Understanding the Sectoral Patterns of Foreign Direct Investment in the Baltic States: How do Prevailing Skills, Political Stability and Political Ideologies Matter?

By
Mantas Pupinis

Submitted to
Central European University
Department of International Relations and European Studies

In partial fulfilment of the requirements for the degree of Master of Arts

Supervisor: Professor Béla Greskovits

Word Count: 17111

Budapest, Hungary
2012

Abstract

The present thesis analyzes the empirical problem: despite very similar initial positions, the three Baltic States have developed different sectoral patterns of foreign direct investment (FDI) in the period 1991-2007. While Lithuania has attracted a significantly larger share of FDI in manufacturing, Latvia and Estonia, on the other hand, have specialized in FDI in financial and business services. Analysis is based on a theoretical approach to economic relations borrowed from economic sociology – economic substantivism – which tells that economic activity is always embedded in wider social, institutional, cultural and political context. By using various methods (analysis of statistical data, party programs, legal documents and media) and data from various sources the thesis analyzes the influence of the prevailing skills, political stability and political ideology on the types of attracted FDI. The thesis has two main findings. First, the prevailing skills do indeed have an influence on the sectoral patterns of FDI in Lithuania and Estonia. In Lithuania, prevailing skills are conducive to FDI in manufacturing, while in Estonia they are conducive to FDI in financial and business services. Second, the political ideologies of the parties in government have an influence on the type of attracted FDI in all three Baltic States. However, only in Estonia government FDI policies are supported by a high level of political stability.

Acknowledgements

First and foremost, I would like to express my gratitude to Professor Béla Greskovits for his invaluable comments on my project during the whole thesis writing period. Both personal and class discussions with Professor Greskovits were a challenging and enriching experience which contributed greatly to the present thesis. I would also like to thank my Academic Writing Instructor Réka Futász for her advice on the structure and language of my thesis.

I am grateful to my parents Edmundas Pupinis and Diana Pupinienė who have always encouraged me to pursue my interests and supported my studies. Finally, I would like to thank Greta Mackonytė for her useful comments, moral support and understanding.

Table of Contents

List of Graphs and Tables

Graphs:

Tables:

Introduction

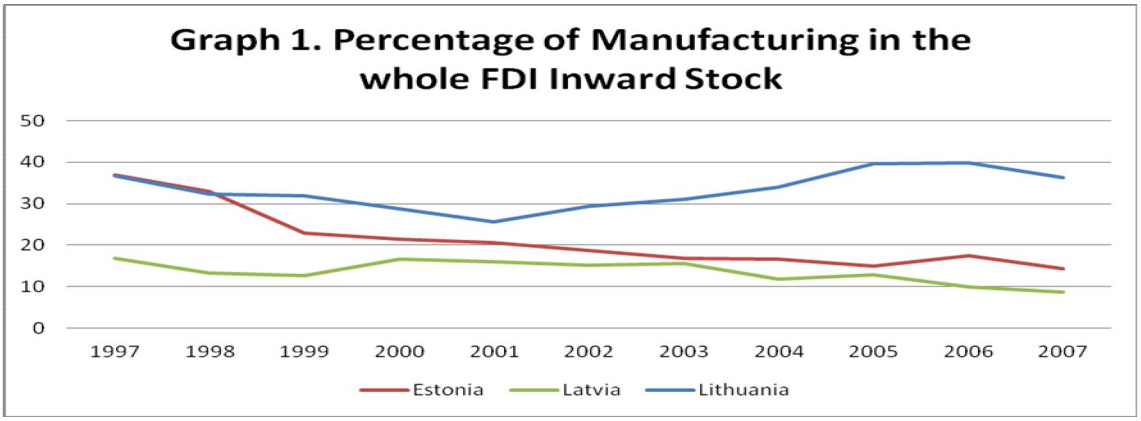
The research on foreign direct investment (FDI) has attracted a lot of interest in academia since the mid-twentieth century, when FDI flows started to make an important influence on the global and national economies. The questions analyzed in this field have proliferated during the last five decades and many answers have been found. However, interest in interplay between foreign capital and domestic political economies in the time of globalization is rather increasing and new issues are being analyzed. The present thesis aims to contribute to the FDI research by investigating the causes of emergence of different sectoral FDI patterns in the Baltic States.

Not only did the three Baltic States (Estonia, Latvia and Lithuania) have the same historical experience as being parts of the Soviet Union but they also took very similar approaches to rebuilding their states and economies after the fall of communism. The inherited Soviet institutional environment and the radical economic liberalization policies made their starting positions very similar after the restoration of independence in the early 1990s. However, after 20 years of independence, it is obvious that *the three states have developed different sectoral patterns of FDI*. The present work will concentrate on the FDI flows to two very different sectors, namely, manufacturing and financial and business services[1]. There are five main reasons why the analysis of this issue is important and interesting as well as why these two particular sectors are chosen. First, juxtaposing manufacturing with financial and business services is valid, since the two sectors are different enough for being sensitive to different types of the host country determinants.

[1] Financial and business services: financial intermediation and real estate, renting & business activities, i.e. J and K in NACE REV.1 codes.

Second, these two sectors seem to have different effects on economy. Third, it is puzzling why foreign companies invest to different sectors in the Baltic States. Fourth, while analyses of manufacturing sector are abundant, there was very little done on the financial and business services FDI before. Fifth, by analyzing this question one can generally understand more about the process of transition and its interplay with foreign capital.

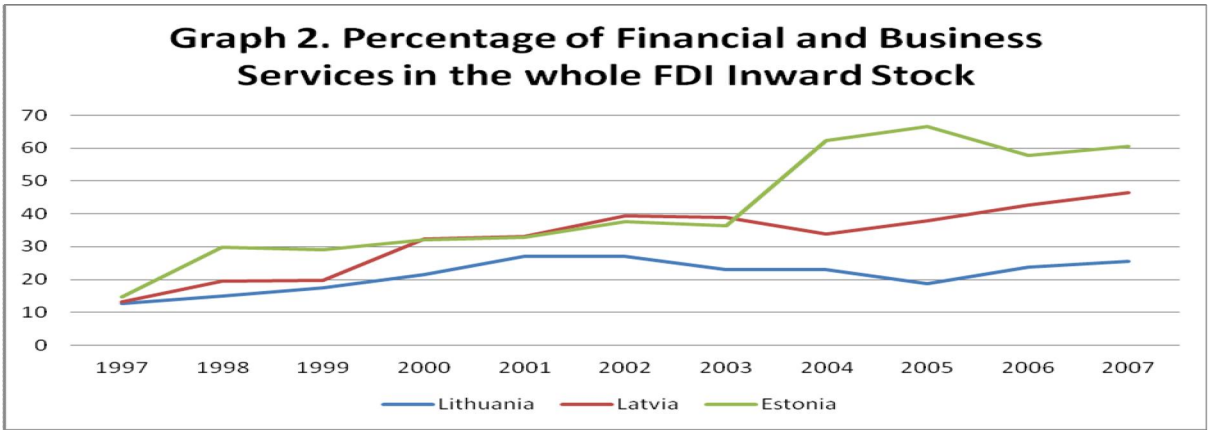
Lithuania attracts a significantly larger share of FDI to manufacturing than the two other Baltic States (see Graph 1). In 2007, the share of manufacturing FDI in the whole FDI stock amounted to 36.3% in Lithuania, while it constituted only 14.4% and 8.8% of the whole stock in Estonia and Latvia, respectively.



Source: Vienna Institute of International Economic Studies (WIIW) database on FDI. Author's own calculations.

On the other hand, Estonia and Latvia have attracted a significantly larger share of the overall FDI stock to financial and business services than Lithuania (Graph 2). Estonia is a clear leader in this respect. Its percentage of the FDI in financial and business services in 2007 amounted to 60.6% of the overall stock. Latvia's number in the same year was 46.6%, while Lithuania attracted only 25.6% of the whole FDI stock to financial and business services (see Graph 2). Graphs 1 and 2 also show that the cited data from

2007 is not a onetime deviation but rather a manifestation of the emerging different patterns.



Source: WIIW database on FDI. Author's own calculations.

It is necessary to note that before the restoration of independence a significant share of GDP in all three Baltic States was created in the manufacturing sector: 39.6% in Estonia, 36.4% in Latvia, and 32.8% in Lithuania (Table 1).[2]

Table 1. Distribution of GDP in different sectors in the Baltic States in 1990

	Estonia	Latvia	Lithuania
Agriculture and fishing	15.6	21.1	27.7
Manufacturing	39.6	36.4	32.8
Construction	7.1	9.8	10.5
Transport	6.4	10.9	6.0
Other	31.3	21.1	22.9

Source: Mygind, 1998.

Later all of the Baltic States faced a decrease in GDP produced in the manufacturing sector. In 2007, share of GDP produced in manufacturing was 11% in

[2] Niels Mygind, "The Internationalization of the Baltic Economies," *BRIE Working Paper* 130 (1998), 22, http://brie.berkeley.edu/publications/WP130.pdf (accessed May 22, 2012).

Latvia, 19% in Lithuania and 17% in Estonia.[3] Moreover, nowadays all three Baltic States produce the lion's share of their GDP in the services sector. The development of the different FDI patterns in the Baltic States, despite their very similar starting positions, makes the outlined situation worthy of deeper analysis. Therefore, *the present research will try to explain the emergence of different FDI patterns in the Baltic States in the period 1991-2007*. The research question hence is formulated as follows: why have Lithuania, Latvia and Estonia developed different patterns of sectoral FDI flows despite very similar starting positions?

The Baltic States are especially good cases for such study not only due to the fact that they are similar in many respects but also because their analysis allows studying the emergence of the different sectoral FDI patterns from the very beginning of the process. This is the case since the Baltic States became independent in early 1990s and the data on FDI flows is accessible from almost all of the years since then.

Understanding what determines FDI flows to different economic sectors is highly relevant since FDI often has a decisive role in determining the development path of the state. Global economic interconnectedness has a great influence in shaping the economic, social, institutional and cultural organizations of the nation states. This argument can be explained by two more evident claims. First, it is a widely held view in the literature on development that different prevailing economic sectors shape the economic and social development of a country.[4] Secondly, the influence of FDI on the host country is quite

[3] World Bank Database, 2012, http://data.worldbank.org/indicator/NV.IND.MANF.ZS (accessed May 22, 2012).

[4] Software industry: Sean Ó Riain, "The Flexible Developmental State: Globalization, Information Technology, and the Celtic Tiger," *Politics and Society* 28, no. 2 (June 2000): 157–193; Primary resources: Michael D. Shafer, "Capturing the Mineral Multinationals: Advantage or Disadvantage?," in *Multinational Corporations*, ed. Thomas H. Moran (Lexington: Lexington Books, 1985), 25–53; Automobile industry: Lee Naeyoung and Jeffrey Cason, "Automobile Commodity Chains in the NICs: A Comparison of South

often so powerful that it can determine which economic sector is prevailing in a country and thus seriously influence or even determine its path of development.[5] Therefore, it is necessary to understand why different sectoral FDI patterns emerge in different countries. By doing this one can get an insight into the overall development path of a particular country. Why is Lithuania getting a considerable amount of FDI to its manufacturing sector, while Latvia and Estonia are gradually becoming the so-called hubs of financial and business services? The answer to this question is important not only to get a deeper understanding of the cases under investigation in this thesis but also can yield relevant theoretical insights.

The present thesis will also seek to fill the gap in understanding what attracts FDI to financial and business services. The previous work in the emerging literature on sectoral FDI patterns until very recently has been done mostly on the manufacturing sector. Only last year have a few important papers on the financial and business services appeared.[6] This thesis expands on their insights.

Korea, Mexico, and Brazil," in *Manufacturing Miracles*, ed. Garry Gereffi and Donald L. Wyman (Princeton: Princeton University Press, 1990), 223–243; Textile industry: Diane Elson, "Uneven Development and the Textiles and Clothing Industry," in *Capitalism & Development*, ed. Leslie Sklair (London and New York: Routledge, 1994), 189–210; Financial services: Sean Ó Riain, "Addicted to Growth: State, Market and the Difficult Politics of Development in Ireland," in *The Nation-State in Transformation: The Governance, Growth and Cohesion of Small States Under Globalisation*, ed. Michael Bøss (Aarhus: Aarhus University Press, forthcoming).

[5] Béla Greskovits, "Legacies of Industrialization and the Paths of Transnational Integration After Socialism" (presented at the conference "Historical Legacies of Communism," Princeton, United States, 2011).

[6] Magdolna Sass and Martina Fifekova, "Offshoring and Outsourcing Business Services to Central and Eastern Europe: Some Empirical and Conceptual Considerations," *European Planning Studies* 19, no. 9 (2011): 1593–1609; Jane Hardy, Grzegorz Micek, and Paweł Capik, "Upgrading Local Economies in Central and Eastern Europe? The Role of Business Service Foreign Direct Investment in the Knowledge Economy," *European Planning Studies* 19, no. 9 (2011): 1581–1591.

Findings produced by this thesis can also be relevant for policy makers. According to Alfaro and Charlton[7], nowadays policy makers usually tend to believe that some FDI (e.g. in high-tech manufacturing) are more valuable than others. Their beliefs influence national policies towards FDI which, therefore, seek to attract some types of FDI and regulate other types.

This thesis investigates two sets of hypotheses. The first set of hypotheses deals with the connection between the skills prevailing in a particular country and the type of FDI. The thesis looks at the change in the educational systems and skills prevalent in the analyzed states, since skills of the population are reported to be important for investors in manufacturing as well as financial and business services. All of the states inherited from the Soviet Union strong educational systems based on the specific skills formation. Vocational education was a strong part of such systems. Educational systems based on the formation of specific skills are conducive to a strong manufacturing sector in the economy. Thus we could also expect that such states would get more FDI to manufacturing sector as well. Financial and business services, on the other hand, prefer general skills. Sass and Fifekova conducted interviews in the Visegrad states with the top-level managers of the companies which invested in the business services in these states. They report that employees "skilled in information technology or other technical fields and languages" and those who had "excellent communication and interpersonal skills"[8] were preferred by foreign investors in the business sector.

Manufacturing sector should prevail where the "manufacturing experiences" are solid and nurtured. According to Amsden, "past manufacturing experience creates

[7] Laura Alfaro and Andrew Charlton, "Growth and the Quality of Foreign Direct Investment: Is All FDI Equal?," *CEP Discussion Paper* 830 (2007): 1.
[8] Sass and Fifekova, 1604.

relatively high expectations on the part of potential investors that future manufacturing activity will succeed."[9] Therefore, we should expect more FDI to manufacturing in countries where "manufacturing experiences" are present. All three Baltic States inherited very similar manufacturing experiences from the Soviet Union. As it was already mentioned above, in the early 1990s the greatest share of GDP in all three Baltic States was created in manufacturing sector: 39.6% in Estonia, 36.4% in Latvia, and 32.8% in Lithuania.[10] However, as Bohle and Greskovits[11] observe, legacies of the former regime can be perceived "as either threats or assets" after the change of the regime. Hence, manufacturing experiences could have been either strengthened or weakened in the Baltics after the fall of communism according to how they have been perceived. The present thesis hypothesizes that Lithuania managed to keep the manufacturing experiences to some extent while it was weakened in Latvia and Estonia. On the other hand, we should see the more complete systems of general skills formation in Latvia and Estonia. Thus we should expect that the labor force in Estonia and Latvia is better equipped with such skills as knowledge of languages, ability to use information technologies, communication and interpersonal skills which are required in financial and business activities. Hence the first two hypotheses:

H1: The prevalence of FDI in manufacturing in Lithuania is influenced by its educational system and the prevailing skills which are conducive to manufacturing activities.

[9] Alice H. Amsden, *The Rise of "the Rest": Challenges to the West from Late-industrializing Economies* (Oxford: Oxford University Press, 2001), 15.
[10] Mygind, 22.
[11] Dorothee Bohle and Béla Greskovits, "Neoliberalism, Embedded Neoliberalism and Neocorporatism: Towards Transnational Capitalism in Central-Eastern Europe," *West European Politics* 30, no. 3 (May 2007): 444.

H2: The prevalence of FDI in financial and business services in Latvia and Estonia are influenced by their educational systems and the prevailing skills which are conducive to financial and business activities.

The second set of hypotheses deals with the interplay among the political stability, political ideology of the parties in government and the type of FDI. The previous analyses suggest that financial and business services FDI prefers the stable prevalence of the centre and right-wing parties in the government (i.e. pro-capital/pro-market), whereas the manufacturing sector FDI prefers the stable prevalence of the left-wing parties in the government (pro-labor). Overall, FDI in services seems to be more sensitive to political stability than FDI in manufacturing[12]. However, the concept of political stability alone is not enough to explain the differences in the sectoral FDI patterns. The previous literature shows that political stability matters most for those investors which make the largest irreversible investments (sunk costs) in the country.[13] However, there is no unambiguous accessible data about each and every investment in the Baltic States. In some instances, investments can be larger in manufacturing; in other instances, it can be more sizeable in financial and business services. For the proper explanation of the types of FDI in the Baltic States it seems necessary to complement the political stability element with the insights from the literature which finds the important relationship between the political ideologies and the type of investment. According to Pinto and Pinto, left-wing governments are trying to attract foreign investment to the sectors where the foreign capital is a complement of labor, such as manufacturing. On the other hand, centre and right-wing governments are friendly to foreign investments which

[12] *An Open World: Ernst & Young's 2008 European Attractiveness Survey* (Ernst & Young, 2008), 13.
[13] Avinash K. Dixit and Robert S. Pindyck, *Investment Under Uncertainty* (Princeton, N.J: Princeton University Press, 1994), 8.

support the domestic business activities such as financial intermediation and business services.[14] At first glance, it seems that nationalist and right-wing ideology was much more prevalent in Latvia and Estonia than in Lithuania. Thus the indicators of political stability and political ideology must be combined to explain the complicated nature of the different sectoral patterns of FDI in the Baltics in transition. Therefore, the hypotheses are formulated as follows:

H3: The prevalence of FDI in manufacturing in Lithuania is influenced by the fact that its political stability was lower in the year 1991-2007 than in the two other Baltic States and the left-wing ex-communist parties prevailed in government for a significant amount of time.

H4: The prevalence of FDI in financial and business services in Latvia and Estonia is influenced by the fact that their political stability was higher in the year 1991-2007 than in Lithuania and the centre or right-wing parties prevailed in government.

When analyzing the four proposed hypotheses, multi-causality will also be considered, i.e. the observed sectoral patterns of FDI can be a result of the interplay of the proposed phenomena rather than an outcome of one of them.

The present analysis is based on the theoretical approach prevalent in economic sociology – economic substantivism. This view, which is widely agreed to have originated from the writings by Karl Polanyi[15], holds that "markets are institutions that do not emerge naturally or spontaneously, but are socially created"[16] and that "the human

[14] Pablo M. Pinto and Santiago M. Pinto, "The Politics of Investment: Partisanship and Sectoral Allocation of Foreign Direct Investment," *Conference Papers -- Midwestern Political Science Association* (Annual Meeting 2006): 22.
[15] Kurtuluş Gemici, "Karl Polanyi and the Antinomies of Embeddedness," *Socio-Economic Review* 6, no. 1 (January 2008): 5–33.
[16] Nina Bandelj, *From Communists to Foreign Capitalists: The Social Foundations of Foreign Direct Investment in Postsocialist Europe* (Princeton, N.J: Princeton University Press, 2008), 3.

economy (…) is embedded and enmeshed in institutions, economic and non-economic"[17] This means that economic activities are always embedded in economic, social, institutional and cultural environment of its setting. Therefore, in the present thesis FDI is seen as socially and institutionally embedded activity. Such view allows approaching coherently the four hypotheses raised in the introduction and contrasting such institutional determinants of FDI as the prevalence of the different skills and political stability with such purely economic determinants of FDI as labor costs, market size and others which attracted the greatest interest from the scholars so far and will be reviewed in the first chapter. Purely economic determinants can only help to understand the overall quantities of FDI flows rather than qualities, i.e. different sectoral patterns.

The present analysis relies on the logic of Mill's method of difference. Somewhat unconventionally, this logic is used to give grounds for an in-depth comparative analysis of the three cases: Latvia, Estonia and Lithuania. As it was mentioned above, despite of a lot of similarities, these countries have developed different sectoral patterns of FDI, i.e. Latvia and Estonia are specializing in FDI in financial and business services while Lithuania gets the largest share of FDI in manufacturing. It is chosen to analyze all three Baltic States in order to see the whole complexity of the situation and make the results more reliable. By using various methods (analysis of statistical data, party programs, legal documents and media) and data from various sources (World Bank, United Nations, Eurostat databases, etc.), this thesis aims to check the four hypotheses raised in the introduction, namely, on the impact of prevailing skills (H1 and H2), political stability and party ideology (H3 and H4) on different types of FDI.

[17] John Lie, "Embedding Polanyi's Market Society," *Sociological Perspectives* 34, no. 2 (1991): 220.

The time period of 1990-2007 is chosen for analysis. 1990 is the year when the first of the Baltic States (Lithuania) regained its independence and could start pursuing structural reforms. 2007 is chosen as the end of the analyzed period due to the financial crisis (started in 2008) which could distort the statistical data.

The thesis proceeds as follows. First chapter will present the issues discussed in the literature on FDI with a heavy emphasis on the research produced on the interplay of foreign capital with the process of transition. Third chapter will analyze the 1st and 2nd hypotheses on the connection between the prevailing skills and the type of FDI. Fourth chapter will investigate the 3rd and 4th hypotheses on the connection between political stability, party ideology and the type of FDI. The thesis has two main findings. First, the prevailing skills do indeed have an influence on the sectoral patterns of FDI in Lithuania and Estonia. In Lithuania, prevailing skills are conducive to FDI in manufacturing, while in Estonia they are conducive to FDI in financial and business services. Second, the political ideologies of the parties in government have an influence on the type of attracted FDI in all three Baltic States. However, only in Estonia government policies are supported by a high level of political stability.

Chapter 1: Literature on Foreign Direct Investment in Transition Economies

The following literature review aims to constitute an informed starting point for the subsequent study. It is structured as follows. In the first part of the chapter, the study of the determinants of FDI in the post-socialist societies will be reviewed. Then the thesis goes on to look at what influence does foreign capital have on the post-socialist societies. Subsequently, a new trend of research which investigates the causes of the increasing FDI in services is indicated. The last part looks at studies produced on the foreign investment in the Baltic States. The chapter is concluded by explicating the gap in the previous literature and showing the place of the present study in the general FDI research.

1.1. Determinants of Foreign Direct Investment in Central and Eastern Europe

Two groundbreaking articles in the research on FDI in transition were produced by Klaus E. Meyer, and Lankes and Venables in the mid-1990s. They were rather general and explicitly stated their wide objective to make a survey on various issues connected to FDI in CEE. However, they have mostly focused on the determinants of FDI flows. It is very interesting that the first scholars who studied foreign investment in the region have found that the main determinant of FDI in CEE countries was market access and not, for instance, cost differentials.[18] The data of Lankes and Venables also shows that the most prevalent function of foreign investments was to supply regional or local markets, while

[18] Klaus E. Meyer, "Foreign Direct Investment in the Early Years of Economic Transition: a Survey," *The Economics of Transition* 3, no. 3 (1995): 307-308.

exports from the region and services take second and third places respectively.[19] There exist different opinions as well. The analysis by Bevan and Estrin, on the other hand, does not indicate that the market access is the most important determinant of FDI to CEE countries. The authors find that the main determinants are unit labor costs, the size of the host and investor countries and their proximity.[20] This may be because the article was written later, in 2004. Perhaps the primary strategic competition between the Western European multinationals for the CEE markets was less intensive at the time and multinationals have started to put a greater emphasis on seeking lower costs and investing in larger and closer countries.

Cost differentials are, therefore, indicated as a very important determinant of FDI in transitional economies by most of the studies. Scholars particularly emphasize the lower labor costs. Labor force in transition economies is also seen as relatively highly skilled. Moreover, Estrin, Hughes and Todd emphasize a relative abundance of the workers in the region that have previously worked in the manufacturing sectors where high skills were needed: chemicals, engineering, machine tools, vehicles and aerospace.[21] This made a cheaper labor force in the CEE even more attractive, especially for investors in the manufacturing sector.[22] All in all, the majority of scholars agree that such assets as market access, labor costs, market size, geographical proximity and closeness to the large European markets had an influence on the level of FDI in CEE countries. However, at the moment the interest of the research in this field is shifting towards analyzing the impact

[19] Hans-Peter Lankes and A. J. Venables, "Foreign Direct Investment in Economic Transition: The Changing Pattern of Investments," *Economics of Transition* 4, no. 2 (October 1, 1996): 337.
[20] Alan A. Bevan and Saul Estrin, "The Determinants of Foreign Direct Investment into European Transition Economies," *Journal of Comparative Economics* 32, no. 4 (2004): 777.
[21] Saul Estrin et al., *Foreign Direct Investment in Central and Eastern Europe: Multinationals in Transition* (London: Pinter Publishers, 1997), 18.
[22] Ibid, 16-17.

of institutions. This "institutional turn" is, inter alia, driven by the idea that institutional environment can be changed in a short or at least medium term and thus is a good means for CEE countries to compete for useful investment through structural reforms.

The privatization process is a widely discussed topic in this respect, i.e. selling the previously state-owned enterprises to private companies and individuals. Gabor Hunya provides an excellent review of the main methods of privatization.[23] There exists a widely held approach that the type of privatization had an influence on the level of FDI attracted to the countries of the CEE region. Those countries which tried to involve foreign buyers in the early stages of the privatization have naturally attracted the largest share of foreign investment.

Another important institutional determinant of FDI which supports the process of privatization and is also affected by it is what could be put under the name legal, institutional and infrastructure environment. Environment conducive to the market economy based on the private property is necessary for states willing to attract foreign investment. Rule of law, a proper legislation, enforcement of property rights, helpful public administration, decent telecommunications, low-cost and high-quality transportation, and proper utilities of energy supply are vital for foreign companies to come to transitional countries. Fabry and Zeghni take a somewhat different approach on the institutional environment in CEE states. They suggest approaching it not as a determinant of FDI but rather as a "result of an interaction between host country and

[23] Gabor Hunya, "Large Privatization, Restructuring and Foreign Direct Investment," in *Lessons from the Economic Transition: Central and Eastern Europe in the 1990s*, ed. Salvatore Zecchini (Boston: Kluwer Academic Publishers, 1997), 280-286.

foreign investors."[24] The present thesis tries to merge both approaches and invites to look at the institutions of transitional economies as both determinants of FDI and outcome of their interaction with foreign companies.

Political stability is one more determinant which is reported to be of utmost importance for foreign investors considering putting their capital in transitional countries. Particularly worrying for multinationals are such states where civil unrest, revolutions or even civil war could be expected. Major government change can also be an important consideration for MNCs, especially, if the party which is against foreign capital comes to power.[25] For instance, communist ideology sees it as a manifestation of imperialism and exploitation by powerful Western capitalists.[26] The question about parties in power is important for the present thesis since Lithuania had former communists in government soon after regaining the independence whereas nationalists were controlling the governments in Latvia and Estonia during the crucial time of structural reforms.

Clearly, the government policies aimed directly at the attraction of foreign capital must be mentioned among the institutional determinants of FDI. Estrin, Hughes and Todd tell that tax incentives and subsidies are indicated as the most important mechanisms by the foreign investors themselves. However the authors also remark that these incentives are not very important in the first years of transition, since foreign investors do not expect to make large profits in the first years anyway. Simple provision of information to Western investors can also be a very important strategy, since investors usually are not

[24] Nathalie Fabry and Sylvain Zeghni, "How Former Communist Countries of Europe May Attract Inward Foreign Direct Investment? A Matter of Institutions," *Communist and Post-Communist Studies* 39, no. 2 (June 2006): 203.
[25] Estrin et al., 19.
[26] Vladimir I. Lenin, "Imperialism: The Highest Stage of Capitalism," in *The International Political Economy of Direct Foreign Investment*, ed. Benjamin Gomes-Casseres and David B. Yoffie, vol. 1 (Aldershot, Hants, England: E. Elgar, 1993), 3–12.

very familiar with doing business in the region. MNCs may also be interested in the size of the personal tax for their employees.[27]

There are many more institutional characteristics of the CEE countries analyzed as determinants of FDI. In addition to the characteristics of transition, which were discussed in more details above, such as features of the privatization process, institutional, legal and infrastructure environment, political stability and incentives for foreign investors, one can also speak about macroeconomic stability, liberalization of prices, foreign exchange and trade regime, development of the banking sector, and many others. However, the presented review emphasized those of them that are discussed the most in the previous research as well as those that are important for the present analysis.

1.2. The Impact of Foreign Direct Investment on Transition Economies

Already in 1995 Klaus E. Meyer wrote that there were very high expectations about the positive impact of FDI to the transition economies. First of all, it was seen as bringing new technologies and know-how. It also helped the transition economies to get capital which was hard to do in international capital markets. In addition to this, domestic governments saw privatization as a good means to get more revenues to the budget. Western companies were also expected to help creating competition in domestic markets and to develop the private sector. Interaction with foreign companies would help domestic firms to get better knowledge about how business is done abroad, create personal networks and thus to integrate faster to the Western markets.[28] Economists believe that generally there are three ways how foreign investment affects the host

[27] Estrin et al., 21-22.
[28] Meyer, 301.

country: increase in capital stock, higher productivity, and positive spillovers.[29] However, foreign investors can also have a negative effect on the market structures of the host country. For example, foreign investors may want to keep the oligopolistic market and prevent the competition.

Political economists, on the other hand, go as far as to claim that the foreign capital can contribute to or even determine the future path of development of the state. This is the line of argument suggested by Dorothee Bohle and Béla Greskovits. They argue that MNCs have influenced the emergence of different types of capitalism in CEE region by using their "systemic power" through different channels. First of all, since capital was scarce in the region, officials of MNCs became the leading business community in the transitional economies. Second, even before entering the newly emerging markets, MNCs used their transformative influence through their bargaining power enhanced by the ability not to enter. Lastly, after investing, MNCs became powerful actors inside the state and have also influenced the specialization of the country through investing in particular sectors.[30] The authors also show that the Visegrad countries have attracted the largest share of FDI in the complex manufacturing sector whereas the Baltic States, Romania and Bulgaria has gotten their part of foreign investment in the light manufacturing sector. This made the mentioned states specialize in the export of the goods produced in the respective sectors.[31] To sum up, foreign capital can be seen not only as having the same positive influence on every economy such as spillovers of new technologies and management structures but also as steering the host

[29] Josef Christl, "The Role of FDI in Transition," in *Foreign Direct Investment in Europe: A Changing Landscape,* ed. Klaus Liebscher et al. (Northampton, MA: E. Elgar, 2007), 53–58.
[30] Bohle and Greskovits, 456-457.
[31] Bohle and Greskovits, 457-460; Greskovits.

economies to different directions of development according to the type of the invested capital.

1.3. Turn to FDI in Services

The literature discussed above was explicitly taking into account the FDI in the manufacturing and leaving out the FDI in services. This was done mostly due to two reasons. First, there existed a lack of reliable data about investment in services. Second, FDI in manufacturing was more significant in the CEE states.

Only recently the research on FDI in CEE countries turned its attention from manufacturing towards services and especially financial and business services. Such turn was already suggested by the scholars working in the field. According to Resmini, "understanding FDI behavior in the service sectors is crucial for a better comprehension of the future dynamics of FDI."[32] The break-through article in terms of the determinants of business services in CEE states was written by Magdolna Sass and Martina Fifekova only last year. The authors conceptualized the difference between vertical and horizontal investment in business services. The concepts are used in the same sense as in terms of manufacturing.[33] Horizontal investment means that an investor is interested in the domestic market rather than cost reduction as it is in the case of vertical investment. The authors show that it was indeed the case in the Visegrad States that access to their markets interested foreign investors. Also, from 30 interviews with the senior managers conducted in the Visegrad States the authors have indicated that in terms of vertical

[32] Laura Resmini, "The Determinants of FDI in Central, Eastern and South-Eastern Europe: Lessons from the Past and Prospects for the Future," in *Foreign Direct Investment in Europe: A Changing Landscape*, ed. Klaus Liebscher et al. (Northampton, MA: E. Elgar, 2007), 207–226.
[33] Paul R. Krugman, *International Economics: Theory & Policy*, 8th ed. (Boston: Pearson/Addison Wesley, 2009), 183.

investment, cost reduction, availability of qualified labor, strategic location, quality of infrastructure, political and business environment, government incentives and experience of affiliates already operating in the country was of the utmost importance in picking the host country for investment.[34] Insights produced by Sass and Fifekova are very important for the present thesis and later on it will be elaborated in more details what implications it have on the problem analyzed in this text.

1.4. Foreign Direct Investment in the Baltic States

The literature devoted explicitly for studying FDI in the Baltics is very small.[35] Usually the discussions about the foreign investment in Estonia, Latvia and Lithuania are included in the wider writings on the CEE region or, on the other hand, texts dealing with the FDI in only one particular Baltic country are produced. In short, most of the general insights by the articles on the FDI in transition reviewed above are relevant for the Baltic cases as well.

1.5. Conclusion

The presented review of the issues dealt with in the research on FDI in transitional economies constitutes an informed starting point for the present analysis. It also indicates the under-researched areas of the field to which this thesis aims to contribute. First of all, it shows the lack of understanding of the preferred characteristics of the host states by the foreign investors in different economic sectors. Moreover, although there is already some

[34] Sass and Fifekova.

[35] Mantas Degutis and Manuela Tvaronavičienė, "Factor Analysis of Lithuanian and Estonian Inward Foreign Direct Investment," *Business: Theory & Practice* 7, no. 3 (2006): 150–157; Jeanette Thomsen, "Processes of Localization and Institutionalization of Local Managers in Economic Functions in Danish Owned Subsidiaries in Estonia, Latvia and Lithuania Around the 21st Century," *Journal of Business Economics & Management* 9, no. 4 (December 2008): 279–287; Algirdas Miškinis and Birgit Reinbold, "Investments of German MNEs into Production Networks in Central European and Baltic States," *Technological and Economic Development of Economy*, no. 4 (2010): 717–735.

research done on FDI to different sectors of manufacturing, this thesis aims to expand the reserved knowledge about determinants of FDI in financial and business services. It will also contribute to the small amount of literature on FDI and the process of transition in the Baltic States.

Chapter 2: Influence of Prevailing Skills on the Type of Foreign Direct Investment in the Baltic States

As it was already indicated above, the cost and quality of labor was seen as a very important determinant of FDI to the CEE region from the very beginning of the transition period. However, while due to its quantitative nature the variable of labor costs was used to embrace a wide range of different cases, there was no tendency to create complex categorizations of prevailing skills. Thus, most of the literature on FDI was using a binary opposition of low- versus high-skilled labor and did not go further. Perhaps one of the reasons for this was a lack of good data on the skills prevailing in the transitional countries with which one could analyze a few transitional countries. The best proxy often used for evaluating human capital, according to Neuhaus, is "average years of schooling of the labor force". He also mentions a World Bank indicator called "labor force with secondary education".[36] These two indicators, although important for the present analysis, are clearly not enough for analyzing the hypotheses evaluated in this chapter:

H1: The prevalence of FDI in manufacturing in Lithuania is influenced by its educational system and the prevailing skills which are conducive to manufacturing activities.

H2: The prevalence of FDI in financial and business services in Latvia and Estonia are influenced by their educational systems and the prevailing skills which are conducive to financial and business activities.

Such general indicators as those mentioned above will not help to capture the qualitative differences of the skills required in the two analyzed sectors, namely,

[36] Marco Neuhaus, *The Impact of FDI on Economic Growth: An Analysis for the Transition Countries of Central and Eastern Europe* (Heidelberg: Physica Verlag, 2005), 101.

manufacturing and financial and business services. The binary opposition between high and low skills used before, is not sufficient and the present thesis goes further to look closer at the qualities of the labor force in the Baltic States.

Skills of the labor force are very important in both of the analyzed sectors. According to Islam and Shazali "the skill of the workforce is a dominant input of a manufacturing system."[37] The same is the case in the financial and business services. Sass and Fifekova argue that the highly skilled labor for lower cost was the main determinant for business services in the CEE states.[38] Thus, the main question in the present chapter is what type of skills are preferred by the manufacturing sector as compared to those preferred in the financial and business services. The distinction between high and low skills is not enough here, as both highly- and lowly-skilled people work in both sectors. In the next part we will look at what skills are preferred by investors in the two analyzed sectors.

2.1. Differences between Skills Preferred by FDI in Manufacturing and Financial and Business Services

2.1.1. Manufacturing

From the theoretical literature, three arguments about the skills preferred by the manufacturing activity can be derived. First, in terms of high skills, manufacturing activity is supported by the amount of people who are educated in engineering and manufacturing in the tertiary level of education system. Estrin, Hughes and Todd, as many other authors, observe that transitional economies have inherited a highly skilled

[37] Shahidul Islam and S.T. Syed Shazali, "Determinants of Manufacturing Productivity: Pilot Study on Labor-intensive Industries," *International Journal of Productivity & Performance Management* 60, no. 6 (July 26, 2011): 568.
[38] Sass and Fifekova, 1606.

labor force from the socialist times. Since they were writing in 1997, one can suppose that they had in mind mostly the labor force skilled in manufacturing. It is clear when they support their argument about the prevalence of high skills by telling that in transitional economies there are a lot of people who were previously employed in the fields of "chemicals, engineering, machine tools, vehicles and aerospace."[39] However, as Bohle and Greskovits argue, the inheritance from the socialist times can be either weakened or strengthened during the time of transition.[40] It is the aim of this chapter to evaluate how much of the previous "manufacturing experiences" is left in the Baltic States. The amount of people educated in engineering and manufacturing in the tertiary level of educational system thus will be seen as conducive to FDI in manufacturing sector.

Second, low-skilled labor force will be judged as conducive to FDI in manufacturing in the Baltic States. Hardy, Mizek and Capik underline that in the beginning of transition the manufacturing FDI attracted to CEE were in search for cheap and low-skilled labor. Costs were more important than quality.[41] According to Ellingstad, a phenomenon similar to *maquiladoras* in Mexico can be observed in CEE countries. For this thesis one of its characteristics is important. Ellingstad argues that, inter alia, foreign investors are interested in low skills, low wages and low training costs in CEE states. Although labor productivity is also lower, its increase is usually not followed by a respective increase in wages.[42] It seems that the FDI in manufacturing attracted by the Baltic States are overwhelmingly directed to lower costs and not quality. They are

[39] Estrin et al., 18.
[40] Bohle and Greskovits, 444.
[41] Hardy, Mizek and Capik, 1583.
[42] Marc Ellingstad, "The Maquiladora Syndrome: Central European Prospects," *Europe-Asia Studies* 49, no. 1 (January 1997): 8.

vertical rather than horizontal investments. This is not least the case due to the fact that all three Baltic States get an overwhelming amount of manufacturing FDI in the light manufacturing industries rather than complex manufacturing.[43] Light manufacturing sector uses the labor force with lower skills. Thus the amount of low-skilled labor force is seen as conducive to FDI in manufacturing.

Third, the quality of and the amount of people educated in vocational schools are important for manufacturing industries. In vocational education, specific skills conducive to manufacturing activities are built.[44] Of course, not only people working in manufacturing are educated in vocational schools. However, it is a good proxy for analyzing specific skills built for manufacturing activities. Vocational education and training (ISCED 3B and 4) and tertiary non-university specific education (ISCED 5B)[45] are thus seen as the places in the educational systems of the Baltic States where the skills important for foreign investors investing in manufacturing sector of these countries are built.

2.1.2. Financial and Business Services

Financial and business services seem to prefer different types of skills than manufacturing. As Sass and Fifekova show, for the investors in this sector "the main concern was availability of qualified workforce skilled in information technology (…) and languages." They also add that "some companies required excellent communication and interpersonal skills." However, expertise in any specific field was usually not

[43] WIIW data.
[44] Peter A. Hall and David W. Soskice, eds., *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford [England]: Oxford University Press, 2001) 25-26.
[45] UNESCO, "International Standard Classification of Education (ISCED)", 1997.

required.[46] From their observations the present thesis derives four arguments about the skills preferred by the financial and business services. First, the availability of people skilled in information technology is of the utmost importance for investors in financial and business services. Second, foreign investors in financial and business services prefer those countries which are better educated in languages. Third, FDI in financial and business services are positively influenced by the amount of labor force with general skills[47], especially, education in social sciences, business and law. Fourth, investors in financial and business services prefer states abundant with highly-skilled people, i.e. those who have acquired the degree in tertiary education.

2.1.3. Conclusion

Hollinshead and Hardy speak about a phenomenon that they call an "international or spatial division of labor." They argue that "as a result of differentiated patterns of industrial development resulting from institutional and cultural diversity across national borders, different countries and indeed regions within those countries, may offer distinctive and appropriate specialist skills."[48] The aim of this chapter is to see whether such division of labor exists in the Baltic region and also whether it affects the flows of FDI in the region. Also, the prevalence of some type of skills is not a static phenomenon, but it depends on the educational and training system of the country.[49] The next part will present the data on educational systems and prevailing skills in the three Baltic States which will help to test hypotheses 1 and 2.

[46] Sass and Fifekova, 1604.
[47] Hall and Soskice, 30.
[48] Graham Hollinshead and Jane Hardy, "The Offshoring of Financial Services: a Reassessment," *International Journal of Management Concepts & Philosophy* 4, no. 1 (January 2010): 90.
[49] Ibid, 95.

2.2. Educational Systems and Prevailing Skills in the Baltic States

2.2.1. Specific and General Skills

The Baltic States are usually seen as having educational systems conducive to general skills formation.[50] Clearly, compared to other states of the world, the Baltic States fall into this category. However, the Baltic region must be disaggregated into three different states to conduct a more careful analysis of the educational systems in Lithuania, Latvia and Estonia. Such analysis is necessary for accepting or rejecting the hypotheses of this chapter. Since it seems that the Baltic region is even in the minds of foreign investors often seen as a coherent unit, it is reasonable to assume that first the decision to invest in the Baltics is made and only after that the exact country for investment is chosen. This would make the relative differences of the educational systems and skills (more general vs. more specific) in the Baltic countries important. Investments in the particular sectors can also influence the "division of labor" in the Baltics.

2.2.1.1. Institutional Setup of Vocational Education

Let us first look at the institutional setup of the vocational education in the three Baltic countries in the early years of transition. For a long time after the declaration of independence in the early 1990s, systems of vocational education were unreformed in Estonia and Latvia. The vocational education systems in Latvia and Estonia in 1998 were based on the same network of educational institutions as was operating pre-1991.[51] Only

[50] Žilvinas Martinaitis, "The Political Economy of Skills Formation: Explaining Differences in Central and Eastern Europe" (Doctoral Dissertation, Vilnius University, 2010).
[51] EURYDICE, *Supplement to the Study on the Structures of the Education and Initial Training Systems in the European Union: The Situation in Estonia, Latvia, Lithuania, Slovenia and Cyprus* (Brussels, May 1999) 53.

in 1997 did talks about the possible reform of vocational education in Estonia start. However, there was no consensus at the time how the reform should be carried out.[52] In Lithuania, the reform of the system of vocational education inherited from the Soviet Union was started earlier, with the document called "General Concept of Education in Lithuania", published by the Government in 1992.[53] This fostered the slightly different paths of the vocational education.

Two main differences visible in the late 1990s between Estonian and Latvian vocational education systems, on the one hand, and Lithuanian system, on the other, can be distinguished. Firstly, after the reform, Lithuanian students had many more opportunities to enter the vocational education than their colleagues from Latvia and Estonia. There were five options in Lithuania,[54] while in Latvia and Estonia there were only two.[55] Second important difference between the vocational education systems in the Baltic States concerns teachers. In Estonian vocational education institutions teachers were mostly professionals from specific fields. As Eurydice Report indicates, they rather lacked the capacity to convey what they know effectively, because most teachers did not have any theoretical education or knowledge how to convey what they know to students. Since the teachers were not aware of other ways of teaching, the classes were usually lecture-based, without practical exercises.[56] The same was the case in Latvia, where at least until 1998 there was no program in educational institutions which would prepare

[52] Ibid, 23-24.
[53] Meilė Lukšienė et al., "General Concept of Education in Lithuania" (Ministry of Culture and Education of the Republic of Lithuania, 1992), http://www.smm.lt/en/legislation/docs/General_concept_of_education_in_Lithuania_1992.pdf (accessed May 22, 2012), 21-25.
[54] Ibid, 23.
[55] EURYDICE, 53.
[56] Ibid, 25.

teachers for the schools of vocational education.[57] On the other hand, there were three groups of teachers in Lithuania: general teachers, vocational teachers and so-called foremen. General teachers taught general subjects and were graduates of universities of education. Vocational teachers usually had a degree in engineering and no qualification in teaching. Foremen, or instructors, helped the students to get practical skills in firms,[58] and there was no such type of teachers in Latvia and Estonia. It could be seen as an institution of apprenticeship that is very important for building specific skills. It "provides the future workforce with hands-on experience of how a specific job in specific industries is carried out"[59] The body of teachers in vocational education was more complete in Lithuania than in other two Baltic States in the beginning of transition.

Lithuania renovated its system of vocational education more carefully than the other two states. It shows the will of the policy makers to keep nurturing the skills which were acquired during the socialist times or at least not to lose the level of such skills in the society. Arguably, the reforms should have made vocational education in Lithuania at least somewhat more popular than in Latvia and, especially, Estonia. In Estonia, the number of the people attending vocational schools dropped from around 40% to 26% during the first five years of transition.[60] To sum up, the reforms of vocational education in Lithuania seem to have made it more attractive for students than in the other two Baltic States and thus produced more of the labor force with the specific skills which would be attractive for investors in manufacturing. The next part of the chapter looks at the statistical data on the specific and general education in the Baltic States.

[57] Ibid, 54.
[58] Ibid, 81.
[59] Martinaitis, 53.
[60] EURYDICE, 23.

2.2.1.2. Statistical Data on the Specific and General Education in the Baltic States

When speaking about the qualitative differences in terms of skills held by the labor forces of the three Baltic countries it is useful to introduce a standard categorization of the levels of education, because the levels of education are called differently in the analyzed states and have different starting and ending dates. Such standard categorization is International Standard Classification of Education (ISCED) which categorizes the levels and types of education and is internationally accepted.[61]

Table 2 shows the percentage of students who chose vocational or technical program orientation (ISCED 3B) in the upper secondary education (ISCED 3) and post-secondary non-tertiary education (ISCED 4) programs as a share of all students in ISCED 3 and 4. It is visible that the percentage of students enrolling to the programs that are conducive to investments in manufacturing are rather similar in all three countries and Lithuania has even fewer students in these fields than Estonia and Latvia, contrary to the first hypothesis of the thesis. Contrary to the institutional influences, discussed in the previous part, Estonia and Latvia managed to retain more people interested in the technical fields in the secondary and post-secondary non-tertiary education.

Table 2. The number of students in ISCED 3B and 4 levels as a percentage of all students in levels 3 and 4 (%).

GEO/TIME	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Estonia	37.32	36.26	45.62	44.42	49.98	41.96	38.29	38.67	37.36	38.04
Latvia	39.07	37.29	38.83	37.52	37.32	39.08	38.03	32.13	31.41	30.27
Lithuania	32.96	29.40	31.31	29.53	25.61	25.08	21.25	23.23	22.43	22.25

Source: Eurostat, 2012.

[61] UNESCO, 1997. There are six levels of ISCED classification: 1 – primary education; 2 – lower secondary education; 3 – upper secondary education; 4 – post-secondary non-tertiary education; 5 – first stage of tertiary education; 6 – second stage of tertiary education. 3 and 5 levels are also categorized in terms of specificity of the subject studied. 3A is a general upper-secondary level, while 3B – vocational or technical orientation. 5A and 5B differs in the same way in the tertiary education. ISCED categories 3B, 4 and 5B are of the special interest in this chapter, since in these levels people with the specific skills are educated. 3A and 5A are also important because people educated in those levels, on the other hand, have more general skills.

However, the data on the tertiary specific education, which according to theory is conducive to investment in manufacturing, gives different results (Table 3). The ISCED 5 level is important here. Level 5 comprises skills acquired in the first stage of tertiary education. This level is further divided into categories 5A and 5B. Category 5A embraces programs which are "theoretically based / research preparatory (history, philosophy, mathematics, etc.) or giving access to professions with high skills requirements (e.g. medicine, dentistry, architecture, etc.)." Category 5B, on the other hand, embraces programs where students acquire "practical / technical / occupationally specific"[62] skills. 5B level is meant to prepare the students to enter the labor market immediately after graduation. By using the terminology of the Varieties of Capitalism approach, Žilvinas Martinaitis defines category 5B as developing specific skills while category 5A cultivates general skills.[63] As it was already mentioned above, the specific skills can be seen as preferred by the investors in manufacturing sector while the general ones are preferred by the investors in financial and business services.

Table 3. Distribution of tertiary students in the different ISCED levels (5A and 5B) as a percentage of all tertiary students

YEAR	1998		1999		2000		2001		2002		2003		2004		2005		2006	
ISCED	5A	5B	5A	5B	5A	5B	5A	5B	5A	5B	5A	5B	5A	5B	5A	5B	5A	5B
Lithuania	69	31	69	31	69	31	69	30	70	28	70	29	70	29	70	29	70	29
Latvia	92	8	93	7	93	7	88	11	84	15	80	19	87	12	86	13	85	14
Estonia	80	20	83	17	86	14	85	12	85	13	59	38	60	37	62	36	63	34

Source: Eurostat, 2009[64], 189. And author's own calculations from the Eurostat, 2012.

In Table 3[65] one can see that from 1998 to 2002 there was a clear difference between Lithuania, on the one hand, and Latvia with Estonia, on the other. Lithuania had

[62] UNESCO, 1997, 35.
[63] Martinaitis, 33.
[64] Eurostat, *The Bologna Process in Higher Education in Europe: Key Indicators on the Social Dimension and Mobility*, 2009.
[65] 2001-2006 numbers do not always add up to 100, since in these years a relatively small number of master students were also taken into account.

significantly more students attending 5B type of education than the two other Baltic States. However, the situation in Estonia has changed dramatically since the year 2003. More students started to enroll in the 5B type of education. Meanwhile, in Latvia the distance between 5A and 5B even increased to some extent and even more students started to choose more general education. Numbers in Lithuania stayed virtually the same.

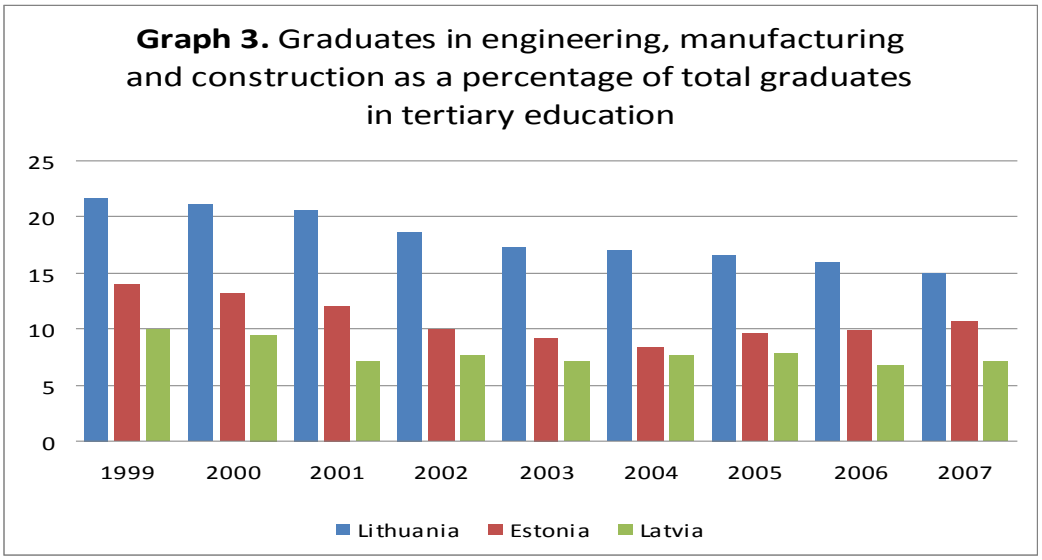
One could conclude that the effect of the change in ratio between enrollment in 5A and 5B type of education in Estonia should not have had a visible effect until 2007, since people who graduated after 2003 should not have had a great effect immediately. Thus the change in enrollment in tertiary level towards more specific education should not have influenced the structure of skills held by the labor force in Estonia during the studied period. However, such an observation allows us to conclude that the structure of skills held by the labor force in Estonia is changing. All in all, Table 3 shows that before 2007 in Lithuania there was significantly more labor force with specific skills acquired in tertiary education than in two other Baltic states.

The main conclusion of this part is that although the institutional setup of the vocational education in the early years of transition seemed to create better incentives for students to choose vocational education in Lithuania, this materialized only in the tertiary vocational education (ISCED 5B) but not in upper-secondary and post-secondary non-tertiary vocational education. The next part of the chapter will look more specifically at what actual skills are held by the labor forces in the Baltic States that are conducive to FDI in manufacturing, on the one hand, and to FDI in financial and business service, on the other.

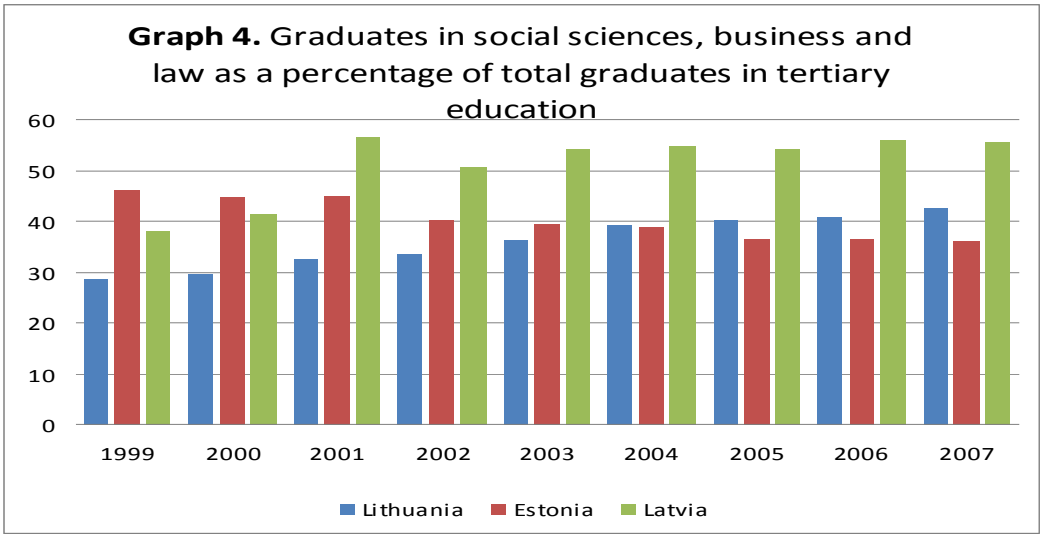
2.2.2. Other Relevant Skills in the Baltic States

2.2.2.1. Skills in Engineering and Manufacturing vs. Skills in Social Sciences, Business and Law

In Graph 3 one can see that in Lithuania in the period 1999-2007 there were significantly more graduates in the fields of engineering, manufacturing and construction than in the other two analyzed states. Graph 4 shows that Estonia and especially Latvia had more graduates in the fields of social sciences, business and law, but, since 2004 Lithuania took over Estonia in the percentage of graduates in these fields. As in the previous chapter, I argue that such change should not have had an influence on the period analyzed in the thesis and the conclusion can be made that there were larger parts of the labor forces in Latvia and Estonia which were educated in social sciences, business and law. Data in these two graphs support the hypotheses analyzed in the chapter.



Source: *EdStats Query*, World Bank database of statistics on education, 2012.



Source: *EdStats Query*, World Bank database of statistics on education, 2012.

2.2.2.2. Language Skills

The data from Eurostat shows that Estonian pupils on average start studying languages earlier and tend to have more classes of languages than Lithuanians and Latvians during every level of secondary education and even in primary education (Table 4). Latvians have slightly more language classes than Lithuanians as well. Eurostat shows that during the primary education (ISCED 1) on average every Estonian pupil is starting to study his or her first foreign language. Also, almost 30 per cent of Estonian pupils start studying a second foreign language, while percentage of such pupils is negligible in both Latvia and Lithuania, as well as in the EU. Statistics also shows that in Latvia around 50 per cent of pupils start studying their first foreign language, whereas in Lithuania only 30 per cent of students are in this category. In the lower secondary education (ISCED 2) the number of studied languages is more equal among the states. Estonian pupils study on average 2 foreign languages, while Latvians and Lithuanians – on average 1.7 languages. However, in the level of upper secondary education (ISCED 3), the number of languages

studied gets unequal again and is in line with the first hypothesis. On average, in this level Estonian pupils study 2.4, Latvians 1.8 and Lithuanians 1.6 foreign languages.[66] Although numbers seem to be rather similar due to the particularities of the measured data, from them one can conclude that Estonians tend to study more languages at school than both Latvians and Lithuanians, while Latvians study somewhat more than Lithuanians in primary and upper secondary levels of education. The EU27 averages are 0.6 in ISCED 1, 1.4 in ISCED 2 and 1.6 in ISCED 3. This clearly shows that Estonian pupils study significantly more foreign languages in all levels of school education than average Europeans, whereas Latvians study slightly more and Lithuanians slightly less. The numbers higher than the EU average are highlighted in the table.

Table 4. The average of languages studied per pupil in levels ISCED 1-3

	ISCED 1	ISCED 2	ISCED 3
EU 27	0.6	1.4	1.6
Estonia	1	2	2.4
Latvia	0.5	1.7	1.8
Lithuania	0.3	1.7	1.6

Source: Eurostat, 2012.

Moreover, more Latvians and Estonians speak English, 41 and 46 per cent, respectively. In Lithuania, 37.9 per cent of people speak English. A significantly larger share of people who speak English in Latvia and Estonia is especially important evidence for the present thesis, since investors in financial and business services from the Western countries (or those dealing with the West) are especially interested in the employees' knowledge of English.[67] To conclude, Latvians and Estonians are indeed somewhat better

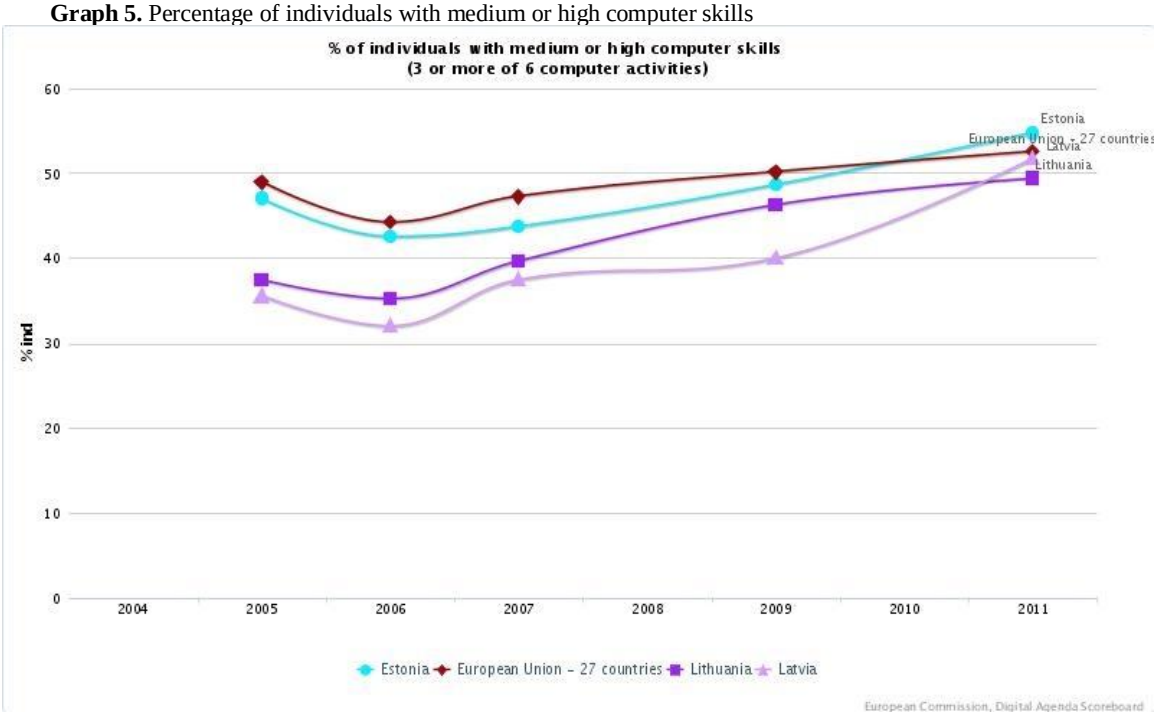
[66] Eurostat, 2012. Averages are counted from the year 1998-2007.
[67] Eurostat, 2012. Numbers are from the year 2007.

in languages (especially important – in English) than Lithuanians. This fact, according to theory, is conducive to FDI in financial and business services.

2.2.2.3. Information Technology Skills

Graphs 5 and 6 summarize the data on the IT literacy in the Baltic States. It is clear from the graphs that Estonia is a leading state in the Baltics in terms of percentage of individuals both with high computer and internet skills, while Latvia and Lithuania are similar in their IT literacy skills. Graph 7 shows that this data is not accidental since it reflects the skills acquired by people during their formal education. This means that Estonian educational system is more efficient in building information and communication technology (ICT) skills.

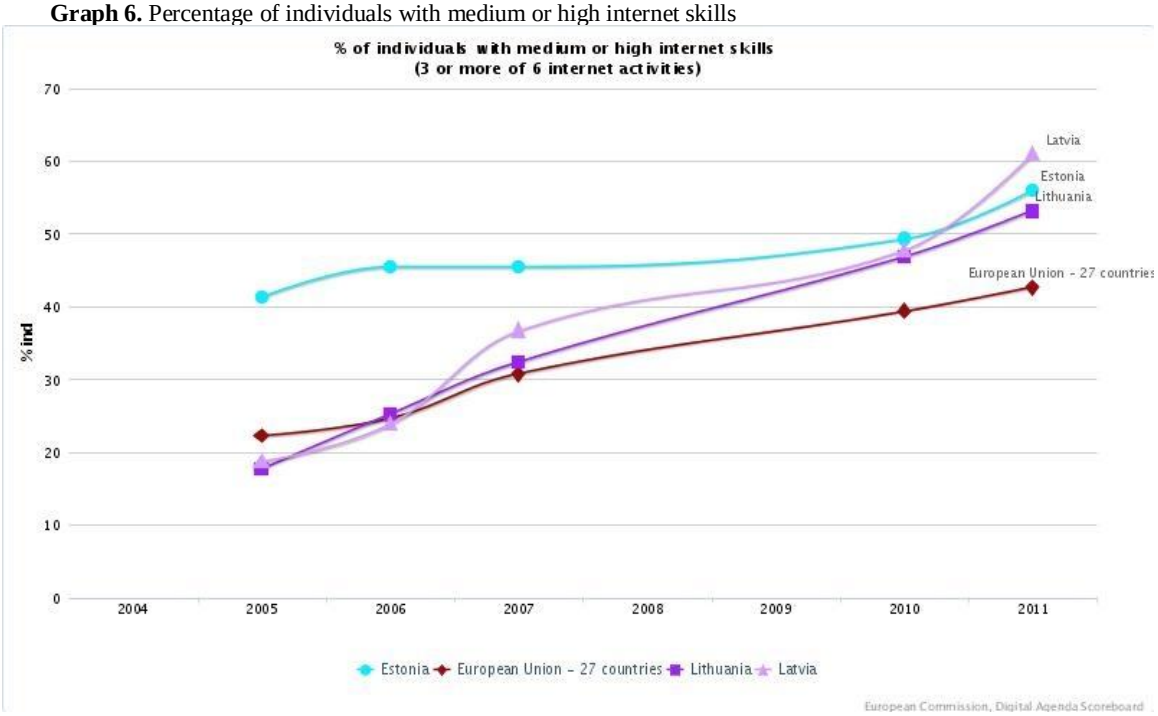
Graph 5. Percentage of individuals with medium or high computer skills



Source: Digital Agenda for Europe, 2012.[68]

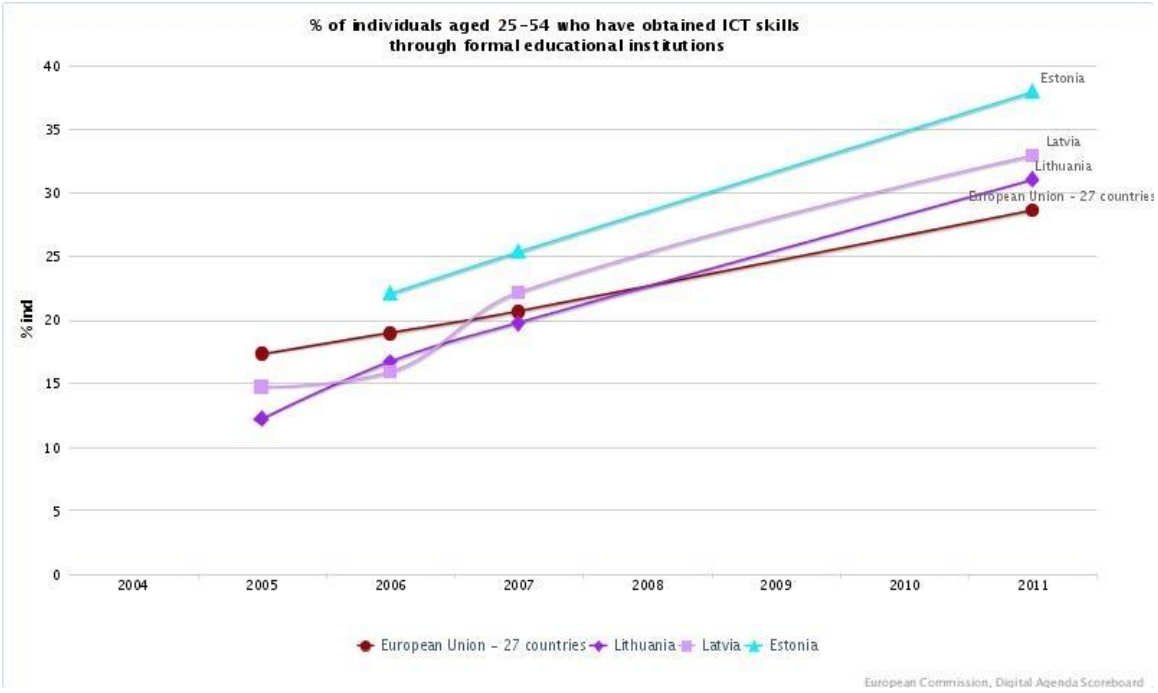
[68] Digital Agenda for Europe, 2012, http://ec.europa.eu/information_society/digital-agenda/index_en.htm (accessed May 22, 2012).

Graph 6. Percentage of individuals with medium or high internet skills



Source: Digital Agenda for Europe, 2012.

Graph 7. Percentage of individuals who have obtained ICT skills through formal education



Source: Digital Agenda for Europe, 2012.

2.2.2.4. General Abundance of High and Low Skills in the Baltic States

It is also important to evaluate a general size of the low- and high-skilled labor force in the analyzed states, since, as it was mentioned in the beginning of the chapter, FDI in manufacturing prefers the low-skilled labor force, whereas highly-skilled labor force is conducive to FDI in financial and business services.

Table 5 shows the number of people with the lower secondary skill attainment, which is often used as a proxy for the estimation of the amount of low-skilled labor.[69] One can see from the table that in the period 1998-2007 Lithuania had a larger pool of unskilled labor than the two other Baltic countries. Estonia had the least amount of unskilled labor while Latvia was taking a middle position.

Table 5. People with the lower secondary skill attainment as a percentage of population in the Baltic States

GEO/TIME	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Estonia	22.4	21.3	20.0	18.7	17.5	16.7	16.2	14.8	14.9	14.1
Latvia	27.1	26.1	26.7	29.6	23.2	22.1	20.9	20.5	20.2	19.6
Lithuania	29.6	28.2	28.3	28.5	27.7	26.6	26.3	25.4	24.1	23.2

Source: Eurostat, 2012.

Table 6, on the other hand, shows that Estonia was consistently building the largest stock of labor force with tertiary education in the Baltics. The percentage of people with tertiary education is higher in Lithuania than Latvia. One can see from the table that at least from the year 2003 the number of highly-educated people was increasing in all three states.

[69] Dalia Marin, "The Opening up of Eastern Europe at 20 - Jobs, Skills, and 'Reverse Maquiladoras' in Austria and Germany" (Bruegel Working Paper, July 2010), 20.

Table 6. People with the tertiary education as a percentage of 25-64 years old population in the Baltic States

GEO/TIME	2000	2001	2002	2003	2004	2005	2006	2007
Estonia	28.9	30.1	30.5	30.6	31.4	33.3	33.3	33.3
Latvia	18.2	18.2	19.3	18.1	20.0	20.5	21.1	22.6
Lithuania	No reliable data	22.2	21.9	23.2	25.2	26.3	26.8	28.9

Source: Eurostat, 2012.

2.3. Conclusions

At first look, the evidence on the educational systems and skills produced by them is rather puzzling. The data seem to support the hypotheses raised in the beginning of the chapter in some instances but reject them in others. However, important conclusions can be made. I argue that the data support the first hypothesis and allows us to accept it. Although Lithuania does not have a larger pool of labor force educated in the levels ISCED 3B and 4, i.e. lower vocational education (Table 2), it has a larger pool of people than two other Baltic States, which is taught in the level ISCED 5B, i.e. tertiary vocational education (Table 3). Also, Lithuania has a much larger pool of people with skills in engineering and manufacturing (Graph 3). These people are important to take the leading positions in manufacturing plants. Moreover, the data shows (Table 5) that Lithuania has a significantly larger share of the unskilled labor force than other analyzed countries. According to the theoretical arguments in the first part of the chapter, unskilled labor force is an important input in the light manufacturing sectors prevailing in Lithuania and the other two Baltic States. The largest amount of people educated in engineering and manufacturing together with the largest pool of unskilled labor seem to be a perfect mix for manufacturing activities to thrive. Therefore, I accept the first hypotheses that *the prevalence of FDI in manufacturing in Lithuania is influenced by the prevailing skills which are conducive to manufacturing activities*.

The second hypothesis can be accepted only partially. Latvia cannot be said to have the educational system conducive to FDI in financial and business services. Although it has the largest amount of graduates in social sciences, business and law among the three Baltic States (Graph 4) and the largest share of the people that are studying general programs in the first stage of the tertiary education (Table 3), it is very similar to Lithuania in terms of language and information technology skills and has even more people studying in lower vocational education (Table 2). Moreover, Latvia has a very low number of people with tertiary education as compared to Lithuania and Estonia (Table 6).

Estonia seems to be closer to the ideal case for FDI in financial and business services. Of all three Baltic States, it has the highest percentage of people with tertiary education (Table 6) and the smallest pool of unskilled labor (Table 3). It is also significantly better in languages (Table 4) and IT technologies (Graphs 5 and 6). It is trailing behind in terms of graduates in engineering and manufacturing (Graph 3) and has a high number of graduates in social sciences, business and law (Graph 4). The only puzzling issue is that it has the highest share of labor force educated in lower vocational education in the Baltics (Table 1). Thus I partially accept the second hypotheses and argue that *the prevalence of FDI in financial and business services in Estonia is influenced by the prevailing skills which are conducive to financial and business activities.*

Table 7. The level of support of the evidence for the hypotheses 1 and 2

	Lithuania	Latvia	Estonia
Percentage of students in lower vocational education (table 2)	-	-	-
Distribution of tertiary students between the general and specific programs (table 3)	+	+	+ (but the trend is changing)
Percentage of graduates in engineering, manufacturing and construction (Graph 3)	+	+	+
Percentage of graduates in social sciences, business and law (Graph 4)	+	+	+ (but the trend is changing)
The average of languages studied (table 4)	+	Very weak support	+
IT skills (Graphs 5 and 6)	+	-	+
Percentage of people with lower secondary skill attainment (table 5)	+	+	+
Percentage of people with tertiary skill attainment (table 6)	+	-	+

Chapter 3: Influence of Political Stability and Political Ideologies on the Type of Foreign Direct Investment in the Baltic States

Political stability was mentioned by a large number of scholars as a very important determinant of FDI in the transitional countries. The lack of political stability exacerbates uncertainty and risk, which are already abundant in the transitional economies. The situation with which every investor had to deal at least in the beginning of transition can be sensed very well in the adaptation by Bandelj of the interview with the representative of a foreign chamber of commerce in Prague:

> Just imagine Mr. Investor, arriving at the airport in Sofia or Ljubljana, in Budapest or Riga in the early 1990s, during "a very chaotic time," venturing into a "loose environment [with] no infrastructure for investors," trying to understand Lithuanian or Romanian, or the legal system, which "is changing so rapidly it is difficult to keep abreast of all the changes," not knowing whether the tenuous post-Communist coalition government will falter next week or in six months, or if the thirty-something pieces of paperwork he just handsomely paid for (plus a "handling fee" to the bureaucrat in the office) will turn out to be completely useless or just (still) insufficient to acquire the assets he is interested in… among other adventures of doing business in postsocialist Europe.[70]

The text above clearly indicates that uncertainty and risk are connected not only to economic, but also to political transition. Moreover, economic and political transitions are connected to each other and it is both hard to disentangle them as well as to tell which had a greater effect. The following chapter tries to analytically distinguish the political sphere from the economic sphere to show the former's effect on the latter. This chapter investigates whether different levels of political stability in the Baltic States had an influence on the types of FDI in Lithuania, Latvia and Estonia.

However, the level of political stability is not enough to explain the different sectoral patterns of FDI in the Baltics. Large investments in manufacturing can be as

[70] Bandelj, 168.

sensitive to political stability as FDI in financial and business services. Therefore, in the present thesis the argument about the political stability is complemented with the argument about the political ideologies of the parties in government and their influence on the types of FDI. According to Pinto and Pinto, "in host countries governed by the left, FDI will flow to sectors where it is a complement of labor, such as manufacturing."[71] On the other hand, a country is expected to attract more FDI to financial and business services, where "foreign capital is a complement of capital"[72] employed in the country, if the centre or right political parties govern the state, since they are expected to be business-friendly. There could be a counterargument to this claim that even those parties which were hostile to foreign investments or some types of it before the expansion of FDI flows (for instance, ex-communists and left-wing parties generally), will immediately start trying to attract more FDI whenever they have such a chance, i.e. we should see a convergence to neoliberal pro-market ideology even among the left-wing parties. However, Haupt shows that the pressures of globalization (including the increasing FDI flows) do not make ideologies of political parties converge to a neoliberal direction.[73] Therefore, the present chapter is based on the insight that the ideological differences supported by the political stability have an influence on the emergence of the different sectoral patterns of FDI. Political stability is necessary for the parties in government to be able to implement their policies effectively. Two hypotheses thus were formulated, the investigation of which is the aim of the present chapter:

[71] Pinto and Pinto, 22.
[72] Ibid.
[73] A. B. Haupt, "Parties' Responses to Economic Globalization: What Is Left for the Left and Right for the Right?," *Party Politics* 16, no. 1 (August 10, 2009): 7.

H3: The prevalence of FDI in manufacturing in Lithuania is influenced by the fact that its political stability was lower in the years 1991-2007 than in the two other Baltic States and the left-wing ex-communist parties prevailed in government for a significant amount of time.

H4: The prevalence of FDI in financial and business services in Latvia and Estonia is influenced by the fact that their political stability was higher in the years 1991-2007 than in Lithuania and the centre or right-wing parties prevailed in government.

3.1. Operationalization of Political Stability

Different types of political stability have different effects on FDI. Therefore, it is very important how the concept is operationalized. Estrin, Hughes and Todd claim that large scale political instability, such as revolution or civil war, is almost a fatal blow for a country in trying to attract FDI in any sector.[74] However, the concept of political stability is not only about the absence or presence of revolutions or civil wars. In the words of Ben Shepherd, "stability means a predictable political environment."[75] In transitional countries, there are a lot of factors that can make political situation uncertain and instable. Some of those factors are the same as in the developed Western countries. Some of them are more typical for the process of transition. As noted by Brada, Kutan and Taner, levels of political stability differed significantly among the transitional states, ranging from "normal political uncertainty that accompanies transition" to much more severe political uncertainty created by the social unrest of a large scale, for instance, war. Thus one can differentiate between the levels of political stability in the CEE countries versus that of

[74] Estrin et al., 19.
[75] Ben Shepherd, "Political Stability: Crucial for Growth?," *LSE IDEAS Strategic Update* (March 2010): 8.

the Balkans and often some other transitional states in Asia.[76] This chapter will deal with the "usual" political uncertainty created by the changes in political sphere in the Baltic States, since there was no large-scale political unrest in the analyzed cases.

Eli Margolis provides a useful summary of the approaches to political stability as state stability that exist in the literature.[77] According to her, there are six dominant approaches to political stability. Political stability can be approached as 1) an absence of violence; 2) an absence of structural change; 3) an absence of control; 4) a state functionality; 5) indicators and correlates; 6) a pattern of political behavior. The approach chosen by this thesis is that of political stability as a pattern of political behavior suggested by Claude Ake. He defines political stability as the "regularity of the flow of political exchanges."[78] Margolis restates his approach in a somewhat different but clearer way: political stability is "the degree of regularity in the political behavior of a polity."[79] In accordance with this and with the hypotheses raised in the beginning of the chapter, the thesis argues that the regularity which one should evaluate in the Baltic States is the persistence of the parties with the same political ideology in the governments.

The precise definition of political stability used by this chapter is the one formulated by David Sanders who sees "instability as an authority's break from its past patterns."[80] Such definition suits the present thesis very well, since investors are in the first place concerned about government's formal consistency, i.e. whether it is acting according to the rules created by itself. Why can a government as a "persistent" actor

[76] Josef C. Brada, Ali M. Kutan, and Taner M. Yigit, "The Effects of Transition and Political Instability on Foreign Direct Investment Inflows," *Economics of Transition* 14, no. 4 (December 2006): 651.
[77] J. Eli Margolis, "Understanding Political Stability and Instability," *Civil Wars* 12, no. 3 (2010): 327.
[78] Claude Ake, "A Definition of Political Stability," *Comparative Politics* 7, no. 2 (January 1, 1975): 273.
[79] Margolis, 327.
[80] Ibid, 332.

refuse to act according to the rules it has previously created? Because ideologically different parties are changing inside of it and make the government "break from its past patterns." It seems clear that if the fluctuation in the governing parties is significant, then there is a greater possibility that the new governing parties will have to act according to the rules created by the previous governing parties. The experience of the transitional countries shows that parties are reluctant to do so and rather try to change the main laws whenever they have a chance. Thus high ideological fluctuations of subsequent governments seem to create political instability and uncertainty which is not liked by the foreign investors, since they are not sure whether the new governments will respect the laws created by the previous governments. Arguably, this is especially so when nationalistically-minded governments are followed by the former communists and vice versa, and this can easily be the case in the post-Communist states. Thus the present thesis evaluates the degree of political stability in the country by looking at the ideological polarization among the changing governments in the Baltic States. Such definition of political stability is especially suitable for the present analysis, since it is able to incorporate evaluation of the effects of the different political ideologies as well.

Timothy Frye was the scholar who described the "perils of ideological polarization" in the post-communist world the most eloquently. According to him, economic performance of a particular country after the regime change was a "reflection of the political struggle between ex-communist and anticommunist factions engaged in a war of attrition over economic and political resources."[81] Sanders also observed earlier that "ideology and political leadership have been unduly ignored in past studies of

[81] Timothy Frye, "The Perils of Polarization: Economic Performance in the Postcommunist World," *World Politics* 54, no. 3 (2002): 309.

instability."[82] One of the disadvantages for the country created by a political polarization, according to Frye, is an unstable political environment. He also argues that in such conditions foreign investors are reluctant to put their capital in the country.[83] The present thesis takes a slightly different approach from Frye. It looks not to overall polarization of the party system, but rather to the level of ideological polarization between the main parties in the Baltic governments. Parties that did not have an important role in governing the countries are not considered. Such a route is chosen due to the reason that governments have an actual control over investment promotion policies.

It is interesting to observe that Frye classifies all three Baltic States as non-polarized.[84] This only shows that it is very important what cases one is comparing. The present thesis deals with the important variation in the sectoral patterns of FDI in a particular type of capitalist political economies constituted by the Baltic countries.[85] In the subsequent sections, by looking very closely at the actual compositions of the Baltic governments, the present thesis goes on to show that Lithuania is significantly more polarized and therefore suffers lower level of political stability than both Latvia and Estonia. Moreover, Latvia and Estonia were governed by the centre-right coalitions most of the time, while in Lithuania the ex-communists from the left of the political spectrum enjoyed the office for a significant amount of time. The thesis argues that this had an important impact on the type of FDI in the Baltic States.

[82] Patrick M. Morgan, "Review of D. Sanders Book Patterns of Political Instability," *Social Science Quarterly* 64, no. 2 (June 1983): 425.
[83] Frye, 309, 315.
[84] Ibid, 317.
[85] Bohle and Greskovits.

3.2. Political Stability and Party Ideologies in Lithuania, Latvia and Estonia

The empirical analysis in this chapter relies on the data in the Tables 8-10. The tables show the composition of each government in Lithuania, Latvia and Estonia from the change of the regime until 2007. It also indicates the ideological orientation and duration of each government. The full names of the parties are indicated in the footnotes. Abbreviations used in the tables are in the original languages.

Juan Linz observes that one of the widely used indicators of the governmental stability is the average duration in office.[86] In the tables 8-10, one can see that on average Estonian governments enjoyed the longest time in office (527 days), while the average government duration in Lithuania was 519 and in Latvia 428. It could be an important indicator of the government stability in the Baltic States, despite the fact that the leading parties in the governments mostly stayed the same. Higher volatility of governments can preclude the parties in power from implementing their FDI policies, since they have to worry how to keep the office in the first place.

[86] Juan J. Linz, "Democracy's Time Constraints," *International Political Science Review / Revue Internationale De Science Politique* 19, no. 1 (1998): 28.

Table 8. Estonian governments according to composition and ideological orientation 1992-2007[87]

No.	Period	Duration (days)	Composition of the Government	Ideological orientation
I.	1992 10 21 - 1994 11 08	742	I, ERSP, M, IND	Centre-right
II.	1994 11 08 - 1995 04 17	164	I, ERSP, M, IND	Centre-right
III.	1995 04 17 - 1995 11 06	199	KE, K, EME, IND	Centre-left
IV.	1995 11 06 - 1996 11 21	393	KE, RE, EME, IND	Centre-right
V.	1996 11 21 - 1997 03 17	102	KE, EME, IND	Centre
VI.	1997 03 17 - 1999 03 25	744	KE, EME, ERE, IND	Centre
VII.	1999 03 25 - 2002 01 28	1035	I, RE, M	Centre-right
VIII.	2002 01 28 - 2003 04 10	436	RE, K	Centre-right
IX.	2003 04 10 - 2005 03 24	714	ResP, RE, ER	Centre-right
X.	2005 03 24 - 2007 04 05	742	RE, K, ER	Centre-right
	Average:	527		

Sources: Mackonytė[88], 26-27; Müller-Rommel et al.[89], 881-882; Berglund, Ekman and Aarebrot[90], 90; author's own calculations.

[87] Parties in the governments in 1992-2007: EME = Estonian Country Peoples Party (*Eesti Maarahva Erakond*); ER = Estonian People's Union (*Eestimaa Rahvaliit*); ERE = Estonian National Progress Party (*Eesti Rahvuslik Eduerakond*); ERSP = Estonian National Independence Party (*EestiRahvusliku Soltumatuse Partei*); I = Pro Patria Union (*Isamaaliit*); IND = Independent; K = Estonian Centre Party (*Eesti Keskerakond*); KE = Estonian Coalition Party (*Eesti Koonderakond*); M = Moderates (*Mööd*ukad); RE = Estonian Reform Party (*Eesti Reformierakond*); ResP = Res Publica (*Res Publica*).

[88] Greta Mackonytė, "Lietuva Ir Estija: Kodėl (ne)pažabotas Valstybės Biudžeto Deficitas? (Lithuania and Estonia: Why Is the State Budget Deficit (Un)Curbed?)" (BA thesis, Vilnius University, 2011).

[89] Ferdinand Müller-Rommel, Katja Fettelschoss, and Philipp Harfst, "Party Government in Central Eastern European Democracies: A Data Collection (1990–2003)," *European Journal of Political Research* 43, no. 6 (October 2004): 869–893.

[90] Sten Berglund, Joakim Ekman, and Frank H. Aarebrot, eds., *The Handbook of Political Change in Eastern Europe*, 2nd ed. (Cheltenham: Edward Elgar, 2004).

Table 9. Lithuanian governments according to composition and ideological orientation 1990-2008 [91] [92]

No.	Period	Duration (days)	Composition of the Government	Ideological orientation
I.	1990 03 17 - 1991 01 10	299	Sąjūdis, LKP, IND	„Rainbow coalition"
II.	1991 01 10 - 1991 01 13	4	Sąjūdis, LKP, IND	„Rainbow coalition"
III.	1991 01 13 - 1992 07 21	555	Sąjūdis	Right
IV.	1992 07 21 - 1992 11 26	128	Sąjūdis	Right
V.	1992 12 12 - 1993 03 10	103	LDDP	Left
VI.	1993 03 10 - 1996 02 08	1073	LDDP	Left
VII.	1996 02 23 - 1996 11 19	290	LDDP	Left
VIII.	1996 12 04 - 1999 05 03	888	TS (LK), LKDP, LCS	Right
IX.	1999 06 01 - 1999 10 27	163	TS (LK), LKDP	Right
X.	1999 11 03 - 2000 11 09	362	TS (LK), LKDP	Right
XI.	2000 10 27 - 2001 06 20	249	LLS, NS, LCS, MKDP, LLRA	Centre-right
XII.	2001 07 04 - 2004 12 14	1259	LSDP, NS	Centre-left
XIII.	2004 12 14 - 2006 06 01	534	LSDP, NS, DP, VNDPS	Centre-left
XIV.	2006 07 18 - 2008 11 17	853	LSDP, LVLS, LiCS, PDP	Centre-left
	Average:	519		

Sources: Mackonytė, 28; Müller-Rommel et al., 886; Berglund, Ekman and Aarebrot, 167-169; author's own calculations.

[91] Parties in the governments in 1990-2008: DP = Labor Party (*Darbo Partija*) IND = Independent; LCS = Lithuanian Centre Union (*Lietuvos Centro Sąjunga*); LiCS = Liberan and Centre Union (*Liberalų ir Centro Sąjunga*); LDDP = Lithuanian Democratic Labour Party (*Lietuvos Demokratinė Darbo Partija*); LKDP = Lithuanian Christian Democratic Party (*Lietuvių Krikščionių Demokratų Partija*); LKP = Lithuanian Communist Party (*Lietuvos Komunistų Partija*); LLRA = Electoral Action of Lithuanian Poles (*Lietuvos Lenkų Rinkimų Akcija*); LLS = Lithuanian Liberal Union (*Lietuvos Liberalų Sąjunga*); LSDP = Lithuanian Social Democratic Party (*Lietuvos Socialdemokratų Partija*); LVLS = Lithuanian Farmers' Union (*Lietuvos Valstiečių Liaudininkų Sąjunga*); MKDP = Modern Christian Democrats (*Modernieji Krikščionys Demokratai*); NS = New Union (*Naujoji Sąjunga*); Sąjūdis = Lithuanian independence movement; PDP = Civil Democracy Party (*Pilietinės Demokratijos Partija*); TS (LK) = Homeland Union/Lithuanian Conservatives (*Tėvynės Sąjunga*/*Lietuvos Konservatoriai*); VNDPS = Union of the Farmer's Party and the Party of New Democracy (*Valstiečių ir Naujosios Demokratijos Partijų Sąjunga*).

[92] The second government was omitted from the calculation of the average due to its exceptionally short duration.

Table 10. Latvian governments according to composition and ideological orientation 1990-2007[93]

No.	Period	Duration (days)	Composition of the Government	Ideological orientation
I	1990 05 04 – 1993 07 07	1160	Latvian People's Front	Centre
II	1993 07 08 – 1994 09 14	433	LC, LZS	Centre
III	1994 09 15 – 1995 12 20	461	LC, TPA, IND	Centre
IV	1995 12 21 – 1997 02 12	419	DPS, TB, LC, LNNK, LZS, LVP	Centre
V	1997 02 13 – 1997 08 06	174	DPS, TB, LC, LNNK, LZS	Centre
VI	1997 08 07 – 1998 04 07	243	TB, LNNK, DPS, LC, LZS, LKDS	Centre
VII	1998 04 08 – 1998 11 25	231	TB/LNNK, LC, LZS/LKDS/LLDP	Centre-right
VIII	1998 11 26 – 1999 02 03	69	LC, TB/LNNK, JP	Centre-right
IX	1999 02 04 – 1999 07 15	161	LC, TB/LNNK, LSDA	Centre-right
X	1999 07 16 – 2000 05 03	292	TP, TB/LNNK, LC	Centre-right
XI	2000 05 04 – 2002 11 06	916	TP, LC, TB/LNNK, JP	Centre-right
XII	2002 11 07 – 2004 03 09	488	JL, LPP, LZS, TB/LNNK, LZP, IND	Centre-right
XIII	2004 03 10 – 2004 12 01	266	LZP, ZZS, LPP, TP	Centre-right
XIV	2004 12 02 – 2006 11 07	705	TP, JL, LPP, ZZS, IND	Centre-right
XV	2006 11 08 – 2007 12 20	407	TP, LPP/LC, TB/LNNK, ZZS, IND	Centre-right
	Average:	428		

Sources: Müller-Rommel et al., 884; Berglund, Ekman and Aarebrot, 121-128; author's own calculations.

In the tables 8-10 one can see that Estonian and Latvian party systems are centre or even centre-right-oriented, while Lithuanian party system is polarized, i.e. it has experienced relatively radical swings from the right to the left of the political spectrum since the change of the regime. Let us look deeper at the party systems of each state and see whether the pattern that one can clearly see in the tables actually has grounds.

[93] Parties in the governments in 1990-2008: DPS = Democratic Party Saimnieks (*Demokratiska Partija Saimnieks*); Independent = IND; JL = New Era (*Jaunais Laiks*); JP = New Party (*Jauna Partija*); LC = Latvia's Way (*Savieniba Latvijas Cels*); LKDS = Christian Democratic Union of Latvia (*Latvijas Kristîgo Democratu Savieniba*); LLDP = Democratic Party of Latgale (*Legate Latgates Demokratiskas Partijas*); LNNK = National Conservative Party (*Latvijas Nacionali Konservativa Partija*); LPP = Latvia's First Party (*Latvijas Prima Partija*); LSDA = Latvian Social Democratic Union (*Latvijas Socialdemocratu Apvieniba);* LVP = Latvian Unity Party *(Latvijas Vienibas Partija*); LZP = Latvias Green Party *(Latvijas Zala Partija);* LZS = Latvian Farmers Union *(Latvijas Zemnieku Savieniba);* TB = Alliance 'Fatherland and Freedom' *(Apvieniba 'Tevzemei un Brivibai');* TP = Peoples Party *(Tautas Partija);* TPA = Political Union of Economists *(Tautsaimnieku Politisko Apvieniba); ZZS* = Green and Farmers Union *(Zalo un Zemnieku savieniba).*

3.2.1. Latvia and Estonia

The insight which one can gain from the tables 8-10, namely, that Latvian and Estonian party systems do not have a high level of ideological polarization, is confirmed by other sources.

According to Lagerspetz and Vogt, in Estonia "despite the individual identity of the main parties, basically any of them seemed to be able to cooperate with any other"[94]. It is also very interesting that the parties which were born out of the Estonia's independence movement – Popular Front – namely, the Estonian Centre Party (K) and Moderates (M) were both centre-oriented. It is already very dissimilar to Lithuania. As will be shown later, the largest part of Lithuanian independence movement created the right-wing party and is the strongest right-wing political power in the country since then. In Estonia, the main part of the independence movement was centre-minded. As indicated convincingly by Lagerspetz and Vogt, "using the distinction left-wing versus right-wing is not very informative in the Estonian context."[95] It seems that the lack of the native ex-communists in Estonia was the main reason why the radical answer from the right of the political spectrum did not materialize.

The data about Latvian party politics tell a somewhat similar story. The Investment Guide for Latvia, published by the Organization for Economic cooperation and Development (OECD) in 1998, claimed that "the Latvian party system (…) is characterized by strong centre-orientation."[96] Smith-Sivertsen underlines that the former communists did not come back to power after independence, as was the case in Hungary,

[94] Mikko Lagerspetz and Henri Vogt, "Estonia," in *The Handbook of Political Change in Eastern Europe*, ed. Sten Berglund, Joakim Ekman, and Frank H. Aarebrot, 2nd ed. (Cheltenham: Edward Elgar, 2004), 67.
[95] Ibid, 67-68.
[96] Organisation for Economic Co-operation and Development, *Investment Guide for Latvia* (Paris: Organisation for Economic Co-operation and Development, 1998), 206.

Poland or Lithuania. That was mostly because Latvia did not have its "own communists". Leaders of the Latvian Communist Party were Russians who came before the regime change and did not have an opportunity to continue their political careers after the declaration of independence.[97] Due to the fact that the former communists were largely Russians and were directly connected to occupation, there was even a tendency of Latvian parties to avoid labeling themselves as leftists.[98] It seems that, similar to the case of Estonia, the lack of native ex-communists created no incentive for a more radical right to appear. According to the OECD, the centre-orientation of the party system helps to keep the institutions functioning properly, since they are not strongly affected by the ideological disputes of the main parties. Such situation brings political stability and certainty which are valued by the foreign investors.[99] The leading policy makers of Latvia have also declared the promotion of FDI as a priority of their parties.[100]

To sum up, it is clear that in Latvia and Estonia centre-oriented party systems have evolved. The reason of it seems to be the lack of the native ex-communists which could consolidate the right-wing parties and create a polarized system. The predicted effect on FDI of the centre-right coalitions in Latvian and Estonian governments can be clearly sensed in the websites of Latvian and Estonian investment promotion agencies. Estonia's investment promotion agency mentions the business services sectors, such as information and communication technologies (especially software development) and research & development, as the ones where Estonia would like to "offer opportunities"

[97] Hermann Smith-Sivertsen, "Latvia," in *The Handbook of Political Change in Eastern Europe*, ed. Sten Berglund, Joakim Ekman, and Frank H. Aarebrot, 2nd ed. (Cheltenham: Edward Elgar, 2004), 97.
[98] Ibid, 99.
[99] OECD, *Investment Guide for Latvia*, 206.
[100] *Latvian PM Suggests Priorities for His Party Ahead of Elections* (Baltic News Service, April 6, 2002).

for foreign investors.[101] In the news archive of the Investment and Development Agency of Latvia (IDAL) it is clear that at least in early 2000s Latvia's government focused on FDI in financial intermediation and business services.[102] The Chairman of the Latvia's Foreign Investors Council told in interview that Latvia should focus on investments in research and development. Also, when asked in which sector Latvia's government should promote FDI, he told that for the time being government should focus on increasing the "overall performance" of the economy. Meanwhile, it should understand what the competitive advantages of the country are and develop an investment strategy.[103] Thus it seems that Latvia's government was focusing on financial and business services FDI to increase the overall business environment of the country.

3.2.2. Lithuania

Lithuania's case is a different story. In Lithuania, the former Communist Party managed to build-up on its "organizational network and professionalized leadership" in comparison to Latvia and Estonia where former communists disaggregated into meaningless small groups. It was due to the fact that in Latvia and Estonia communists were seen as immigrants from the Soviet Union, while in Lithuania they were always nationals and more nationally-oriented.[104] Therefore, since the change of the regime, in Lithuania there have existed two major political powers which were leading the governing coalitions interchangeably since 1991 (Table 9). One of them – the right wing

[101] Estonian Investment and Trade Agency, "Key Sectors", 2012, http://www.investinestonia.com/en/business-environment (accessed May 22, 2012).
[102] Investment and Development Agency of Latvia, "News Archive", 2012, http://www.liaa.gov.lv/eng/home/news/news_archive/.
[103] IDAL, 2012, http://www.liaa.gov.lv/eng/home/news/news_archive/foreign_investors_council_in_l/ (accessed May 22, 2012).
[104] Kjetil Duvold and Mindaugas Jurkynas, "Lithuania," in *The Handbook of Political Change in Eastern Europe*, ed. Sten Berglund, Joakim Ekman, and Frank H. Aarebrot, 2nd ed. (Cheltenham: Edward Elgar, 2004), 138-139.

political group – started with Sąjūdis, i.e. Lithuanian independence movement. In 1993, the more nationalistically-minded leaders of Sąjūdis created the party Homeland Union (Lithuanian Conservatives) (TS(LK)). Another – the left wing political group – emerged from the Lithuanian Communist Party (LKP). In 1990, LKP changed its name to Lithuanian Democratic Labor Union (LDDP). In 2001, LDDP merged with the Lithuanian Social Democratic Party (LSDP) and kept the latter name since then. According to Duvold and Jurkynas, "the emotional assessments of the Soviet regime penetrated nearly all political issues in Lithuania, thus making compromise between the Labor Democrats on the Left and Sąjūdis on the right virtually impossible."[105] The present thesis argues that such swings in the governing parties are the indicator of lower political stability in Lithuania as compared to the other Baltic States. It was exacerbated by the open hostility between the two leading parties.

Moreover, the return of the ex-communists to power could have turned down foreign investors, especially in the financial and business services, due to their specific programmatic ideas. This view is supported in the theoretical literature. For instance, Estrin, Hughes and Todd observe that "the threat of major government change," especially if the parties that are highly likely to come to power are "unsympathetic to multinational firms," is a serious drawback of the host country when trying to attract the FDI.[106] According to Sinn and Weichenrieder, "the return of communist parties has irritated investors."[107] The closer analysis of the ideological views of the leading

[105] Ibid, 135.
[106] Estrin et al., 19.
[107] Hans-Werner Sinn and Alfons J. Weichenrieder, "Foreign Direct Investment, Political Resentment and the Privatization Process in Eastern Europe," *Economic Policy* 12, no. 24 (April 1997): 182.

Lithuanian parties as written in their electoral programs confirms the expectations of foreign investors.

In the 1996 parliamentary election program of TS(LK), there is a chapter explicitly devoted to attracting foreign capital.[108] In the chapter, mostly different types of planned incentives for foreign investors and intentions to decrease the bureaucratic burden are mentioned. For instance, there are suggestions to "create free economic zones in Šiauliai, Kaunas and Klaipėda", „liberalize rights for foreign investors to acquire land", „ensure quick and objective judicial processes", etc.[109] There is only one reference to the exact economic sector in the sixth point of the sixth chapter: „[we are planning] to invite large world-class enterprises, banks and insurance companies to open their branches in Lithuania, and to provide them with legal and economic guarantees."[110] It is very interesting that the only economic sector mentioned explicitly in the chapter on FDI is what is refered to as financial and business services in the present thesis. As one can see in the table 9, TS(LK) won the elections in 1996 and was the largest party in the governing coalitions in 1996-2000. Accordingly, as one can see in Graph 8, FDI in financial and business services was increasing in the period 1997-2001, while the parties from the right in the ideological spectrum led by the TS(LK) were in power. In the evaluation of the electoral programs of 2000, the Lithuanian free market institute argued that in their electoral program TS(LK) prefers foreign investments over the domestic ones. They claim that "especially investments from the Western countries will be

[108] "Electoral Progam of the Homeland Union (Lithuanian Conservatives) 1996, New Lithuania's Way", 1996, http://www.tslk.lt/1996_seimo_rinkimai_naujas_lietuvos_kelias.htm.
[109] Ibid.
[110] Ibid.

preferred more than those from the East."[111] Although the latter program did not have a chance to be implemented, it clearly indicates the ideological views of TS(LK).

In the election program of Lithuanian Democratic Labor Party in 1996, there is no separate chapter on foreign investments and the topic is touched only in one paragraph. Interestingly, FDI is tightly associated with the manufacturing activities: "For the development of the manufacturing sector, the long term economic strategy is necessary. It should foresee an increase in the manufacturing output and construction of the modern factories by using Lithuanian and foreign investors as well as income from privatization. We should foster the development of such branches of manufacturing which produce goods that are competitive in the foreign markets. We must actively propagate the consumption of goods produced in Lithuania."[112] Accordingly, one can see an increase in the FDI in manufacturing during the period 2001-2005 and decrease in FDI in financial and business services (Graph 8).

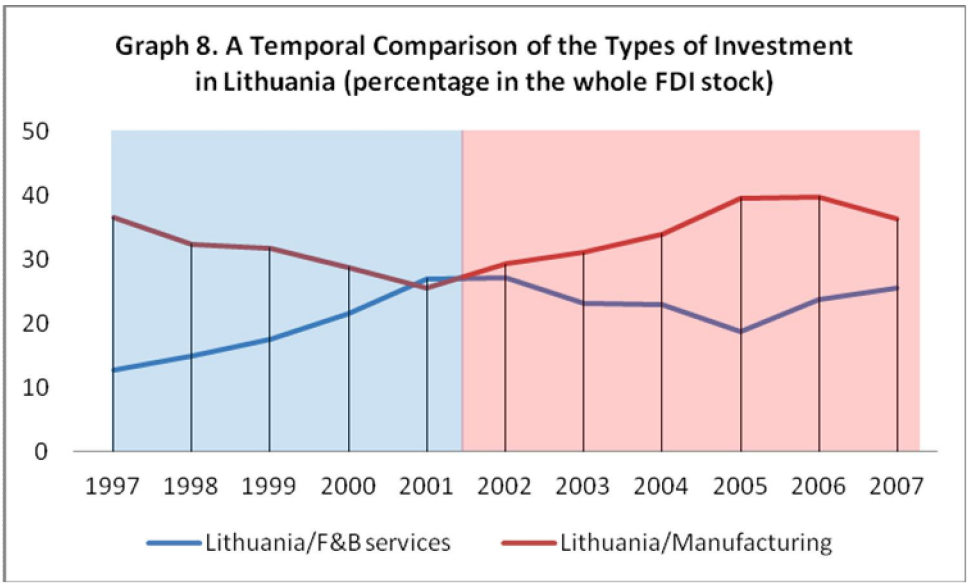
In the electoral program, prepared for the parliamentary elections of 2000, Lithuanian Social Democratic Party suggested to increase state investments, local investments and argued for the greenfield FDI.[113] The orientation to manufacturing can be seen in the long-term Lithuanian Social Democratic Party program as well: "Foreign investment is very important for the economy of the country. However, *it cannot create the efficient manufacturing by itself*. When searching for FDI, we must also create

[111] Lithuanian Free Market Institute, "Evaluation of Electoral Programs 2000", 2000, http://www.lrinka.lt/index.php/analitiniai_darbai/rinkiminiu_programu_ivertinimas_2000_m/2398;from_topic_id;61 (accessed May 22, 2012).
[112] "Electoral Program of Lithuanian Democratic Labor Party 1996", 1996, http://www.lddp.lt/programa.html (accessed May 22, 2012).
[113] Lithuanian Free Market Institute, 2000.

incentives for Lithuanian entrepreneurs to invest in their Homeland."[114] The conclusion is that the social democrats spoke only about the promotion of FDI in manufacturing.

After the analysis of the programmatic ideas of both parties, conclusion can be made that TS(LK) was generally more supportive of FDI than LSDP. Although the programs of the conservative party usually have chapters devoted explicitly for FDI, they often do not refer to a specific sector. When they do, they speak about the banking and insurance or activities which create a high value-added.[115] LSDP, on the other hand, in their programs did not emphasize the importance of FDI at all. There were only small parts of the whole text devoted to this topic and always connected to manufacturing and greenfield investments. All in all, so far the evidence from the Baltic States seems to strongly support the hypotheses of the present chapter. Lithuania has a polarized party system as compared to centre-oriented Latvian and Estonian ones. Moreover, as predicted by theoretical works, Lithuanian ex-communists are somewhat hostile to FDI and speak only about the FDI to manufacturing, while anti-communists strongly support FDI in their programs and speak explicitly about the FDI in financial and business services. Graph 8 shows that statistical data strongly support the results of qualitative analysis. The investment in financial and business services grew during the time when the right-wing parties governed the country (marked in blue) and fell during the socialists' time in office (red color). FDI in manufacturing reacted in precisely the opposite way.

[114] "Long-term Program of Lithuanian Social Democratic Party", 2009, http://www.lsdp.lt/lt/straipsniai/206-partijos-programa.html (accessed May 22, 2012).
[115] "Electoral Program of Homeland Union (Lithuanian Christian Democrats) 2008, Let's Begin", 2008, http://www.tsajunga.lt/index.php/seimo_rinkimu_programa_2008_2012/9081 (accessed May 22, 2012).



Source: WIIW database on FDI. Author's own calculations.

3.2.3. Sources of the Different Levels of Political Stability and Ideological Polarization in the Baltic States

A short look at why such differences are observed in the otherwise similar states may be useful. As it was already observed many times in the previous literature, Latvia and Estonia pursued a restrictive citizenship policy after the change of the regime. Estonian Parliament adopted the Citizenship Resolution in 1992. The rights to citizenship were granted only to pre-1940 citizens and their descendants. Others wishing to apply for citizenship had to satisfy additional criteria: pass the language test, stay the residents of the country for at least two years, and give an oath of allegiance.[116] The same was the case in Latvia. Moreover, in Latvia for some time there was even no law on the conditions of naturalization and there was a long debate between the main political groups about defining such conditions.[117] It seems that there was a widespread agreement among the main parties that the large part of the Russian-speaking population should be

[116] Lagerspetz and Vogt, 75.
[117] Smith-Sivertsen, 102-105.

excluded from the democratic governance of the country. The main cleavage of the discussion was how manageable should the conditions of naturalization be. Duvold and Jurkynas note that the situation was very different in Lithuania than in the other two Baltic States. Lithuania did not experience a sizeable inflow of immigrants during the Soviet times and thus decided to warrant citizenship to all inhabitants after the declaration of independence.[118] It is paradoxical that the existing ethnic cleavage in Latvian and Estonian politics actually seems to have created a formal stability in the government by not allowing the national minorities to vote. Of course, the naturalization process later has increased the number of likely voters of the former communists. However, parties with the largest share of the former communists had a worse competitive position than other parties due to the late-comer characteristics, i.e. they did not have formed a strong party organization and still had an image of non-national invaders.

3.2.4. Polarization of the Party Systems as an Indicator of Political Stability in the Baltic States

How one can know whether polarized party systems are indicative of the level of political stability in the analyzed states? The World Bank provides three indicators which can capture the effect of the polarized party systems on the political stability. Those are, namely, "Political Stability and Absence of Violence", "Government Effectiveness" and "Regulatory Quality", showed in the graphs 9, 10 and 11. The political stability and absence of violence indicator, created by the World Bank, measures "the perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional

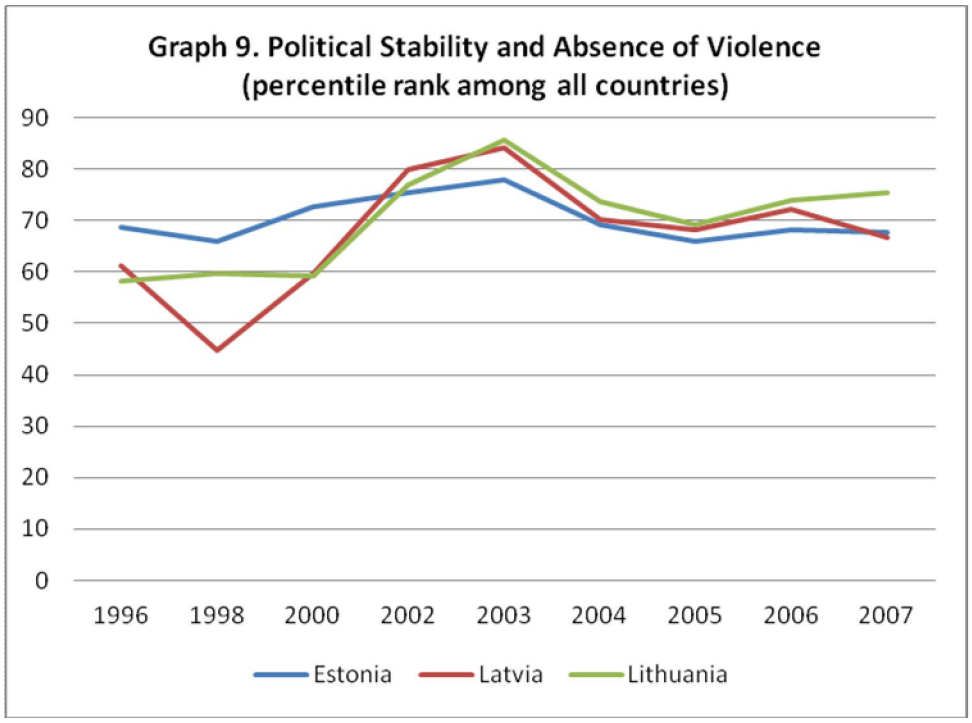
[118] Duvold and Jurkynas, 148.

or violent means, including domestic violence and terrorism."[119] The World Bank defines government effectiveness as "the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies."[120] Regulatory quality, as measured by the World Bank, "captures perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development."[121] These three indicators suits perfectly to measure political stability as operationalized in the present thesis.

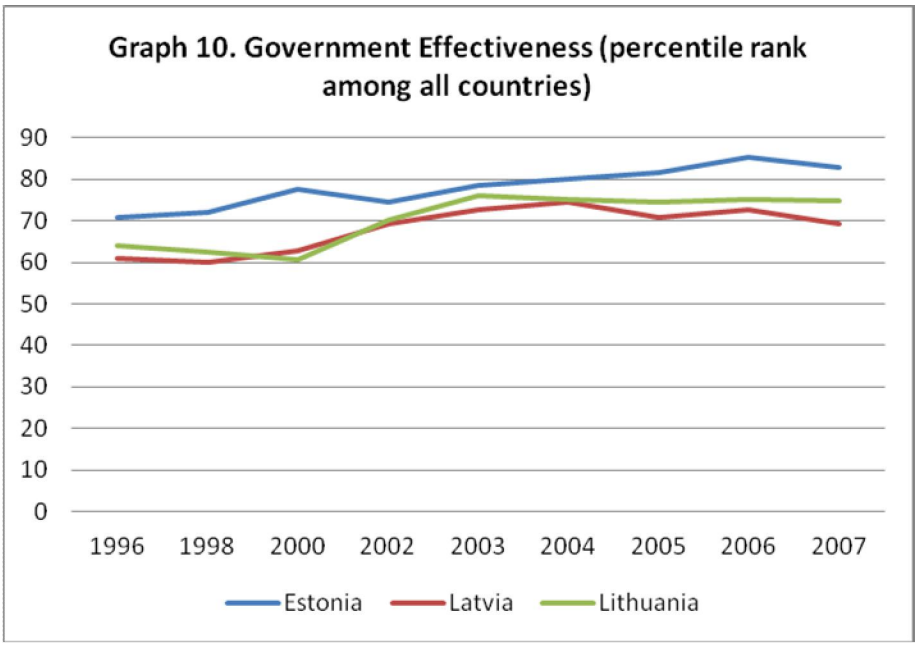
Graph 9 shows that since the mid-1990s to early 2000s the political stability was higher in Estonia than in the two other analyzed states. Although Latvia enjoyed a higher level of stability than Lithuania in 1998, it decreased drastically in 1998 and later came back to the Lithuanian level in 2000s. Later one can see the convergence of political stability in the Baltic States, which can probably be explained by the European integration process. As one can see in the Graph 10, Estonia has significantly higher government effectiveness than the other two Baltic States. It is interesting that government effectiveness does not differ much in Latvia and Lithuania, and the latter even scores more in this indicator. The same is shown by the indicator of the regulatory quality (Graph 11). The behavior of these two indicators confirms the results of the qualitative in-depth analysis of the ideological polarization between the governing parties in Estonia and Lithuania. However, the World Bank indicators do not correlate with the previous findings about the Latvian party system. Although the qualitative analysis showed that the Latvian party system is strongly centre-oriented, it does not seem to

[119] Worldwide Governance Indicators, World Bank, 2011.
[120] Worldwide Governance Indicators, 2011.
[121] Ibid.

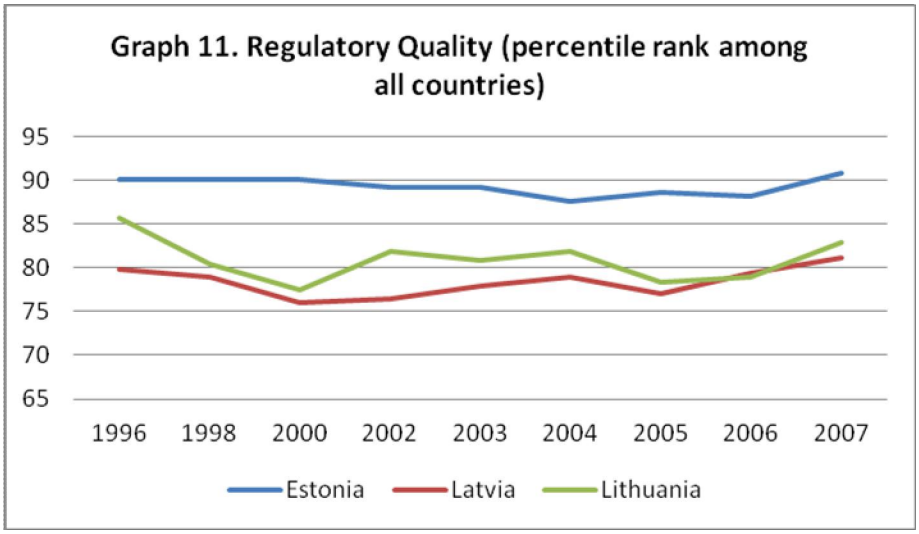
influence the government effectiveness and regulatory quality of Latvian state institutions. It may be the case due to the very short average duration of Latvian governments (Table 10). This indicator is significantly lower than in the two other analyzed countries and is even exaggerated by the quite long duration of the first government by Latvian People's Front.



Source: Worldwide Governance Indicators, 2011.



Source: Worldwide Governance Indicators, 2011.

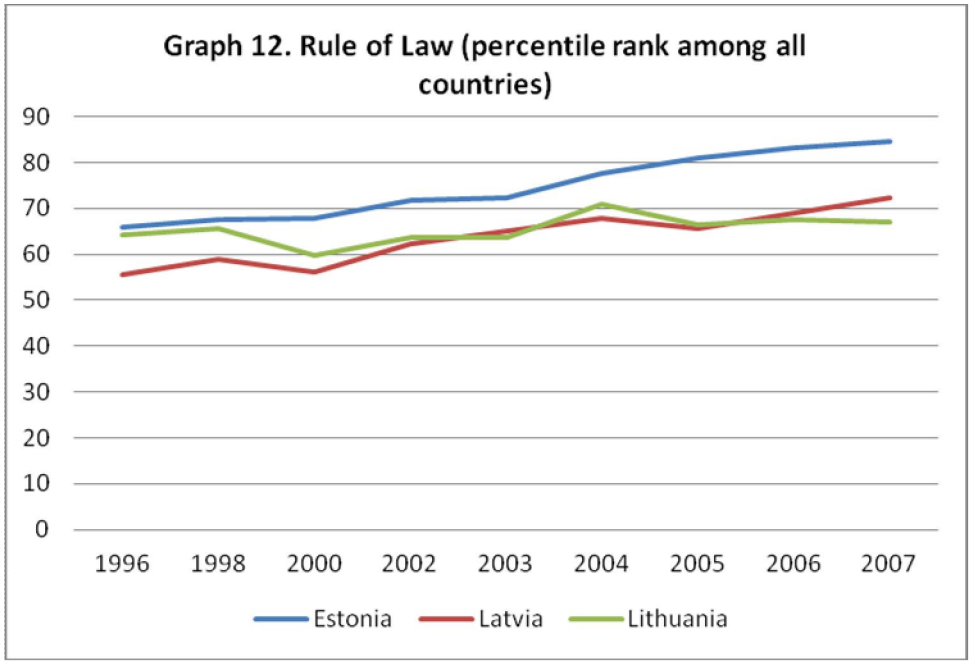


Source: Worldwide Governance Indicators, 2011.

Moreover, the legal environment and its establishment have an influence on the political stability in the country. Frye argues that the lack of political stability, brought about by the political swings, is exacerbated by the week judicial systems.[122] And indeed the rule of law indicator from the World Bank governance database shows that Estonia

[122] Frye, 315.

had a better system of law enforcement than the two other Baltic States (Graph 12). Thus one can conclude that the effects of ideological swings in government in Lithuania were exacerbated by the weak judicial system which could not deter the governing parties from the radical changes in policy. In Estonia, on the other hand, strong judicial system was complementary to the centre-oriented party system and thus created a stable political environment. Latvia is a hard case. Qualitative analysis of the party preferences suggests that the party system was strongly centre-oriented. However, political stability, government effectiveness, regulatory quality and rule of law indicators show that the state was nevertheless performing much worse than Estonia.



Source: Worldwide Governance Indicators, 2011.

3.3. Conclusion

To sum up, the analyzed data allows to accept the hypothesis that *the prevalence of FDI in financial and business services in Estonia is influenced by the fact that its*

political stability was higher in the year 1991-2007 than in Lithuania and the centre or right-wing parties prevailed in government. The empirical data clearly shows that since the regime change right-wing parties, friendly to FDI in financial and business services, prevailed in Estonian government. Moreover, government was sufficiently stable to implement the right-wing FDI policies. The cases of Lithuania and Latvia are more puzzling. Graphs 9, 10 and 11 show that Lithuanian governments were somewhat more stable than Latvian ones. Also, their duration in office was much higher than Latvian and similar to Estonian. Furthermore, Graph 8 clearly shows that the sectoral patterns of FDI in Lithuania were influenced by the political ideology of the ruling coalitions. Although the centre and right-wing parties prevailed in Latvian governments all the time since the regime change, the level of political stability (including high volatility of governments) does not seem to be high enough to enable the government to pursue coherent FDI policies. However, one sees the relative prevalence of FDI in financial and business services in Latvia. This finding is in line with the prevalent centre-right ideology in Latvian governments. Therefore, results from Latvia and Lithuania seem to suggest that the ideology of the coalition in power may be more important than government stability for explaining the sectoral patterns of FDI.

Conclusions

The present thesis started with the statement of the empirical problem: despite very similar initial positions, the three Baltic States have developed different sectoral patterns of FDI in the period 1991-2007. While Lithuania has attracted a significantly larger share of FDI in manufacturing, Latvia and Estonia, on the other hand, have specialized in FDI in financial and business services. Why did this happen? Explaining the outlined puzzle was the aim of the thesis.

By using a theoretical approach to economic relations borrowed from economic sociology – economic substantivism – which tells that economic activity is always embedded in wider social, institutional, cultural and political context, this thesis investigated two sets of hypotheses. The first set of hypotheses suggested that the different types of the skills prevailing in the Baltic States may have an influence on the types of attracted FDI. The second set of hypotheses gave grounds for the analysis of the connection among the political stability, political ideologies and the sectoral patterns of FDI.

The analysis carried out in the second chapter of the thesis allowed to conclude that the prevalence of FDI in manufacturing in Lithuania is influenced by the prevailing skills which are conducive to manufacturing activities. The largest percentage of people educated in engineering and manufacturing in association with the largest pool of unskilled labor make Lithuania attractive to investors in manufacturing. The prevailing skills in Estonia, on the other hand, seem to make it the ideal case for FDI in financial and business services. Among the Baltic states, it has the highest percentage of people with tertiary education (a lot of them are studying social sciences, business and law), the

smallest pool of unskilled labor, its people are also better in languages and information technologies. The evidence about Latvia was ambiguous and did not allow making clear conclusions about the connection between the skills prevailing in the country and the types of FDI. However, the overall conclusion of the chapter is that the prevailing skills do indeed have an influence on the sectoral patterns of FDI.

The investigation of the interplay between the political stability, political ideology and the types of FDI in the third chapter concluded that the prevalence of FDI in financial and business services in Estonia were influenced by both the centre-right ideology of the parties in office and the political stability which allowed government to pursue its policies effectively. The level of political stability was found to be lower in both Lithuania and Latvia. However, FDI seemed to correlate with the ideologies of the parties in government in both countries. This suggested that the political ideologies of the ruling parties may have a greater influence on the decisions of foreign investors than the level of political stability, especially in such countries which can suffer only from the "usual" political instability caused by the political process in young democracies.

It is necessary to acknowledge that there can also be other factors which had an influence on the emergence of different sectoral patterns of FDI in the Baltic States. One of the possible explanations can stem from the relations among countries. It may be the case that countries get the largest share of investment from culturally or historically close states (e.g. Estonia from Finland; Lithuania from Poland), which specialize in offshoring of particular types of activities. Another viable route would be to test the influence of the infrastructure provided by the Baltic States for foreign investors. For instance, the quality

of telecommunications, transportation, energy supply, etc. may have different effects on the different types of FDI. These explanations may be tested in the future research.

The present thesis makes a contribution to three strands of literature on FDI in transitional states. First, it brings new insights to the literature which analyses the sectoral patterns of FDI flows. The juxtaposition of manufacturing and financial and business services, although of course with many limitations, allows making valuable conclusions about the effects of prevailing skills, political stability and political ideologies on the types of attracted FDI. Second, the present thesis contributes to the strand of literature which takes a "services' turn" in the study of FDI and tries to analyze not only the determinants of FDI in manufacturing but also the determinants of FDI in services. Third, it widens the literature which deals with the FDI flows in the Baltic States. Although the Baltic region is often seen as a coherent unit in academic literature, this thesis showed that a lot of interesting facts can be revealed by looking in depth at each of the states in the Baltics.

Bibliography

Ake, Claude. "A Definition of Political Stability." *Comparative Politics* 7, no. 2 (January 1, 1975): 271–283.

Alfaro, Laura and Andrew Charlton. "Growth and the Quality of Foreign Direct Investment: Is All FDI Equal?" *CEP Discussion Paper* 830 (2007): 1–26.

Amsden, Alice H. *The Rise of "the Rest": Challenges to the West from Late-industrializing Economies*. Oxford: Oxford University Press, 2001.

An Open World: Ernst & Young's 2008 European Attractiveness Survey. Ernst & Young, 2008.

Bandelj, Nina. *From Communists to Foreign Capitalists: The Social Foundations of Foreign Direct Investment in Postsocialist Europe*. Princeton, N.J: Princeton University Press, 2008.

Ben Shepherd. "Political Stability: Crucial for Growth?" *LSE IDEAS Strategic Update* (March 2010): 8–11.

Berglund, Sten, Joakim Ekman, and Frank H. Aarebrot, eds. *The Handbook of Political Change in Eastern Europe*. 2nd ed. Cheltenham: Edward Elgar, 2004.

Bevan, Alan A., and Saul Estrin. "The Determinants of Foreign Direct Investment into European Transition Economies." *Journal of Comparative Economics* 32, no. 4 (2004): 775–787.

Bohle, Dorothee, and Béla Greskovits. "Neoliberalism, Embedded Neoliberalism and Neocorporatism: Towards Transnational Capitalism in Central-Eastern Europe." *West European Politics* 30, no. 3 (May 2007): 443–466.

Brada, Josef C., Ali M. Kutan, and Taner M. Yigit. "The Effects of Transition and Political Instability on Foreign Direct Investment Inflows." *Economics of Transition* 14, no. 4 (December 2006): 649–680.

Degutis, Mantas, and Manuela Tvaronavičienė. "Factor Analysis of Lithuanian and Estonian Inward Foreign Direct Investment." *Business: Theory & Practice* 7, no. 3 (2006): 150–157.

Digital Agenda for Europe, 2012, http://ec.europa.eu/information_society/digital-agenda/index_en.htm.

Dixit, Avinash K., and Robert S. Pindyck. *Investment Under Uncertainty*. Princeton, N.J: Princeton University Press, 1994.

Duvold, Kjetil, and Mindaugas Jurkynas. "Lithuania." In *The Handbook of Political Change in Eastern Europe*, edited by Sten Berglund, Joakim Ekman, and Frank H. Aarebrot, 133–180. 2nd ed. Cheltenham: Edward Elgar, 2004.

EdStats Query. World Bank database of statistics and education, 2012. http://databank.worldbank.org/ddp/home.do?queryId=189.

"Electoral Progam of the Homeland Union (Lithuanian Conservatives) 1996, New Lithuania's Way", 1996. http://www.tslk.lt/1996_seimo_rinkimai_naujas_lietuvos_kelias.htm.

"Electoral Program of Homeland Union (Lithuanian Christian Democrats) 2008, Let's Begin", 2008. http://www.tsajunga.lt/index.php/seimo_rinkimu_programa_2008_2012/9081.

"Electoral Program of Lithuanian Democratic Labor Party 1996", 1996. http://www.lddp.lt/programa.html.

Ellingstad, Marc. "The Maquiladora Syndrome: Central European Prospects." *Europe-Asia Studies* 49, no. 1 (January 1997): 7–21.

Elson, Diane. "Uneven Development and the Textiles and Clothing Industry." In *Capitalism & Development*, edited by Leslie Sklair, 189–210. London and New York: Routledge, 1994.

Estonian Investment and Trade Agency. "Key Sectors", 2012. http://www.investinestonia.com/en/business-environment.

Estrin, Saul, Kirsty Hughes, Sarah Todd, and Royal Institute of International Affairs. *Foreign Direct Investment in Central and Eastern Europe: Multinationals in Transition*. London: Pinter Publishers, 1997.

Eurostat. *The Bologna Process in Higher Education in Europe: Key Indicators on the Social Dimension and Mobility*, 2009.

Eurostat, 2012. http://epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home/.

EURYDICE. *Supplement to the Study on the Structures of the Education and Initial Training Systems in the European Union: The Situation in Estonia, Latvia, Lithuania, Slovenia and Cyprus*. Brussels, May 1999.

Fabry, Nathalie, and Sylvain Zeghni. "How Former Communist Countries of Europe May Attract Inward Foreign Direct Investment? A Matter of Institutions." *Communist and Post-Communist Studies* 39, no. 2 (June 2006): 201–219.

Frye, Timothy. "The Perils of Polarization: Economic Performance in the Postcommunist World." *World Politics* 54, no. 3 (2002): 308–337.

Gemici, Kurtuluş. "Karl Polanyi and the Antinomies of Embeddedness." *Socio-Economic Review* 6, no. 1 (January 2008): 5–33.

Greskovits, Béla. "Legacies of Industrialization and the Paths of Transnational Integration After Socialism". Princeton, United States, 2011.

Hall, Peter A., and David W. Soskice, eds. *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage*. Oxford [England]: Oxford University Press, 2001.

Hardy, Jane, Grzegorz Micek, and PaweŁ Capik. "Upgrading Local Economies in Central and Eastern Europe? The Role of Business Service Foreign Direct Investment in the Knowledge Economy." *European Planning Studies* 19, no. 9 (2011): 1581–1591.

Haupt, A. B. "Parties' Responses to Economic Globalization: What Is Left for the Left and Right for the Right?" *Party Politics* 16, no. 1 (August 10, 2009): 5–27.

Hermann Smith-Sivertsen. "Latvia." In *The Handbook of Political Change in Eastern Europe*, edited by Sten Berglund, Joakim Ekman, and Frank H. Aarebrot, 95–132. 2nd ed. Cheltenham: Edward Elgar, 2004.

Hollinshead, Graham, and Jane Hardy. "The Offshoring of Financial Services: a Reassessment." *International Journal of Management Concepts & Philosophy* 4, no. 1 (January 2010): 87–99.

Hunya, Gabor. "Large Privatization, Restructuring and Foreign Direct Investment." In *Lessons from the Economic Transition: Central and Eastern Europe in the 1990s*, edited by Salvatore Zecchini, 263–275. Boston: Kluwer Academic Publishers, 1997.

Investment and Development Agency of Latvia. "News Archive", 2012. http://www.liaa.gov.lv/eng/home/news/news_archive/.

Islam, Shahidul and S.T. Syed Shazali. "Determinants of Manufacturing Productivity: Pilot Study on Labor-intensive Industries." *International Journal of Productivity & Performance Management* 60, no. 6 (July 26, 2011): 567–582.

Josef Christl. “The Role of FDI in Transition.” In *Foreign Direct Investment in Europe: A Changing Landscape*, edited by Klaus Liebscher, Josef Christl, Peter Mooslechner, and Doris Ritzberger-Grunwald, 53–58. Northampton, MA: E. Elgar, 2007.

Krugman, Paul R. *International Economics: Theory & Policy*. 8th ed. The Addison-Wesley Series in Economics. Boston: Pearson/Addison Wesley, 2009.

Lagerspetz, Mikko and Henri Vogt. “Estonia.” In *The Handbook of Political Change in Eastern Europe*, edited by Sten Berglund, Joakim Ekman, and Frank H. Aarebrot, 57–94. 2nd ed. Cheltenham: Edward Elgar, 2004.

Lankes, Hans-Peter, and A. J. Venables. “Foreign Direct Investment in Economic Transition: The Changing Pattern of Investments.” *Economics of Transition* 4, no. 2 (October 1, 1996): 331–347.

Latvian PM Suggests Priorities for His Party Ahead of Elections. Baltic News Service, April 6, 2002.

Lenin, Vladimir I. “Imperialism: The Highest Stage of Capitalism.” In *The International Political Economy of Direct Foreign Investment*, edited by Benjamin Gomes-Casseres and David B. Yoffie, 1:3–12. Aldershot, Hants, England: E. Elgar, 1993.

Lie, John. “Embedding Polanyi’s Market Society.” *Sociological Perspectives* 34, no. 2 (1991): 219–235.

Linz, Juan J. “Democracy’s Time Constraints.” *International Political Science Review / Revue Internationale De Science Politique* 19, no. 1 (1998): 19–37.

Lithuanian Free Market Institute. “Evaluation of Electoral Programs 2000”, 2000. http://www.lrinka.lt/index.php/analitiniai_darbai/rinkiminiu_programu_ivertinimas_2000_m/2398;from_topic_id;61.

“Long-term Program of Lithuanian Social Democratic Party”, 2009. http://www.lsdp.lt/lt/straipsniai/206-partijos-programa.html.

Lukšienė, Meilė et al. “General Concept of Education in Lithuania”. Ministry of Culture and Education of the Republic of Lithuania, 1992. http://www.smm.lt/en/legislation/docs/General_concept_of_education_in_Lithuania_1992.pdf.

Mackonytė, Greta. “Lietuva Ir Estija: Kodėl (ne)pažabotas Valstybės Biudžeto Deficitas? (Lithuania and Estonia: Why Is the State Budget Deficit (Un)Curbed?)”. BA thesis, Vilnius University, 2011.

Margolis, J. Eli. “Understanding Political Stability and Instability.” *Civil Wars* 12, no. 3 (2010): 326–345.

Marin, Dalia. “The Opening up of Eastern Europe at 20 - Jobs, Skills, and ‘Reverse Maquiladoras’ in Austria and Germany”. Bruegel Working Paper, July 2010.

Martinaitis, Žilvinas. “The Political Economy of Skills Formation: Explaining Differences in Central and Eastern Europe”. Doctoral Dissertation, Vilnius University, 2010.

Meyer, Klaus E. “Foreign Direct Investment in the Early Years of Economic Transition: a Survey.” *The Economics of Transition* 3, no. 3 (1995): 301–320.

Miškinis, Algirdas and Birgit Reinbold. “Investments of German MNEs into Production Networks in Central European and Baltic States.” *Technological and Economic Development of Economy*, no. 4 (2010): 717–735.

Morgan, Patrick M. “Review of D. Sanders Book Patterns of Political Instability.” *Social Science Quarterly (University of Texas Press)* 64, no. 2 (June 1983): 424–425.

Müller-Rommel, Ferdinand, Katja Fettelschoss, and Philipp Harfst. “Party Government in Central Eastern European Democracies: A Data Collection (1990–2003).” *European Journal of Political Research* 43, no. 6 (October 2004): 869–893.

Mygind, Niels. “The Internationalization of the Baltic Economies.” *BRIE Working Paper* 130 (1998): 1–45.

Naeyoung, Lee and Jeffrey Cason. “Automobile Commodity Chains in the NICs: A Comparison of South Korea, Mexico, and Brazil.” In *Manufacturing Miracles*, edited by Garry Gereffi and Donald L. Wyman, 223–243. Princeton: Princeton University Press, 1990.

Neuhaus, Marco. *The Impact of FDI on Economic Growth: An Analysis for the Transition Countries of Central and Eastern Europe*. Contributions to Economics. Heidelberg: Physica Verlag, 2005.

Ó Riain, Sean. “Addicted to Growth: State, Market and the Difficult Politics of Development in Ireland.” In *The Nation-State in Transformation: The Governance, Growth and Cohesion of Small States Under Globalisation*, edited by Michael Bøss. Aarhus: Aarhus University Press, forthcoming.

———. “The Flexible Developmental State: Globalization, Information Technology, and the Celtic Tiger.” *Politics and Society* 28, no. 2 (June 2000): 157–193.

Organisation for Economic Co-operation and Development. *Investment Guide for Latvia*. Paris: Organisation for Economic Co-operation and Development, 1998.

Pinto, Pablo M., and Santiago M. Pinto. "The Politics of Investment: Partisanship and Sectoral Allocation of Foreign Direct Investment." *Conference Papers -- Midwestern Political Science Association* (Annual Meeting 2006): 1–28.

Resmini, Laura. "The Determinants of FDI in Central, Eastern and South-Eastern Europe: Lessons from the Past and Prospects for the Future." In *Foreign Direct Investment in Europe: A Changing Landscape*, edited by Klaus Liebscher, Peter Mooslechner, Josef Christl, and Doris Ritzberger-Grunwald, 207–226. Northampton, MA: E. Elgar, 2007.

Sass, Magdolna, and Martina Fifekova. "Offshoring and Outsourcing Business Services to Central and Eastern Europe: Some Empirical and Conceptual Considerations." *European Planning Studies* 19, no. 9 (2011): 1593–1609.

Shafer, Michael, D. "Capturing the Mineral Multinationals: Advantage or Disadvantage?" In *Multinational Corporations*, edited by Thomas H. Moran, 25–53. Lexington: Lexington Books, 1985.

Sinn, Hans-Werner, and Alfons J. Weichenrieder. "Foreign Direct Investment, Political Resentment and the Privatization Process in Eastern Europe." *Economic Policy* 12, no. 24 (April 1997): 179–210.

Thomsen, Jeanette. "Processes of Localization and Institutionalization of Local Managers in Economic Functions in Danish Owned Subsidiaries in Estonia, Latvia and Lithuania Around the 21st Century." *Journal of Business Economics & Management* 9, no. 4 (December 2008): 279–287.

UNESCO. "International Standard Classification of Education (ISCED)", 1997.

Vienna Institute of International Economic Studies (WIIW) database on FDI.

World Bank Database, 2012, http://data.worldbank.org/indicator/NV.IND.MANF.ZS.

Worldwide Governance Indicators, World Bank, 2011. http://info.worldbank.org/governance/wgi/index.asp.