. Finally, although Lithuania's quality of governance has improved, the country still lags behind the Northern and Western European small states (see Appendix).

To summarize, Lithuania scores very low on the independent variables of democratic corporatism; thus, the democratic corporatism theory would predict low export competitiveness and adjustment capabilities (the dependent variable). Lithuania nevertheless scores highly on the dependent variable, which makes the country a good candidate for a “deviant” case analysis.

3. Lithuania's exports: secular growth and adjustments

Lithuania has demonstrated remarkably good results when it comes both to adjustment to crises and overall expansion of exports. Lithuania's exports-to-GDP ratio in 2000 was 39%, went up to 49% in 2004, reached 73% in 2011, and further climbed to 77% in 2019 (Eurostat data). Thus, it increased by 39 percent between 2000 and 2019, which was the 11th fastest export-to-GDP ratio growth rate in the world and second fastest in the EU (after Slovakia) (calculated by the authors using World Bank data). Lithuania's exports-to-GDP ratio in 2019 was the 15th highest in the world and 9th highest in the EU.

A more precise way to measure the role of exports in the economy is to look at their share in value added. This corroborates the fact that Lithuania's international integration has been developing fast. The share of value-added in exports in economic output in 2000 was 19%, which

went up to 28% in 2004, 40% in 2014,²⁹ and reached 45–50% in 2019.³⁰ Between 2000 and 2014, Lithuania made the biggest leap in the share of exported value added of the three Baltic countries.³¹ Lithuania's integration measured thusly looks even greater than the one revealed by standard trade statistics – in 2014, Lithuania's share was the fourth highest in the EU. Only Malta, Luxembourg, and Ireland exceeded it. The fast growth in export capacity “points to Lithuania's competitive advantage and attractiveness of Lithuanian-origin goods and services in foreign markets.”³²

Successful export expansion was an important reason behind the very fast catch-up process (Appendix); Lithuanian annual real GDP per capita growth at nearly 4% was the biggest among OECD members between 2006 and 2017.³³ At the same time, economic growth in Lithuania was extremely volatile (see Appendix), repeatedly punctuated by crises.

After the upheaval in the early years of the post-communist transition and the banking crisis of 1995, the first serious economic challenge came about as a result of the Russian crisis of 1998–99, which “caught both exporters and government representatives off-guard.”³⁴ The Lithuanian economy had up to that point been very dependent on exports to the Commonwealth of Independent States (CIS) – its share comprised 36% of Lithuanian exports.³⁵ Unsurprisingly, the effect of the Russian crisis on Lithuania was severe. However, exports – and with them economic growth – recovered fairly quickly. A major reason was that Lithuanian companies were able to demonstrate a “strong penetration into EU markets”³⁶; this reorientation proceeded “at a remarkable speed.”³⁷ There was also export growth into other markets, such as CEFTA, the US, and EFTA.

In the mid-2000s, the Lithuanian economy experienced a pronounced economic boom, which eventually morphed into economic overheating and macroeconomic imbalances. As a result, it suffered gravely from the GFC, as the economy contracted by 15% in 2009. Lithuania opted for internal devaluation as its anti-crisis strategy and defied abundant pessimistic predictions in being able to avoid currency devaluation, restore fiscal sustainability, and saw robust growth return unexpectedly quickly. Given the collapsed housing market and dried-up domestic demand, exports' bounce back was the key reason behind the unexpectedly robust recovery. From 2009 to 2013, Lithuania's exports-to-GDP ratio jumped from 52% to 79% (Eurostat data) – the best result in the entire EU.

The next challenge again stemmed from the Russian market, this time having to do with geopolitical tensions in the wake of Russia's military intervention in Ukraine. In 2014, Russia declared an embargo on EU imports, mostly agricultural food products, as a countermove to the EU's sanctions on Russia. Of all the EU members, Russian sanctions were expected to have the strongest impact in Lithuania.³⁸ Lithuania had the highest value of exports subject to the ban in terms of absolute value as well its share in the GDP.³⁹ Notwithstanding, the Russian embargo had a

relatively minor impact in terms of aggregate performance. Estimates put it at 0.81% of GDP growth lost in 2014 and an additional 1% in 2015.

⁴⁰ It is true that certain specific sectors – most notably food (especially dairy), transport, and tourism – were considerably affected, but the whole economy remained relatively unscathed. Lithuanian overall exports of goods and services contracted by 5% on an annual basis in 2015, stayed at that level in 2016, and started expanding robustly in 2017 (by 19 %) (Eurostat data).

During the COVID-19 pandemic, Lithuania again managed to positively surprise forecasters. In the spring of 2020, the economy was expected to contract by 7.9% in 2020, ⁴¹ but actual data show that economic activity fell by only 0.9%. ⁴² It was the most significant forecast improvement and also the smallest economic contraction in the EU (with Ireland being the only country to maintain growth). This occurred in spite of the second pandemic wave being particularly severe in the country (at a particular time Lithuania had the highest rate of infections in the world) and, as a result, very strict measures being introduced. Yet again, a major reason behind the relatively robust performance of the economy was its good export results. The annual growth in Lithuanian goods' exports (excluding mineral products) in 2020 was 3.4%, while exports of Lithuanian origin went up by 6% (Statistics Lithuania data).

4. Lithuanian export profile

Lithuania specializes in exporting medium-complexity, low and medium value-added products and services that do not rely on the use of high technologies. ⁴³ Furthermore, looking at the “smile curve” of the value chain ⁴⁴ – where value-added is usually created mostly at the beginning (such as design and innovative R&D) and the end of the chain (marketing and customer service) – Lithuania generally produces goods in the middle part of the chain, where opportunities to capture value-added are more limited. ⁴⁵ It is also important to note that this profile has remained largely unchanged over time (see Appendix), ⁴⁶ even though the country saw very fast aggregate economic convergence.

In 2019, exports of goods comprised 70%, and exports of services amounted to 30% of the total exports (Statistics Lithuania). Of goods exports, 60% were exports of Lithuanian origin, and 40% were re-exports. Looking at exports of Lithuanian origin, the biggest share went to mineral products (18%), various manufacturing products (12%, mostly furniture products), processed food, beverages and tobacco (9%), and chemical products (8%). Export share in value-added in manufacturing is dominated by four sectors: “food, tobacco and beverages, furniture manufacturing, textiles, and chemical product manufacturing.” ⁴⁷ The share of furniture in value-added in the economy is the highest in the EU, while the share of food and beverages is one of the highest; by contrast, the share of engineering is one the lowest. ⁴⁸

The lion's share of services exports (60%) are attributed to the transport sector. Lithuania has the highest share of transport services in value-added in the EU.⁴⁹ Furthermore, while generally a negative correlation exists between a country's level of development and share of the transport sector, Lithuania is an exception to this pattern, as the sector's share has been increasing, while the country's economy has been growing.⁵⁰

Lithuania's export specialization and its trends over time already provide valuable insights that help us address the main puzzle of this paper. First, from the point of view of democratic corporatism, the model's institutions are deemed to be important when it comes to sustaining competitiveness in high value-added, technologically intensive, complex exports that compete primarily on quality. Additionally, "creative corporatism" has also been important in facilitating substantial transformations of economic structures and comparative advantages.⁵¹ By contrast, Lithuania does not specialize in exporting products and services of this kind, and neither has it seen a profound transformation or even evolution of its competitiveness profile. Thus, the democratic corporatist elements deemed necessary to sustain competitiveness have so far not been necessary in Lithuania.

From a short-term adjustment perspective, Lithuania's exporting profile has also been helpful. The fact that Lithuania specializes in exporting relatively standardized, lower value-added goods that are in the middle of the value chain – coupled with the fact that the country is small – means that Lithuanian companies are price-takers on international markets.⁵² Econometric evidence shows that Lithuanian exports are not very sensitive to shifts in global demand, and instead primarily rely on supply side factors, namely domestic production capacity.⁵³

Being a price-taker, of course, has its downsides, as it offers limited opportunities to capture a higher share of value-added and makes exports very sensitive to price changes. In the words of Notten, "Lithuanian exporters are highly responsive to price incentives as a result of operating in markets characterized by high competition."⁵⁴ At the same time, it has the advantage in the sense that it is relatively easy to switch standardized exporting products from one market to another (Kuokštis 2011); the expansion of exports is not limited by external demand. Such was the case in response to the Russian embargo, when companies in the agricultural food sector were able to reorient their exports from the Russian market to Western ones. During the COVID-19 crisis, Lithuanian specialization in exporting relatively unsophisticated products also turned out to be beneficial, because the demand for necessity goods, such as tobacco and agricultural food products, remained robust throughout 2020.⁵⁵

5. Labour market institutions and cost competitiveness

Given that Lithuanian exports are very price-sensitive, how have the country's companies handled problems with cost competitiveness? Going back to the democratic corporatist model, Lithuania lacks wage

bargaining institutions that are considered to be helpful in limiting excessive wage growth. Although there are formal institutions in Lithuania – such as the Tripartite Council, which deliberates the minimum wage, regulation of labor relations, and has made it a frequent practice to sign agreements on economic policies between the Government and social partners – their role in managing responses to external shocks has been marginal. Compared to the prototypical democratic corporatist small state model, Lithuania stands at the opposite end of the spectrum when it comes to the coordination and centralization of wage bargaining. How does it then achieve the wage moderation and compression deemed necessary to ensure the cost competitiveness of its exports? The task of retaining cost competitiveness is further complicated by the fact that the country has followed a “hard currency” policy since 1994, when it adopted a currency board regime. This further limited room to improve competitiveness by adjusting the nominal exchange rate – a standard response to cost competitiveness problems.

One should first notice that Lithuania did in fact experience problems in this area – during periods of economic expansion, wage growth substantially exceeded productivity growth, leading to increasing ULCs.⁵⁶ This was already observed in late 1990s⁵⁷ but was particularly evident in 2004–2007, when wages were increasing much faster than productivity and there were abundant warnings by both businesses (especially in the exposed sector) and analysts about declining competitiveness. In 2015–2019, wages again grew faster than productivity, leading to increasing concerns over competitiveness losses.

Given all this, why has Lithuanian competitiveness not yet suffered over the longer run? The answer is that while cost competitiveness deteriorated during periods of robust domestic demand growth, it was also relatively quickly restored when such adjustments were necessary. This happened as a response to the Russian financial crisis of 1999, as wages fell by 4% in 2000.⁵⁸ However, it was most evident during the GFC, when Lithuanian nominal wages adjusted quickly in a comparative context – they fell earlier and faster than in other countries facing similar precarious conditions, namely in the European South⁵⁹ as well as Latvia and Estonia.⁶⁰ Lithuania's generally high degree of de facto labour market flexibility (its lax enforcement of labour regulations) – inaccurately portrayed by formal assessments of regulation – was a key factor in the fast adjustment of wages.⁶¹ One could additionally point to the insight formulated by Calmfors and Driffill that “extremes work best”⁶² in the sense that both very decentralized and highly centralized wage bargaining settings can lead to efficient macroeconomic outcomes. Decentralized wage bargaining leads to a lower ability for workers to coordinate and exert pressure on employers, thus providing an alternative method of wage moderation for the coordinated and centralized system of democratic corporatism.

However, this “textbook” internal devaluation model can account for only part of Lithuania's ULC adjustments. First, during the GFC, wages

fell much more in the public than in the private sector. Secondly, the bulk of adjustment of ULCs came in terms of productivity growth rather than lower wages.⁶³ Third, even the adjustment of ULCs does not fully explain the very fast growth of exports, as they increased more than might have been expected based on this indicator alone.⁶⁴ Given this, what are the additional factors behind productivity growth and fast sectoral reallocation during adjustment phases that helped sustain Lithuanian competitiveness?

6. (Lack of) Domestic compensation

Lithuania has developed relatively limited mechanisms of domestic compensation. By this we refer both to welfare transfers for those individuals that are disadvantaged due to economic dynamism as well as policy measures used to protect domestic companies from or actively help adjust to either external competition or fluctuations in world markets. As shown in the Appendix, the Lithuanian welfare state is one of the least compensating in the EU. The lack of redistribution – as well as the nature of labour institutions discussed above – results in high income inequality. Companies have also largely been left to deal with challenges on their own and received little protection (very different from the Southern European type of capitalist economy with high levels of protection and state involvement).⁶⁵

This was particularly evident during periods of crises. First, during both the 1999 Russian crisis and the GFC, Lithuania responded on a macroeconomic level by enacting policies that involved fiscal consolidations and defending the fixed exchange rate regime. The “hard currency” policy put additional pressure on exporters, because major Lithuanian trade partners, such as Russia and Poland, often devalued their currencies during crises. The only exception to the austerity response was the COVID-19-induced shock, when Lithuanian authorities enacted an economic stimulus package which was unprecedented in the country’s history but largely in line with European trends. In response to the Russian embargo of 2014, the government’s role was also rather limited when it came to compensating the losers or helping find foreign markets. All this should also be viewed in the context of a very volatile economic environment. As shown in the Appendix, the standard deviation of economic growth has been almost twice the size of that in small CEE countries and about three times that of small Western/Northern European states.

Instead of providing “protection” and “compensation,” the Lithuanian state has largely managed to create a competitive environment with a level playing field. Lithuania scores high on product market regulation (i.e., it does not regulate product markets excessively) as well as indicators of economic freedom. Lithuania is 8th in the OECD in terms of product market regulation and 5th in the EU in terms of the economic freedom index (see Appendix). In the words of Bohle and Jacoby,

Lithuania has relied on a “Hayekian strategy” underpinned by “lean state macroeconomic orthodoxy” and “complemented by microeconomic market efficiency.”⁶⁶

What mechanisms link this “Hayekian strategy” with the capacity of the Lithuanian economy to adjust and expand its exports? One way in which this strategy should work is via encouraging higher dynamism in the business economy, where the forces of creative destruction eliminate low productivity firms and re-allocate resources towards higher productivity ones.⁶⁷ Lithuania does in fact stand out in terms of business dynamism. Every single year from 2004 to 2019, Lithuania had the highest business churn rate (the sum of business deaths and births) in the EU (Eurostat data). These “cleansing” effects were particularly evident during the GFC.⁶⁸ The high degree of business dynamism in Lithuania was already observed in the 1990s when the country had “by far the highest job turnover” – the sum of job destruction and creation – “among both the transition economies and mature market economies.”⁶⁹ Based on this observation, the author concluded that the “labour market in Lithuania seems flexible enough to enable what has been a dramatic reallocation of jobs and labour.”⁷⁰

In response to the volatile and uncertain environment, Lithuanian companies have reacted by learning to better hedge risks. For instance, the highly volatile (and politically fraught) Russian market has led many Lithuanian companies to limit the use of long-term contracts and the amount of funds receivable from Russian clients. During the GFC, enterprises were at different levels of preparedness to face the crisis and react flexibly – those that had been expanding fast and had invested heavily into new facilities as well as machinery prior to GFC encountered significantly higher difficulties during GFC. Besides, Lithuanian companies have been controlling risk by diversifying geographically. Lithuanian exports have become substantially more geographically diversified over time.⁷¹ Lithuania’s geographic diversification is higher compared to the two other Baltic countries as well as Poland.⁷²

One observable implication of hedging strategies is wariness to take on leverage. This is corroborated by evidence – the Lithuanian non-financial private sector has registered one of the lowest leverage ratios in the EU. In 2019, private sector debt stood at 55%, making it the lowest in the EU (see Appendix). Relatedly, businesses on the whole have been reluctant to expand their capacity and invest into new risky projects – the investment rate since the GFC has been below the Eurozone average.⁷³ The very fact that Lithuania has not moved into higher value-added and more complex sectors also suggests reluctance on the part of firm owners to engage in risky new ventures.

Another result of the highly volatile nature of Lithuania’s development – and a factor behind the economy’s flexibility⁷⁴ – has been the predominance of small and medium enterprises (SMEs). SMEs can be more flexible in their operations compared to large firms.⁷⁵ In 2018,

of those EU countries for which data were available, Lithuania had the fourth highest SME share in the economy based on value added and held sixth place based on the number of employees (calculated by the authors based on Eurostat data). Furthermore, this is not a recent phenomenon, as the share of smaller companies has been growing.⁷⁶

All of the above-discussed elements help to better explain the “exceptional flexibility” of Lithuania’s economy, which goes beyond the macroeconomic dimension of downward nominal wage flexibility and additionally encompasses the “microeconomic dimension” of adjustment flexibility.⁷⁷ This flexibility allows Lithuania to be resilient in the face of shocks as well as makes it politically easier to implement policies of fiscal consolidation and internal devaluation compared to other countries that have more “rigid” economic structures.⁷⁸

The rather limited state involvement in the economy has resulted in another factor that has bolstered Lithuanian competitiveness. The relatively low redistribution in Lithuania is due to its low overall tax burden, especially in terms of corporate taxation. The Lithuanian tax-to-GDP ratio has consistently been one of the smallest in the EU (see Appendix). While the extent to which low taxes can be a source of competitiveness in general is debatable, there is a strong case that they have provided a competitive edge for Lithuanian firms, given their specialization and competition is mainly on price. One interesting, and substantively important, case is provided by the Lithuanian transport sector. After the Russian embargo in 2014, Lithuanian logistics companies have been very successful in compensating their losses in the Russian market by penetrating the EU market – “in 2015–2017, Lithuania’s market share in the EU road cargo transport services each year on average increased by almost one-fifth.”⁷⁹ This was yet another manifestation of the reorientation capacity of the Lithuanian economy. One important source of this success has been lower wage costs, which allowed Lithuanian firms to outcompete established Western companies. The low wages in turn reflect Lithuanian companies’ ability to hire employees from third countries (such as Ukraine) as well as their use of the peculiarities of the Lithuanian tax system which allows for a substantial reduction of the tax burden, whereby payments to drivers are made in the form of daily allowances.⁸⁰

That said, the state has provided important public goods that have allowed businesses to adjust and exports to expand. Apart from the creation of a generally competitive, non-interventionist business environment, Lithuanian authorities have been very active in securing international economic integration. In this respect, the decision-making by Lithuanian authorities has been important in terms of reducing vulnerability to external shocks and facilitating the adjustment of economic agents. It was the policy of restructuring interdependencies – improving trade conditions with the EU, first by signing a free trade agreement in 1994 and joining the EU ten years later, and, at the same time, minimizing dependence on trade with Russia.⁸¹ Econometric

evidence suggests that the Lithuanian economy has benefited the most of all EU countries from membership in the Union.⁸² Membership in the EU was also important because it included key Lithuania's trade partners, such as Latvia, Poland, and Estonia, allowing access to the largest common market in the world. Lithuanian companies, especially transport service providers, managed to turn into an advantage the peripheral position of Lithuania, combining the strengths of legal certainty and free trade within the EU with the familiarity of the Eastern markets and their culture of informal deals. However, with respect to facilitating the management of external shocks, it was rather an unintended positive effect of EU membership, since at the time of accession the focus in Lithuania was on the direct benefits of EU membership. In other words, although the Lithuanian government for the most part did not step in and micro-manage the adjustment of the economy in the field of trade policy during periods of crises, it had created the foundations for this adjustment by taking the broad approach of ensuring access to foreign markets, even if this approach had been driven by geopolitical considerations as much as economic logic.

7. Education and skills

A very high overall volatility was, unsurprisingly, accompanied by a significant labour market turnover. In 2002 and 2007, the mean tenure in Lithuania was among the lowest, and in 2012 the lowest in the EU.⁸³ Since the beginning of the transition, there was “a radical shift from industry specific to general skills. This was accompanied by dramatic decrease in participation in vocational training, severed links between industry and formal training, and exponential growth in enrolments in higher education.”⁸⁴ These developments were similar in the two other Baltic countries and to a lesser extent in Poland and Hungary, but were quite different from the trends in Czech Republic, Hungary, Slovakia, and Slovenia. Martinaitis argues that what led to this divergence was the level of stability during the transition.⁸⁵ Some countries implemented more gradual transition policies, had longer government tenure, more stable governments, more employment stability, and more extensive unemployment benefits, which led to the formation of specific skills' systems. Other states, such as Lithuania, underwent more radical transition policies, had less government stability, shorter tenures, less stable employment, and fewer unemployment benefits, which reduced incentives for individuals to acquire specific skills and instead led them to invest in general skills.

The emphasis on general skills (as opposed to specific) is highlighted by the fact that Lithuania has the second-highest tertiary education rate in the EU (see Appendix), with social science studies being especially popular, while vocational education has been on the decline. Of course, the quantitative measure of tertiary education graduates is not an ideal reflection of the level of human capital in the country, as there are

significant problems with education quality.⁸⁶ Furthermore, there is a significant mismatch of skills in the labour market⁸⁷; employers express their concerns over the lack of a highly skilled labour force.⁸⁸ Only one Lithuanian university breaks into the top-500 global university ranking (in 2021, Vilnius University took the 423rd place in the QS World University Rankings).

At the same time, one could argue that the state has so far been successful in providing a basic education level for the majority of the labour force. While there is a lack of highly-skilled employees due to the relatively low level of education quality, Lithuania's exports' specialization has not been based on the production of goods and services that require them. Instead, the Lithuanian labour force has acquired general skills that can be flexibly applied in many fields; this can be considered a rational response, given the very volatile nature of Lithuania's economic development. Furthermore, such a profile of skills allows easier employment transitions abroad, which can partly explain Lithuania's relatively large emigration flows.

Other indicators that can be considered to capture the level of general skills also point to them being at a relatively high level. Lithuanians are proficient in foreign languages. In 2016, 96% of Lithuanians between the ages of 25–64 reported being fluent in at least one foreign language (Eurostat data). This was the fourth-highest figure in the EU, only surpassed by Sweden, Latvia, and Denmark. Furthermore, the percentage of Lithuanian youth (people of ages 16–24) that have good basic digital skills stands at 93%, which is the second-highest place in the EU (surpassed by Croatia and shared with Estonia and the Netherlands) (Eurostat data). Overall, Lithuania – although to a lesser extent than Estonia – has invested more into education than the Visegrad countries.

⁸⁹

8. Legitimacy

No economic regime is sustainable in the long run – especially in a democracy – without sufficient legitimacy. Moreover, Katzenstein's original conception of the small states model was as much – and perhaps even more – about political legitimacy as it was about economic efficiency.

⁹⁰ How has Lithuania been able to create legitimacy without the building blocks of democratic corporatism?

One should first note that the level of legitimacy in Lithuania is debatable. One could argue that the Lithuanian case is compatible with the democratic corporatist theory, as the country has been characterized by low levels of trust in political institutions.⁹¹ Lithuania is a leading example of the phenomenon of electoral hyper-accountability, as incumbents in the country's parliament are yet to win a re-election.

⁹² Besides, the especially high historical emigration rates, while helping with the economic adjustment, can be interpreted as an expression of

deep dissatisfaction with the state of affairs, “a signalling device for dysfunctional states.”⁹³

However, several important counterpoints can be made. First, although confidence in representative institutions, such as the government and parliament, has consistently been low, trust in institutions responsible for the implementation of public policy, such as the legal system and public administration, has been growing (see Appendix).⁹⁴ Second, the influence of populist and especially radical parties in Lithuanian politics has been fairly limited. Even when such parties were elected into the parliament, they were either not included into ruling coalitions or, when included, did not have substantial influence on economic and social policies. Furthermore, Lithuania has bucked the CEE trend of democratic backsliding – it is noteworthy that a special issue devoted to this phenomenon in CEE covers all countries except Lithuania.⁹⁵ Finally, net migration in 2018 was zero and turned positive in 2019 (Eurostat data). Thus, to the extent that we interpret migration as people casting votes with their feet, we should conclude that legitimacy has increased.

What are the reasons for this sufficiently high level of legitimacy that has allowed the Lithuanian model, based on limited domestic state intervention, lack of corporatist elements, high volatility, and deep international economic integration, to prevail? First, the Lithuanian transition project, including its political-economic model, was based on building a system that would be as different as possible from the Soviet one.⁹⁶ Thus, the elements of the democratic-corporatist model that could be associated with the socialist past, such as trade union influence and even redistribution, were de-legitimized by association. Viewed from another angle, one could also point to the very weak organizing capacity of social actors, which meant that high levels of dissatisfaction were rarely expressed in protest form, but instead by “exiting” the political system or emigrating.⁹⁷

Second, the main strategic goal of Lithuania since the start of the transition was to seek as much integration into the Western economic, political, and security structures as possible. This culminated in 2004 with Lithuania's accession to the EU and NATO, further bolstered by membership in the Eurozone in 2015 and the OECD in 2018. The strategy of “returning to the West” has overshadowed other possible concerns, and also supported both input and output legitimacy, as the country's authorities were able to build consensus around and deliver on these integration projects.

Finally, one should also point to output legitimacy based on purely material gains – Lithuania has lived through one of the fastest convergence among all EU members over the last several decades. In terms of GDP per capita (at purchasing power parity (PPP)), by 2020, the country has surpassed most of the EU “new” member states except for Estonia, Czech Republic and Slovenia (also see Appendix). Besides, Lithuania's real consumption per capita in 2019 was the highest among

all new members and even exceeded that of Spain's (Eurostat data). While it is true that inequality is a pressing issue, the lowest income earners have also seen a very substantial improvement in their fortunes. For instance, the minimum monthly wage in Lithuania went from 130 euros in 2004 to 232 euros in 2010 and 642 euros in 2021 (Eurostat data); by January of 2021, it was the highest in the CEE region.

Conclusions

Writing in 2009, Nölke and Vliegenthart⁹⁸ noted that developmental prospects for Visegrad countries that specialize in the assembly and exports of complex manufacturing products look “brighter” than for the Baltic countries. This was because the Baltic economic specialization resembled that of less developed, semi-peripheral states (Lane 2005; Greskovits 2008).⁹⁹ Defying such predictions, in terms of real GDP per capita (PPP), by 2016, Lithuania had already surpassed all of the Visegrad countries except Czech Republic. A key reason behind this has been Lithuania's ability to grow its exports and adjust to repeated crises of competitiveness. In this way, Lithuania's case attests to an alternative successful path of development apart from the canonical small states model, which is also quite different from the “dependent market economies”¹⁰⁰ regime of the Visegrad countries.¹⁰¹ Moreover, contrary to what has been suggested in the literature, Lithuania's performance has not been limited to one-off “lucky” circumstances but originated from its particular domestic institutional structure, which allowed its flexible adjustment to external shocks of different nature. It remains to be seen how the country's economy will perform under conditions of economic decoupling between the West and Russia (as well as China) and historically high energy prices.

Lithuania's case is also relevant for debates regarding the state's role in the economy. It showcases how a country can develop successfully even without extensive state intervention in terms of an active reorganization and moulding of the economic structure. In a sense, Lithuania has been able to follow the standard prescription of the mainstream economics and traditional advice of privatization, liberalization, and macroeconomic stabilization with state institutions by providing a domestic and external economic environment that allows companies to adjust and diversify their activities. The state has invested in basic public goods in the form of education and economic integration while also exposing the economy to the forces of international competition and gales of creative destruction. In other words, Lithuania has followed the “regulatory state” approach and not gone down the road of either “state-permeated” or “authoritarian capitalism.”¹⁰² Since this places more importance on the microeconomic adjustment and agility of enterprises, further research into their operation in terms of decision-making regarding export diversification, product portfolios, and investing into the skills of their employees could provide useful insights.

At the same time, one should be cautious about drawing overly optimistic expectations about Lithuania's future developments. By extension, one should also be careful when extracting lessons for other countries aiming to escape the middle-income trap.¹⁰³ More specifically, the institutional pattern that has so far enabled Lithuania's economic success might turn out to be detrimental for its future development. While specialization in low value-added, medium complexity sectors has so far not hindered the country's progress and even facilitated adjustments, it may also provide insufficient incentives to climb up the value chain. Limited leverage has enabled companies to hedge risks, and yet in the long run it can result in lower investment and thus weaker productive capacity. High economic volatility has gone hand in hand with creative destruction, leading to productivity gains, but has also given rise to the prevalence of small and medium companies, which are usually less productive and innovative than large firms. High labour market turnover and emphasis on basic general skills have contributed to flexible adaptation but may also hinder the build-up of human capital. Finally, the lack of corporatist elements in the form of compensation, consultation, and wage bargaining may lead to a political backlash against the existing model, especially as other sources of legitimacy dry up.

Put differently, there is the danger that the Lithuanian institutional model will lead to the country becoming "stuck" in an undesirable political-economic equilibrium. In terms of income per capita, Lithuania is already above the middle-income trap threshold,¹⁰⁴ and yet its exporting profile is essentially that of a middle-income one; hence, "the challenge of transitioning from a low-wage to a high-productivity economy" has not yet been resolved.¹⁰⁵ It remains to be seen whether the country will not become a victim of its past success.

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Appendix

	Small Western and Northern European countries	Lithuania	Change in Lithuania (since 2004, unless indicated otherwise)	Small Central Eastern European EU members
	Small Western and Northern European countries	Lithuania	Change in Lithuania (since 2004, unless indicated otherwise)	Small Central Eastern European EU members
Aggregate economic indicators				
Exports, % of GDP, in 2019	59	77	+29	83
Real GDP per capita, PPP, in thousands of USD, in 2019	58.9	38.5	+25.5	36.2
Standard deviation of GDP growth, 2004-19, in %	1.94	15.47		15.30
Sophistication of exports and economic structure				
Share of high-tech exports in total exports, in % in 2018 (data for Norway from 2015, Switzerland from 2014)	11.6	7.9	+0.6	12.2
Economic complexity index, 2018	1.37 (1.5 when Norway is excluded)	0.88	+0.53	1.62
R&D personnel, % of labor force, 2019, no data for Switzerland	1.66	0.92	+0.08 (since 2008)	1.05
Labor market institutions and income inequality				
Bargaining coverage, in %, years 2014-17, depending on country	83.0	7.0	-4.0 (since 2006)	37.3
Bargaining coordination, 2017	4	1	0	1.5
Trade union density, in %, 2018	44.8	7.7	+2.2	12.9
Employers' organization, in %, years 2012-17, depending on country, no data for Czech Republic and Switzerland	73.8	17.0	-3.0 (from 2007 to 2015)	52.7
Share of low wage earners, in %, 2018, no data for Switzerland	10.4	22.3 (second in EU)	-6.8 (since 2006)	19.1
Gini of disposable income, in %, 2019	27.1	35.4 (second in EU)	-10.9 (since 2005)	25.6
State involvement				
Taxes, % of GDP, 2019	41.1	30.4 (4 th smallest in EU)	+1.1	36.2
Social protection benefits, % of GDP, 2018	27.6	15.5 (4 th smallest in EU)	+2.5	18.5
Product market regulation, 2018	1.30	1.19 (8 th in OECD)	NA	1.36
Heritage economic freedom index, 2020	75.4	76.7 (6 th in EU)	+4.3	69.0
Firm characteristics				
Business churn rate, in %, 2018	14	43 (highest in EU)	-6	20
Private non-financial sector indebtedness, % of GDP	184	55 (lowest in EU)	+15	77
Education				
Tertiary education, in % of young adult population, 2018	49	59 (2 nd in EU)	+27	38
R & D expenditure, % of GDP, 2018, no data for Switzerland	2.80	0.99	+0.20	1.67
Trust in institutions				
Trust in parliament, in %, 2020, only EU countries	61	16	+1 (since 2005)	30
Trust in political parties, in %, 2020, only EU countries	42	10	0 (since 2005)	16
Trust in legal system, in %, 2020, only EU countries	77	45	+15 (since 2005)	41
Trust in public administration, in %, 2020, only EU countries	70	53	NA	54
Quality of institutions				
Government effectiveness, 2019	1.75	1.04	+0.33	0.79
Control of corruption, 2019	1.94	0.68	+0.25	0.44

Sources: private sector debt, high-tech export share, social protection expenditure, tax-to-GDP ratio, business churn, tertiary education, R&D personnel and expenditure, Gini coefficient, wage compression from Eurostat; volatility of GDP growth calculation based on data from the International Monetary Fund; exports-to-GDP and real GDP per capita from the World Bank; economic complexity from the Atlas of Economic complexity; product market regulation and trade union density from OECD; trust in institutions from Standard Eurobarometer; bargaining coverage, employers' organization, coordination from the database on Institutional Characteristics of Trade Unions, Wage Setting, State Intervention and Social Pacts (ICTWSS); economic freedom index from the Heritage Foundation; government effectiveness and control of corruption from World Bank Governance Indicators.

Notes

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