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CONTENTS

| | |
|--|-----|
| From the Editor | 3 |
| <i>Edgars Rožāns</i> The (Non) Existence of Economic Cycles | 4 |
| <i>Viesturs Pauls Karnups</i> Leadership and Innovation: Nature and Trends | 13 |
| <i>Oleg Nikiforov, Sergei Grichin</i> Small Business in Contemporary World Economy: a Comparative Study of Issues | 22 |
| <i>Karl Stern</i> Concerning Estonian-Latvian Trade Relations during the 1930s | 36 |
| <i>Knut Michelberger</i> The Problem of Diminishing Marginal Utility of 'Good' Corporate Governance: Firm Performance and Supervisory Board Governance of German Stock-Listed Companies | 60 |
| <i>Agnesa Lahiža</i> Overall Influence of Solvency II on Latvian Insurance Market Changes | 79 |
| <i>Džiugas Petruškevičius</i> A Consideration of Sustainable HR Management Implementation in a Sme Context: the T Optimus Case | 84 |
| The Authors | 110 |

FROM THE EDITOR

Dear Reader,

This is the second issue for 2016 and we expect to be able to publish the next issue in spring-summer 2017.

The authors are both PhD students and established academics. The articles are a more homogeneous set this time and mainly concentrate on management and economics. In this issue we have articles by authors not only from Latvia, but also from Russia, Lithuania, Germany and Estonia.

For past and future authors the good news is that we have finally been added to the EBSCO Ultimate database system. The journal can be found in the Sociology Source Ultimate database. Unfortunately only issues from 2014 have been included.

We hope you enjoy this issue and are looking forward to the next issue.

Best wishes

Viesturs Pauls Karnups
General Editor

THE (NON) EXISTENCE OF ECONOMIC CYCLES

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MBA

Abstract

Although over the years there has been a lot of research done on the subject of possibility of existence of economic cycles, none of it has given convincing results to confirm them. So for the moment being it is quite safe to agree with the common view among mainstream economists that discredit the idea of them. That is also confirmed given that interest in the different typologies of economic cycles has diminished significantly with the progress of modern macroeconomics, which does not give a support to the idea of regular periodic economic cycles. Nevertheless, given exponentially growing vast and unexplored data nowadays that is becoming available in different scientific fields, giving also room for inter-disciplinary research, it could prove to be too early to call the concept of economic cycles impossible.

Keywords: Economic cycles

Introduction

Despite the scale of complexity modern economics have reached, it still fails to answer many of questions raised in its planning, which hinders economic policy planners on various levels to make the most effective decisions to sustain and advance economic development.

One of such economic phenomena is the existence or non-existence of economic or otherwise known as business cycles. Exactly that would be the purpose of this article, to find out what previous research has been made on this topic and whether there is any concrete evidence to suggest that economic (business) cycles really do exist.

To achieve this aim a number of tasks should be set and investigated:

- How are economic cycles defined
- Research made so far on economic cycles
- What is the current situation regarding acceptance of economic cycles

To implement the above-mentioned tasks, mainly descriptive, analytical and comparative methods were used.

Accordingly, to assess the existence or non-existence of economic cycles, the article is structured as follows. Section 1 provides a few definitions of the subject investigated, Section 2 investigates the historically proposed theories to explain economic cycles and the last section makes the conclusions derived from the article.

Definition of the topic

Economic or business cycles are fluctuations of economic variables in markets that happen on more or less frequent basis and with different strength. One of the most recognised definitions on business cycles is given by Arthur Burns and Wesley Mitchel,¹ stating that the business cycles are a type of fluctuations found in the aggregate economic activity of nations that organise their work mainly in business enterprises – a cycle consists of expansions occurring at about the same time in many economic activities, followed by similarly general recessions, contractions, and revivals which merge into the expansion phase of the next cycle. This sequence of changes is recurrent, in duration business cycles vary from more than one year to ten or twelve years, they are not divisible into shorter cycles of similar character with amplitudes approximating their own.

Of course there are many other theories trying to explain economic or business cycles (Zarnowitz)², which would be worth mentioning here, if further analysis would be given for the subject. However, several key concepts can be distinguished, as done by Jan Jacobs³. First, there is the distinction between business cycles and macroeconomic fluctuations. The former is a cyclical phenomenon, in the study of which attention is paid to describing and forecasting turning points. Researchers of macroeconomic fluctuations are not interested in turning points; they try to capture general patterns in macroeconomic time series like *e.g.*, their volatility. Secondly, a theory may require an exogenous cause for cycles or may be able to explain cycles without having to rely on outside forces. In other words, there exist *exogenous* and *endogenous* business cycle theories. Thirdly, a theory may assume a (neoclassical) general *equilibrium* framework or may be Keynesian oriented by starting from *market imperfections* or even *disequilibrium*. Fourthly, cycles may be the result of *real shocks* or *monetary shocks*. Fifthly, business cycles may arise from too much or too little *investment* or *consumption*. Sixthly, political business cycle theories assume a large role of the *government* in the creation and propagation of business cycles. Finally, business cycle theories can be expressed at different levels of aggregation. There are *micro* theories that explain business cycles from

¹ Burns, A. E., Mitchell, W. C. Measuring business cycles, volume 2 of Studies in Business Cycles. National Bureau of Economic Research. New York. 1946

² Zarnowitz, V. Business cycles: theory, history, indicators, and forecasting, volume 27 of National Bureau of Economic Research Studies in Business Cycles. The University of Chicago Press. Chicago and London. 1992

³ Jacobs, J. Econometric Business Cycle Research: an assessment of method. Springer Science & Business Media. pp. 4-5. 1998

actions of individual economic units, and *macro* theories that work with aggregate variables.

The historically proposed theories to explain economic cycles

Starting from the end of the 19th century economic theory has been matched with statistical data which has given a chance for economists to sort out a possibility of economic cycles. The first researcher to mention in this field would have to be Jean Charles Léonard de Sismondi in 1819 with his work on economic crisis, which was in opposition to at the time dominant theory of economic equilibrium. Before that classical economics either denied existence of economic cycles or blamed them on external factors or paid attention to them only in a long term. Later on the theory of Sismondi was proven by the very first peacetime international economic crisis – the Panic of 1825. Robert Owen expressed similar thoughts almost at the same time; they both identified the cause of economic cycles as overproduction and under consumption,⁴ the latter of which – under consumption theory, was regarded as a heterodox branch in economics, until being developed in Keynesian economics in the 1930s. Sismondy's theory of crisis was later developed in many other theories, including in works of infamous Karl Marx, as well as by Charles Dunoyer, who developed it into a theory of alternating cycles.⁵

Nevertheless, despite all the work done on trying to explain business cycles, there isn't definitive answer for explaining lags, i.e., a real linkage between the short-run situation and the long-run picture is not evident.⁶ And that is, as mentioned before, despite a pretty long history for it in the history of our modern era economics. Mary Morgan sets out three groups of forerunners.⁷ In the first one putting Jevons and Moore as its most distinguished members, who tried to verify and set out business cycle theories with statistical data. Both of them tried to couple economic cycles to exogenous changes in heavenly bodies. Jevons brought forward the idea that sunspot cycles cause business cycles,⁸ but Moore tried to link

⁴ Batra, R. *Economics in Crisis: Severe and Logical Contradictions of Classical, Keynesian, and Popular Trade Models*. 2002

⁵ Benkemoune, R. *Charles Dunoyer and the Emergence of the Idea of an Economic Cycle*. *History of Political Economy*. pp. 271-295. 2009

⁶ Solow, R. M. *Is there a core of usable macroeconomics we should all believe in?* *American Economic Review (Papers and Proceedings)*, 87(2). pp. 230-232. 1997

⁷ Morgan, M. S. *The history of econometric ideas*. *Historical Perspectives on Modern Economics*. Cambridge University Press, Cambridge, UK. 1990

⁸ Jevons, W. S. *Investigations in currency and finance*. Macmillan. London. 1884

weather cycles and business cycles⁹ and interpreted it with weather cycles by changes in the movements of the planet Venus.¹⁰

Subsequently, the second group dismisses the concept of cycles, looking at each cycle as a different event. Their goal is to deliver reliable descriptive statistics in order to be able to verify and define economic business cycles. Belonging to this group are researchers like Clement Juglar,¹¹ already mentioned Wesley Mitchel,¹² and Warren Persons.¹³

In the 1920's also institutions are being introduced to study business cycles, including the National Bureau of Economic Research (NBER), one the most well-known economic research institutions world-wide even today. At the NBER Jan Tinbergen introduces Econometric Business Cycle Research (EBCR), which with his simultaneous equation models pretty much will dominate the EBCR to this day. He laid out EBCR in the following way.¹⁴

An essential feature of an econometric model is, the author believes, that it combines mathematic-economic treatment with statistical measurement of some type. The ultimate objectives of these models are the same as of any system of business cycle research, viz.

- to explain historical events;
- to forecast future developments under certain conditions;
- to indicate the probable consequences of measures of business cycle policy.

Within the framework of these ultimate objectives, one may distinguish more proximate objectives. These may be separately stated for the economic and the statistical parts of the task. The objectives of the economic part are, in the author's opinion: (a) to clarify notions and opinions of various theories and to localise differences of opinion; and (b) to find the complete implications of any set of assumptions as to type of movement resulting, influence of given types of policy, etc. The objectives of the statistical part are: (a) either, more modestly, to find values for coefficients, etc., as are not contrary to observation; or (b), more

⁹ Moore, H. L. *Economic cycles – their law and causes*. Macmillan. New York. 1914

¹⁰ Moore, H. L. *Generating economic cycles*. Macmillan. New York. 1923

¹¹ Juglar, C. *Des crises commerciales et de leur retour periodic en France, en Angleterre et aux Etats-Units*. Guillaumin. Paris. 1862

¹² Mitchell, W. C. *Business cycles and their causes*, volume 3 of *Memoirs*. California University. Berkeley. 1913

¹³ Persons, W. M. *Indices of business conditions*. *Review of Economic Statistics*. 1919

¹⁴ Tinbergen, J. *On a method of statistical business cycle research: a reply*. *The Economic Journal*, 50. pp. 141-154. 1940

ambitiously, to prove, under certain conditions, something to be true or not true.

Today in general there are only two ways to measure business cycles – one is the method of the National Bureau of Economic Research and the other is the method of classical statistical time series.

Finally, the third group doesn't analyse time series, but uses set experiments to explain business cycle phenomenon and sets out principles for economic theory to correspond with economic cycles. Udny Yule¹⁵ and Eugen Slutsky¹⁶ separately around the same time back in the year 1927 prove that outside forces can make cyclical patterns in macroeconomic data. Sometime later Ragnar Frisch¹⁷ comes up with a way to analyse business cycles by establishing his propagation-impulse model, which subjects the economy to various casual impacts into the business cycle model. He basically parallels the economy to a rocking horse, meaning that for cycles to be explained there is inevitably a need to illuminate why economies keep going up and down, the so-called propagation mechanism, and how economies start their fluctuating, the so-called impulse mechanism.

For the sake of the historic list being as complete as possible the author would also like to add another group of proposers of different cycles, developed in the middle of the 1950's by Schumpeter and others.¹⁸ The common thing for these researchers is that they were putting emphasis on years than anything else to explain economic cycles. Belonging to this group of researchers, in the sequence of the length of their proposed periods, are Joseph Kitchin with his Kitchin inventory cycle of 3 to 5 years,¹⁹ already in the classification of Mary Morgan mentioned Clement Juglar with his Juglar fixed investment cycle of 7 to 11 years,²⁰ Simon Kuznets and his infrastructural investment cycle of 15 to 25 years,²¹

¹⁵ Yule, G. U. On a method of investigating periodicities in disturbed series, with special reference to Wolfer's sunspot numbers. *Philosophical Transactions of the Royal Society, Series A*, 226. pp. 267-298. 1927

¹⁶ Slutsky, E. E. The summation of random causes as the source of cyclic processes. *Econometrica*, 5. pp. 105-146. 1937

¹⁷ Frisch, R. Propagation problems and impulse problems in dynamic economics. *Economic essays in honour of Gustav Cassel*, Allen & Unwin. pp. 171-205. London. 1933

¹⁸ Schumpeter, J. A. *History of Economic Analysis*. George Allen & Unwin. London. 1954

¹⁹ Kitchin, J. *Cycles and Trends in Economic Factors*. *Review of Economics and Statistics* (The MIT Press) 5 (1). pp. 10-16. 1923

²⁰ Lee, M. W. *Economic fluctuations*. Richard D. Irwin. Homewood, IL. 1955

²¹ Kuznets, S. *Secular Movements in Production and Prices. Their Nature and their Bearing upon Cyclical Fluctuations*. Houghton Mifflin. Boston. 1930

and Nikolai Kondratjev with his Kondratjev wave or long technological cycle of 45 to 60 years.²² Regarding the last, it has been supplemented and attempted to explain in interconnection with various factors, even with the scientifically proven 11-year activity cycles of the Sun, which leaves an effect on many terrestrial processes.²³ However, it is important to note that with development of modern macroeconomics, at the current time cycles are not getting too much attention, since there is very little evidence for regular periodicity of economic cycles themselves.

All of the already mentioned theories are of course still not a full accounting of different theories that there are to explain economic cycles, which is far beyond the scope of this research article, however still some other approaches that have been proposed to explain them that should be mentioned here, like for the example the Credit/debit cycle,²⁴ the Real business cycle (RBC) theory,²⁵ the Yield Curve,²⁶ the Georgism,²⁷ the Politically based business cycle²⁸, the Austrian business cycle theory (ABCT),²⁹ and most notably of course Keynesian economics, developed by John Maynard Keynes³⁰, which nowadays serve as the main framework for explaining fluctuations in an aggregate economic activity, that is one of the primary concerns in macroeconomics. Basically Keynesianism deals with various theories how in short term, and especially in times of recessions, economic output is being strongly affected by the aggregate demand. According to Keynesians aggregate demand does not have to correspond with the productive capacity of an economy, instead it is being affected by various factors and can behave unpredictably, leaving significant impact on various macroeconomic indicators.

²² Kondratieff, N. D., Stolper, W. F. *The Long Waves in Economic Life*. Review of Economics and Statistics (The MIT Press). 1935

²³ Zaitsev, Y. *The Discovered Space*. republished in SpaceDaily.com. Oct 04, 2007

²⁴ Perez, C. *The Dynamics of Bubbles and Golden Ages*. Technological Revolutions and Financial Capital. Edward Elgar Publishing Limited. 2002

²⁵ Cencini, A. *Macroeconomic Foundations of Macroeconomics*. Routledge. pp. 40. 2005

²⁶ Adrin, T., Estrella, A., Song Shin, H. *Monetary Cycles, Financial Cycles and the Business Cycle*. Federal Reserve Bank of New York Research Paper Series. pp. 19. 2010

²⁷ Hansen, A. H. *Business Cycles and National Income*. W. W. Norton & Company. New York. pp. 39. 1964

²⁸ Drazen, A. *Political business cycles*. The New Palgrave Dictionary of Economics. 2nd Edition. 2008

²⁹ Woods, T. Jr. *Did Capitalism Cause the Great Depression?* Crown Forum. New York. pp. 174-179. 2007

³⁰ Blinder, A. S. *Keynesian Economics*. Concise Encyclopedia of Economics,– Indianapolis. 637. 2008

Conclusions

As one can see there has been a lot of research done on the subject of possibility of existence of economic cycles, nevertheless none of it has given convincing results to confirm them. So for the time being it is quite safe to agree with the common view among mainstream economists that discredit the idea of regular economic cycles. Especially given that interest in the different typologies of economic cycles has diminished significantly with the progress of modern macroeconomics, which does not give a support to the idea of regular economic cycles. There is also a belief that it is pretty much impossible to prove existence of such cycles in economics, given that although it has a large part of it rooted in the mathematics it still is a social science with too many man-caused variables.

Nevertheless, in order to dismiss the existence of economic cycles there still has to be a lot more research done, and given the impasse in which the research on regular economic cycles is at, the author of this article believes that there should be a lot more inter-disciplinary research on this topic, especially given how much data nowadays is available and unexplored in various scientific fields in relation to other sciences and what ground-breaking results it could give for the macroeconomics and the world of science. There have been early forerunners in trying to explain economic cycles by looking at it all in a different fashion, like for example the already mentioned Jevons, Moore or Kondratjev, with many that have followed, but still the possibilities for a progress are immense.

Or in other words, in an attempt to make possible ground-breaking discoveries, inter-disciplinary research would give a chance to add to already existing research on economic cycles, with a fresh look on it in academic environment to a subject of economics that periodically is being revived or dismissed as dead (like at the current time), using conventional and unconventional but verifiable methods to investigate whether there are other factors that come in to explain economic performance, besides the conventional already existing economic factors.

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LEADERSHIP AND INNOVATION: NATURE AND TRENDS*

Viesturs Pauls Karnups

Dr. oec.

Abstract

Entrepreneurs and managers in today's competitive marketplace rely on enhanced business skills to improve their company's competitive edge. Entrepreneurship today includes new business creation, as well as entrepreneurial activities undertaken within existing businesses or through new market mechanisms. Thus, an important aspect of modern entrepreneurship is innovation and successful innovation requires successful leadership. Leadership is defined in numerous concepts and the understanding of innovation is based on certain levels, market value or impact. There are also differences in the kind of innovation, i.e. product or process innovation. But the overall understanding is that innovation is critical for organisational survival and growth. Organisational structures and processes can be rated as essential and, if fittingly implemented, helpful to enable innovation. But organisation and processes are not at all sufficient requirements; and the imperative and unavoidable requirement for a successful innovative culture can be identified as leadership. In this article an overview of the nature and trends of innovation and leadership will be given, as well as how both terms relate to each other and to what extent different leadership styles impact on innovation. The ultimate role of leaders is to keep companies, industries and economies alive and thriving through innovation.

Keywords: Entrepreneurship, Leadership, Innovation,

Introduction

Entrepreneurs and managers in today's competitive marketplace rely on enhanced business skills to improve their company's competitive edge. Entrepreneurship today includes new business creation, as well as entrepreneurial activities undertaken within existing businesses or through new market mechanisms. Thus, an important aspect of modern entrepreneurship is innovation and successful innovation requires successful leadership. A glance through the Internet reveals hundreds of articles and courses linking leadership with innovation. "Innovation and leadership are closely

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related. Leadership always has some focus on bringing about a better future. In this sense, leaders are necessarily innovators. We would not normally consider a spectator of the status quo to be a leader. The term innovation also suggests some break with the 'norm' or the status quo" (Selman (2002), p. 1). Nevertheless, according to research conducted by Barsh, Capozzi, and Davidson, some 65 percent of senior executives were generally disappointed in their ability to stimulate innovation (Barsh, Capozzi and Davidson (2008), p. 38). On the other hand, this research shows that more than 70 percent of senior executives say that innovation will be at least one of the top three drivers of growth for their companies (Barsh, Capozzi and Davidson (2008), p. 37).

The importance of innovation being established as an inherent component within a company leads to the question which factors might facilitate this kind of entrepreneurial behaviour. Organisational structures and processes can be rated as essential and, if fittingly implemented, helpful to enable innovation. But organisation and processes are not at all sufficient requirements; and the imperative and unavoidable requirement for a successful innovative culture can be identified as leadership. Thus the problem is to identify the degree to which leadership influences the process of innovation. In this article an overview of the nature and trends of innovation and leadership will be given, as well as how both terms relate to each other and to what extent different leadership styles impact on innovation.

Leadership and Innovation

To have a clear understanding of what innovation leadership involves, one must first understand the concept of innovation. The word "innovation" is derived from the Latin words *novus* ("new" or "novel") and *innovatio* ("something newly created"). Thus, innovation means an identifiable new quality and marks a clear difference with previous solutions and practices. Innovation is so much more than a gradual improvement. Selman suggests that one can think of innovation as "intentionally 'bringing into existence' something new that can be sustained and repeated and which has some value or utility" (Selman (2002), p. 2).

In the literature, innovation can also be described as novel and useful ideas of viable products that are put into operation (Hunter & Cushenbery (2011)). It includes three different stages like idea generation, evaluation, as well as implementation and refers to two types of innovation like exploratory innovation, which involves generating brand new ideas, and exploitative innovation, which involves modifying and improving ideas that already exist (Benner & Tushman (2003); March (1991)).

The importance of innovation as an inherent component within a company leads to the question: which factors might facilitate this kind of entrepreneurial behaviour? Organisational structures and processes can be rated as essential and, if fittingly implemented, helpful to enable innovation. But organisation and processes are not at all sufficient requirements; and the imperative and unavoidable requirement for a successful innovative culture can be identified as leadership.

The literature offers numerous definitions for leadership, which are predominantly based on individual traits, leader behaviour, interaction patterns, role relationships, follower perceptions, influence over followers, influence on task goals, and influence on organisational culture. A selection of leadership definitions is shown in Table 1.

Table 1 Selected definitions of leadership

| Author/date | Definition |
|--|--|
| Stogdill (1950) | "Leadership maybe considered as the process (act) of influencing the activities of an organized group in its efforts toward goal setting and goal achievement" |
| Hemphill and Coon (1957) | "Leadership.....is the behaviour of an individual when he is directing the activities of the group toward a shared goal" |
| Janda (1960) | Leadership is... "...a particular type of power relationship characterised by a group member's perception that another group member has the right to prescribe behaviour patterns for the former regarding his (her) activity as a group member" |
| Tannenbaum, Weschler and Massarik (1961) | Leadership is... "...interpersonal influence, exercised in the situation and directed, through the communication process, toward the attainment of specified goal or goals" |
| Katz and Kahn (1978) | Leadership is... "...the influential increment over and above mechanical compliance with the routine directives of the organisation" |
| Hollander (1978) | "Leadership is a process of influence between a leader and those who are followers" |
| Raunch and Behling (1984) | Leadership is "...the process of influencing the activities of an organized group towards goal achievement" |

Source: Chell, E. et al., (1998), p. 409

Innovation leadership, however, is a quite complex concept involving different leadership styles in organisations to influence employees to produce creative ideas, products, services and solutions. Certain elements within an organisation are needed in order for innovation leadership to occur and be successful. Wolfe (1994) has pointed out that one antecedent factor for innovation is organisational culture. Likewise, Isaksen, Lauer, Ekvail, & Britz (2001) concur that innovative endeavours will fail without a supportive climate. This antecedent of a supportive organisational culture/climate encompasses encouragement of creativity, autonomy, resources, and pressures. Additional antecedent elements for innovation leadership include creative work, a creative workforce, and certain leader attributes (Mumford, Scott, Gaddis & Strange (2002)).

At first glance then, the terms innovation and leadership might sound inconsistent or even contradictory. Leadership stands for clear guidance and structures, hierarchy, rules and discipline; all these components being pretty much suited to scotch any innovation. But leadership means much more than fixed structures controlled by a hierarchy and, thus, it must be clearly evaluated which kind of leadership and which extent and constraints of a leading principle are most suitable to create an atmosphere in which innovative ideas can be developed, evaluated and put into practice.

Horth and Buchner claim that six innovative thinking skills are necessary to enable organisations to create something useful – these include looking more deeply at a situation, value individual experience, imagination, serious play (help to have fun at work and play around with ideas, but do not lose the view on business achievements), collaborative inquiry and synthesis (Horth & Buchner (2014), pp. 8-10). Schematically this can be seen in Figure 1 below.

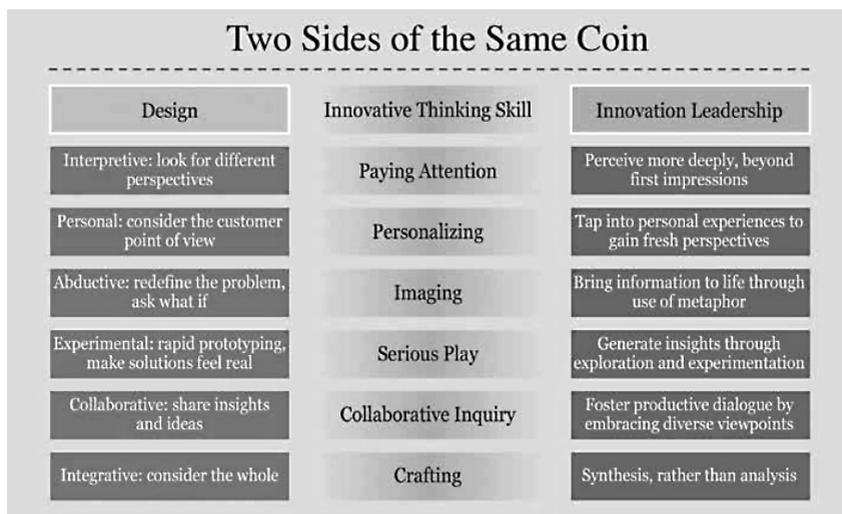


Figure 1 Two Sides of the Same Coin

Source: Horth, D. & Buchner, D., (2014), pp. 11

Innovations are hardly ever made by a single person, but require a team of views and insights and inspiration. Leaders need to make sure that they connect the right people and enable the best networks to find innovative solutions. It has been shown that a certain combination of roles and backgrounds within a network has a big impact on the innovation process. There is a need for employees with ideas, but also for those who can provide research skills and finally for producers who transform ideas into reality.

In principle, everybody can develop ideas, and this basic capability can be further trained and developed. Apart from individual capabilities, any restrictions of idea finding mostly depend on the respective company culture. Innovation needs an atmosphere in which the employees can develop ideas which are openly discussed and evaluated. The importance of innovation as part of the organisational culture is defined by the organisation leaders who develop the general vision and decide on the direction, orientation and focus and who in general terms create, manage and maintain the organisational structures in which innovative ideas can emerge (Agbor (2008)). It is the individual leader who is capable and responsible for bringing the respective innovation strategy into effect and to encourage, stimulate and lead the employees to being innovative. Innovative ideas are per se a bottom-up initiative, but a successful procedure needs matching top-down behaviour (Barsh, Capozzi & Davidson (2008), p. 39). Thus it is the obligation of the leaders to establish in his or her range of influence a business culture which encourages innovative thinking. This can be illustrated in the following Figure 2.



Figure 2

Source: Akkermans, H., Isaksen, S. & Isaksen, E. (2008), p. 3

In a climate survey by Akkermans, Isaksen & Isaksen (2008), they investigated and found that there was a significant relationship between perceived leadership support (LSI) and climate (Figure 3). Although a significant relationship was confirmed between leadership and innovation, when climate was removed, there was an immense drop in

this relationship, which showed an important link between leadership – climate and innovation (Akkermans, Isaksen & Isaksen (2008), p. 4).

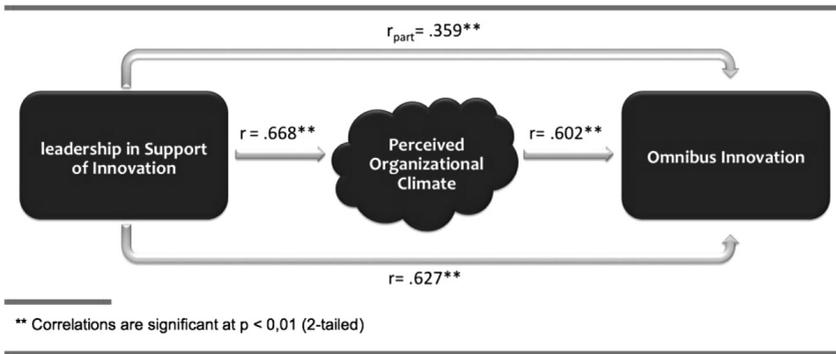


Figure 3 Correlation and partial correlation between LSI, Climate and OI

Source: Akkermans, H., Isaksen, S. & Isaksen, E. (2008) p. 4.

Specific leadership behaviours that help and hinder creation have been identified that create a climate that supports innovation, as the actions of leaders have implications for the climate of innovations. Scott and Bruce (1994) found that leader's behaviour did indeed predict climate for innovation. It also showed that a higher level of interaction between leaders and subordinates, the higher the perceived climate for innovation. People feel that decision makers and leaders are listening and taking their input serious.

Leader Attributes/Characteristics and Leadership Styles

In order for successful innovation leadership to occur, a leader must acquire or possess certain characteristics. These characteristics include expertise in the domain at hand, creativity, ability to carry out transformational leadership behaviours, planning and sense-making and social skills (Mumford, Scott, Gaddis, and Strange, (2002), pp. 712-718). Innovative leaders can be recruited and hired through professional networks and referrals or alternatively found through succession planning, which involves identifying innovative leaders who are already working within the organisation. (McEntire and Greene-Shortridge, (2011), pp. 273-274)

Various leadership styles play an important role in innovation leadership, each of which are used at different stages of the innovation process or for different types of innovation (exploitative vs. exploratory). Frequently associated leadership styles include transformational leadership (Rosing,

Frese & Bausch (2011), transactional leadership (Moss & Ritossa (2007) and ambidextrous leadership (Rosing, Frese & Bausch (2011)). The type of leadership most strongly associated with innovation is transformational leadership.

Transformational leadership can be defined as being concerned with binding people around a common purpose through self-reinforcing behaviours that followers gain from successfully achieving a task and from a reliance on intrinsic rewards. In addition to responding positively to change, transformational leaders actively construct change, facilitate and teach followers and foster cultures of creative change and growth (Munshi, et al., (2005), p. 11).

For example, in one study of the innovation practices at AXA Insurance in Ireland, the CEO John O'Neil engaged in transformational leadership behaviours and introduced the "MadHouse" program that combined workers from different departments and levels of the organisation to work together in a creative way. The result of this experiment after six months was 150 new business ideas for products and services (Oke (2002), cited in Munshi, et al. (2005), pp. 19-20).

Different types of leadership styles and behaviours may be more appropriate at different stages of the innovation process. Current research supports the notion that in the idea generation process, innovation leadership requires a leader to use a more transformational style of leadership. During this stage, a leader needs to promote a safe environment for employees/team members to voice novel ideas and original thinking, as well as provide workers with the resources to do so effectively (Hunter, S. & Cushenbery, L. (2011)). Research has also found that leaders who engage in unconventional behaviours, associated with transformational leadership, were seen as stronger role models and, as a result, increase creative performance in their subordinates. Open leadership behaviours convey that unorthodox and unconventional ideas and behaviours are not only accepted, but also encouraged.

Conclusion

From the above, it is clear that leadership plays a key role in creating an environment that then helps to foster innovation. Therefore the impact a leader or the leadership attitude has, is that the leader creates a certain culture and understanding within his or her team and subordinates. This enables a culture and a climate that stimulates innovation. There are a few key elements how leaders can influence the establishment of such an innovation inspiring company culture and organisation. Different types of leadership style and behaviour may be more appropriate than

others in different stages of the innovation process and in different stages of the organisational life cycle to manage different personality styles of subordinates.

Depending upon the type of leadership style that is adopted by the innovation leader, the leader may be able to influence by establishing a supportive climate for creativity within the organisation, acting as a role model for innovative thinking, providing employees with rewards and recognition for innovative thinking, hiring and team composition. To start with, from a company view, it has been shown that an organisation is much more innovative when company leaders have innovation included in their annual objectives and metrics around their achievements (Evered & Selman (1989). This is a top down approach and should be named in company objectives and concepts. To foster innovation, research shows, that the clear definition of innovation as a company goal and objective leads to higher innovation. The ultimate role of leaders is to keep companies, industries and economies alive and thriving through innovation.

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SMALL BUSINESS IN CONTEMPORARY WORLD ECONOMY: A COMPARATIVE STUDY OF ISSUES¹

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Abstract

The role of enterprise in the contemporary world economy is rather significant. This article is devoted to the study of Russian and foreign academic publications covering the development of small business. The views of researchers from different countries on this process in the world economy are given. The chronological framework of the research ranges from the second half of the XX century to the beginning of the XXI century. The purpose of the article is to analyse research priorities in the field of small business in Russia and abroad and to establish their correlation with the level of small business development and its urgent problems in particular countries and regions. The article includes a comparative analysis of small business problems coverage by Russian and foreign researchers. The analysis revealed the main fields of their research, as well as factors influencing the formation of research priorities, traced the correlation of the research priorities with the problems of development of small business in specific areas, allocated general and specific features in the study of small business development by Russian scientists and their foreign counterparts. The methodical research tools include deductive and quantitative methods, and the method of factor analysis. The deductive method prevails in the introduction to this article, and the inductive method and the method of factor analysis is used in the research part of the article. The authors conclude that the basic research fields in the sphere of small business in a particular country or region are closely connected with the type of business activity in this area, the peculiarities of formation and development of business activity, the role of the government in regulating the social and economic processes, the degree of their efficiency, with historical, cultural and political traditions, and with the level of small business development and economy in the whole. The level of communication of different scholars studying this problem is obviously insufficient. It is necessary to further improve the system of interrelations of business, society and the state; to increase the numbers of contacts between researchers of all countries operational in this field, also through the academic mobility; to increase the availability of

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literature in foreign languages for both Russian and foreign colleagues; also through the integration activities of scientific libraries and university libraries of educational institutions. This article is of interest to researchers involved in the study of business, general economic theory, world economic history and regional economy.

Keywords: specificity, method, small business, factor, region, economy, entrepreneur, country, industry, dynamics.

Introduction

Small business plays a significant role in national economies at present. This is due to several reasons: a) a change in the structure of the world economy (increase in the significance of services and the value of human capital); b) transition of considerable production capacities into the third world countries; c) high efficiency of small business sector in solving social problems, especially in transition economies and countries where the transition has taken place recently. The object of study in this article is the research papers on the problems of small business published in Russia and abroad. The subject of study is the main trends of research of small business development in Russia and abroad based on the analysis of the views of Russian and foreign authors on the process in the modern global economy and the real economic situation. The chronological scope of the study is limited mainly to the second half of XX – early XXI centuries. The present papers aims at comparing the priorities of scientific research in the field of small business in Russia and abroad, its level of development and its relationship with real problems in particular countries.

At the turn of the 20th century in the US, small and medium-sized businesses produce about 50% of GDP of the country and provide employment to almost half of the able-bodied citizens. In the EU, 50% of GDP and 70% of the gainfully occupied population relate to this sector. In China, small businesses produce 60% of GDP [Bescennyj, 2009].

Among the East European countries – members of the European Union, the Baltic countries are worth mentioning in this respect. They present interest to the authors because they are the only countries of the former Soviet Union that joined the European Union. It is due to their industrial structure that small and medium-sized businesses are significant for their economies. Back in the early 20th century, the share of services in their national economies ranges from 65.5% in Lithuania to 74.3% in Latvia. In 2010, 73% of all registered companies in Estonia related to the sector of small and medium-sized businesses. They accounted for 80% of the labour force in the economy, and 78% of the total commercial revenues.

In 2015, 98% of all registered commercial entities in Latvia could be referred to the sphere of small and medium-sized businesses. In 2012,

according to the World Bank, Lithuania ranked 17th out of 183 countries in terms of business environment for entrepreneurial activities, Estonia ranked 22nd, Latvia ranked 24th [Business environment in Latvia, 2015; Lithuania among 17 world's most business-friendly countries, ahead of neighbours, 2015; Saal, Savenkova, 2014; The economic profile of the city of Riga, 2015]. This was largely due to favourable conditions of business registration and other measures of state support of small business in the Baltic States [Company registration: how to start business in Latvia? 2015].

As of December 31, 2013, Russia had 2063 million small businesses, 88.6% of which were micro businesses. The same was true for some foreign countries. Small businesses accounted for 10-12% of GDP. Their annual turnover reached nearly 294.2 billion Euro. They employed about 11.5 million able-bodied citizens. Moreover, there were about 2.5 million self-employed entrepreneurs with annual turnover of over 114.2 billion Euros [Federal State Statistics Service of the Russian Federation; Russian Statistical Yearbook, 2014]. It should be noted, that over the past 20-25 years, these indicators kept changing, but generally indicated positive trends.

Compared with 1997, there was an increase in the number of small businesses by 41.8%. The number of employees has increased by 29.6% since 1998 [Small Business of Russia 2003, 2004]. The annual turnover has increased by a factor of 100. The number of self-employed entrepreneurs has decreased more than 30% since 1999. In 2013, small businesses employed 18.5% of gainfully employed population, compared with 15.9% in 1998.

The statistics confirm the important role of small business in the market economy in Russia and the world economy. The specific problems of the business environment in some countries, differentiation of historical, cultural, political and economic traditions in the countries under review suggest a high degree of relevance of the undertaken study.

Methods

Papers and research materials published in the bases of Elibrary.ru, "Lan" electronic library system, Emerald, Jstor, Bloomsbury Collections, Cambridge Journals Online, EBSCO, Oxford Handbooks Online, ProQuest made the basis of the scientific analysis of the problem. Such a choice was determined by the degree of their availability in the Omsk State Transport University, Russia, which is the work place of one of the authors of this article, the University of Latvia, where he is currently conducting research, and the National Library of Latvia. When working with Elibrary.ru and "Lan"

databases, emphasis was made on the search of the Russian scientists' papers, the other databases were used to search for works mostly by foreign researchers. That is why the authors differentiate between the concepts of "Russian academic literature" and "foreign academic literature." Sub-topics of the study and zoning by geographic parameter were formed according to the content of the selected materials. The selection of papers and research materials was made using a search engine database with "small business development in the second half of the XX – early XXI century" inquiry. The paper analyses the journals dated by the beginning of the year 1991 and onwards. The level of elimination of the found materials by the authors exceeded 90%. The main reasons for elimination were the duplication of journals in different databases, the recurrence of papers, lack of the full texts access, coincidence of only some words of the search inquiry ("small", "business", "country", etc.). The largest number of papers and materials was extracted from databases Elibrary.ru, Emerald, and Cambridge Journals Online. The authors analysed the papers in English, Latvian, German, and Russian. Based on the preliminary analysis, 1066 papers and research materials from 143 journals of Elibrary.ru and "Lan" databases, and 205 journals and scientific publications and dissertations from other databases were selected [Table 1].

Table 1 Data on the selected papers and research materials for the study

| Name of the database | Number of papers |
|--------------------------------|------------------|
| Emerald | 407 |
| Elibrary.ru | 270 |
| Cambridge Journals Online | 151 |
| EBSCO | 95 |
| "Lan"electronic library system | 73 |
| ProQuest | 25 |
| Jstor | 23 |
| Bloomsbury Collections | 18 |
| Oxford Handbooks Online | 4 |
| Total | 1066 |

The inductive, deductive, quantitative methods and the method of factor analysis were used in the study: The deductive method was used mainly in the introduction and the relevance description of the article. The inductive method prevails in the main part of the article where, based on the content analysis of scientific papers on various issues, the conclusions on general and specific features of small business development in some countries were made. The method of factor analysis was applied in identifying

the factors that influenced the researchers' priorities formation in different countries and scientific schools, and in the determining the main trends of small business development in certain countries and the world economy as a whole. The authors used the quantitative method for processing and synthesizing the quantitative data collected.

By foreign academic literature the authors mean the literature published outside of Russia. When using the term "sector of small and medium-sized businesses," the authors focus on the problems of small business. It is often difficult to make a difference between the small and medium-sized businesses due to differences in approaches and practices and a high level forms diffusion.

Results and discussion

The results of the study of how the problems of small business are treated in Russian and foreign academic publications are given in the following tables [tables 2, 3].

The geographical and thematic priorities of small business treatment in the world presented in the tables are rather reasonable. The predominance of the Russian subject matter in the papers by the Russian authors is determined by the priority application interests, insufficient availability of databases containing papers in foreign languages, low level language training, lack of translation skills, specifics of the national economy and society. But it should be admitted that the study of the Russian small business by foreign authors is not vast either, but still it takes place [Kihlgren, 2003; O'Neal, 2012; Small bank, big ambitions: Learning to lead at Promsvyazbank, 2014]. As for the priorities of foreign authors, among the traditional topics [Loscocco, Robinson, 1991; Spence, Jeurissen, Rutherford, 2000] they show more interest to problems of small business development in the third world countries, the Baltic States and China. This is especially true to papers published in the late XX and early XXI centuries [Changing Development Concepts, 2015; Charoensukmongkol, 2015; Elenurm, Alas, 2009; Main developments in the Baltics during 2000-2012, 2013; Shapiro, Gedajlovic, Erdener, 2003; Sharma, Lindsay, Everton, 2015; Tang, Shapira, Meng, 2014], which is determined by a massive penetration of Western capital investment, transfer of large of production capacities into these regions, and the transition of these countries from the planned Command and Administration System to the market economy.

Foreign research material on the subject is more dispersed than in Russia [Table 2]. If one selects the top three most covered sub-topics of small business development in the Russian and foreign academic literature, one will get an absolute discrepancy. In Russian academic literature,

Table 2 Proportion of research papers as per subdivisions of the research topic in Russian academic literature and literature published outside of Russia (subject scope) (%)

| No. | Title | Number of papers in Russian academic literature (proportion in percent, publications in) | Number of papers in academic literature published outside of Russia (proportion in percent, publications in) |
|-----|---|--|--|
| 1 | Theory of business | 24,5 | 2,7 |
| 2 | Small business development | 12,7 | 9,2 |
| 3 | Business culture | 3,1 | 2,5 |
| 4 | Business ethics | 0 | 0,6 |
| 5 | Problems of small business | 14,2 | 5,3 |
| 6 | Small business and innovation | 9,4 | 4,7 |
| 7 | IT-business in the small sector of economy | 2,4 | 7,6 |
| 8 | Family small business | 0,2 | 8,4 |
| 9 | Gender in small business | 0 | 14,1 |
| 10 | Small businesses in different fields of economy | 3,4 | 3,8 |
| 11 | Small business. Trade. Marketing | 2,2 | 7,3 |
| 12 | Business education | 0,2 | 3,6 |
| 13 | Small business and the environment | 0 | 2,3 |
| 14 | Small business and foreign economic relations | 1,2 | 3,1 |
| 15 | State support for small business | 16,5 | 3,1 |
| 16 | History of business | 1,2 | 7,5 |
| 17 | Small business and logistics | 0 | 0,9 |
| 18 | Small business management | 5,5 | 8,3 |
| 19 | Motivation in business | 1,2 | 1,2 |
| 20 | Small businesses in the tourism sector | 1,9 | 2,2 |
| 21 | Investments in small businesses | 0,2 | 1,6 |
| 22 | Total | 100 | 100 |

24.5% is on the theory of business, 16.5% is on the state support of small business, and 14.2% is on the problems of small businesses [Bondar, 2007; Goosen, Pakhomova, Kostanyan, 2010; Ilyasov, 2006; Kumanin, 2012]. In foreign academic literature, 14.1% is on gender factor in small business, 8.4% is on family small business, 7.6% is on IT in small business sector of economy [Dincer, 2010; Eriksonn, Hultman, Naldi, 2008; Estapé-Dubreuil, Torreguitart -Mirada, 2010; Ibrahim, Soufani, Lam, 2003; Kim, Ling, 2001].

Differentiation, in the author's opinion, is determined by the difference in the level of business development in Russia and abroad, at least in Europe and North America, by the nature of the business climate, economic structure, the degree of state influence on economic processes, the role of the government in the economy, and the efficiency of the state support. The size of the territory of a country, climatic conditions, the degree of integration into the international and inter-regional associations and unions also play a role.

The interest in the theory of small business development in Russia in the 1990s was determined solely by the nature of the transition period. There were no historical traditions of this type of activity, all the economically active population was born and raised in conditions of the planned economy. For this reason, the forms and methods of state support, mechanisms for entrepreneurship development and its interaction with the state and society could only be borrowed from the outside. However, the fact that in the early XXI century this area of research remained relevant, indicates that the methods of assessing the efficiency of business and interaction between business and the state, financial strategy of business development, investment and financial mechanisms of venture business, legislation, relationship of business with the state and society, and forms and methods of state support of entrepreneurship are not sufficiently effective and need to be further developed. Unfortunately, this is confirmed by statistical data and research findings. The number of small enterprises has not reached the required minimum threshold, which is confirmed by their share in the GDP. Their number is not comparable with that of the developed countries; there are a high proportion of loss-making companies; their receivables and payables are rather high.

At the same time, one cannot ignore the inverse activity, such as growth in product and services revenue [Nikiforov, 2004; Russian Statistical Year-book, 2014; Small Business of Russia 2003, 2004; Small Business of Russia 2008, 2009]. The vast majority of these papers were published in the 2000-2010 [Abazova, Kurmanov, 2015; Akelyev, 2011; Baranov, 2015; Yudenko, 2009]. This resulted in the re-searchers' increased interest in the problem of relationship between business and the state, in the efficiency of small business state support, in the problems of small business and their solutions. The papers on these issues generally focus on the regional aspects, which indicates that, vast territories, sharp differentiation of social, economic and climatic conditions greatly influenced the situation [Aliyeva, 2015; Anufrieva, Grazhdankina, 2003; Dregalo, Lukin, Ulyanovsky, 2009; Krakhmalev, Tsomaeva, 2011].

With regard to the priorities of foreign researchers, they suggest that small business has become an integral part of the market economy in both

Table 3 Proportion of research papers devoted to small business development in Russian academic literature and academic literature published outside of Russia (geographical criterion) (%)

| No. | Title | Number of papers in Russian academic literature (proportion in percent, publications in) | Number of papers in academic literature published outside of Russia (proportion in percent, publications in) |
|-----|-----------------------|--|--|
| 1 | Europe | 0,5 | 19,7 |
| 2 | Scandinavia | 0 | 6,4 |
| 3 | Baltic Countries | 8 | 18 |
| 4 | Post-Soviet states* | 2,5 | 3,7 |
| 5 | Russia | 86 | 2,5 |
| 6 | the USSR | 0,2 | 0,3 |
| 7 | North America | 0,5 | 14,7 |
| 8 | Third World countries | 1,2 | 22,2 |
| 9 | China | 0,85 | 10,1 |
| 10 | Japan | 0,25 | 2,4 |

* Belarus, Ukraine, Moldova, Georgia, Armenia, Azerbaijan, Kazakhstan, Kyrgyzstan, Turkmenistan, Uzbekistan, Tajikistan.

Table 4 The hierarchy of journals on the number of papers on the topics studied

| The quantitative criterion (Number of publications on the studied issues in research journals dated from 1991 to 2015) | Number of journals that meet the criteria in the Russian academic literature | The proportion of journals that meet the criteria in the Russian academic literature (%) | Number of journals that meet the criteria in academic literature published outside of Russia | The proportion of journals that meet the criteria in academic literature published outside of Russia (%) |
|--|--|--|--|--|
| 1 | 27 | 18,9 | 111 | 54 |
| 2-5 | 27 | 18,9 | 69 | 33,7 |
| 6-10 | 26 | 18,1 | 18 | 8,8 |
| 11-20 | 23 | 16,1 | 4 | 2 |
| 21-50 | 22 | 15,4 | 1 | 0,5 |
| 50 and over | 18 | 12,6 | 2 | 1 |

the developed countries, and the countries of the Third World. The foreign researchers are also interested in various aspects of its development, but especially in increasing its efficiency rather than its formation and survival, in the socio-economic aspects of its development, in the diversity of forms and types of business, in gender and family aspects, in business activities

in high technology industries, such as IT-business [van Akkeren, Gavaye, 1999; Billore, 2011; Gundolf, Meier, Missioner, 2013; Riquelme, 2002; Tillmar, 2007; Wojcik, 2007].

The narrow specialisation of foreign journals compared to the Russian ones is noteworthy. For example, 62.4% of the reviewed foreign publications, such as “Journal of Systems and Information Technology” (IT-business), “International Journal of Contemporary Hospitality Management” (problems of tourist business) specialise in one category [Boer,1992; Hopkins,2012], 16.8% of the Russian journals (“Business, Management and Law” – the theoretical aspects of the activities stated in the title of the journal) [Zolotukhin, 2015].

At the same time, the share of foreign journals that publish materials on a wide range of business issues (2 sub-topics and more) does not exceed 38%, while in Russia there are over 83% of such journals. Moreover, if one considers journals that publish materials on more than 10 sub-topics, this ratio will be 1% to 12.6%. These include the “Journal of Small Business and Enterprise Development”, “Business History Review” (journals outside of Russia), “Vector of Science of Togliatti State University”, “Works of Bratsk State University”, “Innovative Development of Economy Journal” (journals of Russia) [Table 5; Álvaro-Moya, 2012; Ibbotson, Moran, 2005; Kaverzina, Semkina, 2011; Korotkova, 2014; Manova, 2014; Ownick, 2006; Smallbone, Xiao, Xu, 2008].

Table 5 The hierarchy of journals on the number of subdivisions of the research topic in the papers

| Number of subdivisions (as per titles in Table 2) | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 13 | 15 |
|--|------|------|------|------|-----|-----|-----|-----|-----|-----|-----|-----|-----|
| Number of journals in Elibrary.ru and “Lan” databases | 24 | 10 | 12 | 17 | 10 | 13 | 11 | 9 | 9 | 10 | 9 | 9 | 0 |
| Proportion in percent | 16,8 | 7 | 8,3 | 11,9 | 7 | 9,1 | 7,7 | 6,3 | 6,3 | 7 | 6,3 | 6,3 | 0 |
| Number of journals in Emerald, Cambridge Journals Online, EBSCO, ProQuest, Jstor, Bloomsbury Collections, Oxford Handbooks Online data bases | 128 | 32 | 21 | 9 | 3 | 2 | 4 | 2 | 1 | 1 | 0 | 1 | 1 |
| Proportion in percent | 62,4 | 15,6 | 10,2 | 4,3 | 1,5 | 1 | 2 | 1 | 0,5 | 0,5 | 0 | 0,5 | 0,5 |

The publications included in Elibrary.ru and “Lan,” databases, most of which are Russian journals, has rather general content, while the journals in others databases are more specialised. In the author’s opinion, this situation is determined by some specific factors, such as differences in the requirements to the magazine, the amount of commercial activity a journal conducts, difference in the number of publications in Russia and abroad, the quality of papers submitted to the journals for publication and conditions in which investigation are carried out..

It should be noted, that the academic community discusses the problems of small business in Russia much more intensively than abroad. The ratio of journals that pay considerable attention to the problems of small business (over 20 publications in a journal) in Russia and abroad is 1.5% to 28%; of journals regularly publishing such materials (from 6 to 20 publications in a journal) – 10.8% to 34.2%; of journals with up to 5 publications – 33.7% to 18.9%; of journals with few publications – 54% to 18.9% [Table 4].

Among the publications covering the problems of small business development most actively, the authors should mention the “Journal of Small Business and Enterprise Development”, “The Journal of Economic History”, “International Journal of Entrepreneurial Behaviour & Research”, “Business History Review” (journals outside in Russia), “Innovative Economy: Prospects of development and improvement”, “Vestnik NSU. Series: Social and Economics Sciences”, “Business and Economic Horizons”, “Omsk Scientific Bulletin”, “Innovative Development of Economy Journal”, “Vector of Science of Togliatti State University”, “Works of Bratsk State University”, “Economics and Management of Innovative Technologies”, “Economics and modern management: the theory and practice”, “Journal of Economic Regulation”, “Economic and social changes: facts, trends, forecast” (journals of Russia).

Conclusions

Thus, the analysis of the problem in this article leads the authors to the following conclusions:

- research priorities in the field of small business in a particular country are determined by the problems of this sphere, by the specifics of the formation and development of entrepreneurial activity, by the role of the state in regulating social and economic processes, by historical, cultural and political traditions, and by the level of small business development and the economy in general;
- the analysis of small business development and cooperation with the state and society in Russia and abroad shows an insufficient level of communication among researchers from different countries,

which is caused by language barriers, inaccessibility of literature in foreign languages, the differences in research methodology and approaches, and traditions of thinking;

- in Russia, the development of small business is paid more attention to than abroad;
- Journals published abroad have a clearer and narrower thematic specialisation than most of their Russian counterparts.

Consequently, the authors should outline the following main trends in the development of small businesses and research in Russia:

- improving the regulatory framework of entrepreneurial activity and increasing the efficiency of state support of business,
- contributing to the improvement of its relations with society, improving its image and attractiveness;
- expanding academic contacts between Russian and foreign researchers working in the same field, also by means of academic mobility;
- increasing the availability of academic publications in foreign languages for both Russian and foreign researchers by integrating the activities of libraries.

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CONCERNING ESTONIAN-LATVIAN TRADE RELATIONS DURING THE 1930s

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Abstract

The article discusses the Estonian poor trade relations with Latvia in the 1930s. The statistical record shows that Latvia's share in Estonia's balance of trade amounted to less than one per cent prior to the time that World War II broke out.

It's possible that due to their fairly sparse bilateral trade during the 1930s, trade relations of that period between Estonia and Latvia haven't received much attention in the annals of economic history. The objective of this article is to provide a statistical snapshot of trade between Estonia and Latvia during the 1930s and a sketch of the trade measures that regulated the trade relations of the two nations, and to help discern the factors that might have influenced trade between them.

After the UK had taken the step of devaluing the pound, Estonia and Latvia quickly introduced exchange control and licensing systems. Since the national currencies of both countries were initially not devalued, the competitiveness of their products fell off on the markets of the countries that had carried out devaluations, and this boosted trading between Estonia and Latvia up to a point. Viewed from the ten-year perspective, the apogee of trade between the two was during the years of 1933 and 1934. The devaluation of the kroon during the summer of 1933 favoured exports from Estonia to Latvia with her expensive currency, and the Bank of Estonia didn't block forex transactions being conducted with Latvia. Hand in hand with this, a favourable attitude also prevailed towards granting of licenses for the conduct of trade with Latvia.

Nonetheless, trade between the two countries lessened during the second half of the 1930s. Estonia's positive balance of trade then brought about Latvia's clearing debt, and the measures taken to lessen that debt led to a lessening of interest on the part of Estonia towards her southern neighbour. In 1936, the lat was devalued, with the result that products from Estonia lost their competitive edge on the Latvian market. During that year, Estonia's trade with Latvia was quite evidently passive. Estonia, which had ended up in an unfavourable position, reacted in 1937 by backing out of previous trade agreements.

Keywords: non-tariff measures, interwar period, trade statistics, protectionism, Estonia, Latvia

Introduction

Estonia's most important trading partners during recent years have been the countries in her immediate neighbourhood. During 2015, 19% of goods exported were sent to Sweden, with Finland following at 16% and Latvia at 10%. In respect to imported goods, the most important country for Estonia was Finland (with Finnish goods making up 14% of Estonia's imports in total). Next was Germany, from where Estonia imported 11% of her goods, followed by Latvia (9%) and Lithuania (9%). The same countries had also dominated Estonia's list of primary foreign trade partners during the previous year.¹

Seeing statistical indicators such as these should make good logical sense for the reader, since the most active trade relations tend to take place as a rule with countries that are nearby, involving active contacts – not just commercially, but also culturally and politically. All of the aforementioned countries are also members of the EU, which means that no customs tariffs are levied, and that the imposition of limits on quantities of goods that are traded is banned in the EU, as are such limits on trade between countries that might be similar in effect to trade barriers being put on quantities of goods that are exported or imported. In some other cases, the imposition of such quantitative limits is strictly regulated.

Seen from the historical perspective, the Estonian area has been particularly closely linked to that of Latvia. Until 1917, Northern Latvia and Southern Estonia constituted a joint administrative territory known as the Governorate of Livonia. Knowing this, one could assume that Estonia also remained engaged in active trade with Latvia after the nation states of Estonia and Latvia came into being. In reality, the statistical record shows that Latvia's share in Estonia's balance of trade amounted to less than one per cent prior to the time that World War II broke out. The share of Estonia's trade with Finland and Sweden during the same period was slightly more significant, but was nonetheless at a lower level than it currently is. In that era, it was the UK and Germany who played the dominant roles in Estonia's trade relations.

The range of goods produced in a given country is certainly one factor that contributes to the makeup or structure of commerce between nations. After gaining her independence, Estonia was an agrarian society, not unlike Latvia and Finland, where most of the members of the population were also involved in the farming sector. As a result, the exports originating from these countries tended to be of a similar nature. For the most part, agricultural products were exported. Thus there was little impetus for

¹ Statistikaamet. <https://www.stat.ee/277519>, (6.09.2016).

active bilateral trade to be taking place, since all of the countries in the area tended to be producing similar lines of products. These days, however, the countries that this article focuses on produce a more differentiated range of products, which facilitates more extensive trade relations.

Another evident aspect that sets the period in question apart from the present day is the legal framework in which trade took place. These days, one of the pillars of the EU is the free movement of goods, and within this framework, it's difficult for member states to impose trade restrictions based on protectionist considerations. During the period between the two World Wars, states had freer hands for the employment of various trade measures. Protectionism gained ground in particular during the beginning of the 1930s, at which time the world was in a deep economic crisis. The arsenal of trade measures that began to be applied at the beginning of the 1930s was extensive. In addition to the adjustments made in the levels of customs tariffs, trade was also influenced by the application of licenses, exchange control, quotas, and the use of subsidies, as well as through the creation of monopolistic purchasing and sales networks, etc.

Estonia went along with the trend towards trade protectionism, in a manner not unlike that of the countries that neighbour her. In one respect, Estonia did however stand out, this then by virtue of the relatively low additional customs duties that she levied. Estonia had namely inherited high customs rates from the Russian tsarist state she had previously been a part of, and consequently only raised these to a lesser degree, in comparison to other countries that had more leeway for raising rates at their discretion. The general level of Estonian tariff rates in 1927 was 54%, in 1931 59.3%, in 1938 62.7%. The general level of Latvian tariff rate in 1927 was 45.4%.²

On the other hand, Estonia actively used other measures that can be applied to external trade. These days such measures are referred to as non-tariff measures (or NTMs for short)³.

This article turns its attention above all to those measures involved in Estonian-Latvian trade that shaped the framework of trade policies of the time. The article deals with the use of NTMs by both states, and illustrates this by pointing to examples of how NTMs affected trade

² Krepp calculated the tariff level indices for the Baltic countries according to the method elaborated by Liepmann. The only difference was that in his investigation, all group and general tariff level indices were weighted, also including the indices calculated by Liepmann. See: Krepp Endel (1949), "Measurement of tariff levels and tariff levels in the Baltic states" in: J. Olvet-Jensen (ed.), *Apophoreta Tartuensia* (1949). Stockholm, Societas Litterarum Estonica in Svecia, pp. 291 & 293-294.

³ All measures that affect trade can be considered non-tariff measures, except for tariff measures specifically (such as customs levies).

relations between them. This focus is also supported by the fact that the two countries exempted a number of products from customs duties in their bilateral trading arrangements, but this seemingly liberal trend could actually be rendered moot by the use of the NTMs.

Both young countries participated in world trade on a relatively equal basis. As the common market of the Tsarist state disappeared, both countries oriented themselves early on towards the West. In 1934, 28.5%⁴ of the population of Estonia lived in cities, while the same figure for Latvia was 34.6%⁵ in 1935. Latvia was the larger country in terms of population size. In 1939, Latvia had 2 million residents⁶ compared to Estonia's 1.1 million.⁷ The countries were also in relatively equal positions as concerns their degree of activity in international trade. In 1929 Estonia's export activity – expressed on a per capita basis – was 105 kroons and 71 kroons in 1935. In the case of Latvia, the respective figures for the same years were 104 and 61 kroons. As concerns imports, Latvia was the more active of the two in 1929 with 137 kroons, as opposed to Estonia's 110 kroons on a per capita basis. In 1935, the countries were on an equal footing. Latvia imported at the level of 62 kroons and Estonia at 61 kroons per person.⁸

It's possible that due to their fairly sparse bilateral trade during the 1930s, trade relations of that period between Estonia and Latvia haven't received much attention in the annals of economic history. On the other hand, articles and monographs have in fact been written that dwell on the statistical record as it pertains to Estonia's foreign trade, as well as on the trade measures that have been implemented here.

Beginning in the 1930s, the Estonian record began to reflect the use of NTMs by the state.⁹ Articles written during that period reflect an attitude of approval towards the trade policies of the state.

⁴ *Eesti arvudes. 1934.a rahvaloenduse mälestuseks* (1934). Tallinn, Riigi Trüükikoda, p. 10.

⁵ Karnups Viesturs Pauls (2015), "Latvia and India: Economic Relations 1918-1940", *Humanities and Social Sciences Latvia*, Vol. 23, No. 2, p. 41.

⁶ Karnups (2015), p. 41.

⁷ Elango Õie, Ruusmann Ants, Siilivask Karl (1998), *Eesti maast ja rahvast. Maailmasõjast maailmasõjani*, Tallinn, Olion, p. 203.

⁸ Asper Veronika Vilma, Janusson Juhan, Joa Hans, Krepp Endel, Rannes Arkadi, Reiman Hugo (1937), *Eesti majandus ja selle areng Eesti iseseisvuse aastail*, Tartu, Eesti Kirjanduse Selts, p. 76.

⁹ See, for instance, Raud Villibald (1934/35), "Rahvusvahelise kaubanduspoliitika uusi meetodeid", *Konjunktuur*, Vol. 1, No. 2, pp. 162-168; Joa Hans (1938), "Põllumajanduse toetuspoliitika eesmärgid ning meetodeid", *Konjunktuur*, Vol. 4, No. 10/11, pp. 585-593; Meri Georg (1934/35), "Saksa väliskaubanduse organisatsioon ja Eesti eksport", *Konjunktuur*, Vol. 1, No. 3, pp. 224-232.

Estonia's steps pertaining to trade policies during the crisis decade have been repeatedly treated by Rannes.¹⁰ In his article concerning the national licensing system, he shows how it was initially applied for the purpose of lessening imports when the crisis manifested itself, and then goes on to describe the manner in which licenses were used during the second half of the thirties to facilitate an inflow of imports to Estonia from favoured countries.¹¹

Of the contemporary authors, it is Klesment who has turned his attention in particular to the interwar trade policies, focusing on quotas, licenses, exchange control and clearing agreements. Klesment concludes that exchange control and the licensing system were co-joined. Both were employed by Estonia commencing from the end of 1931. He finds that these constitute one of the most radical forms of measures used to regulate imports.¹²

Köll shows that protectionism and government control over all facets of trade was generally speaking much more substantial in the new economies of Eastern Europe than in Western Europe.¹³ She argues that pessimism about the free market system was particularly deep among the farmer's parties of Eastern Europe, and that state regulation was seen as a necessary complement and substitute for a fully free market, and which was also there to stay.¹⁴

In addition to its emphasis on trade policies, Pihlamägi's monograph contains statistical information.¹⁵ The author emphasises that producers themselves favoured a more effective system of licenses, presenting a series of appeals for the imposition of import controls on an ever-lengthening list of products.¹⁶

Stern has chosen to focus on the imposition of NTMs, comparing the trade policies of Estonia of the thirties to those of the other Baltic States and the Nordic countries. His research reveals the similarity of the trade policies of Estonian and Latvia. He focuses on the NTMs applied by both

¹⁰ See, for instance, Rannes Arkadi (1940), *Eriküsimusi rahvamajanduspoliitikas*, Tartu, Hugo Köhler; Rannes, Arkadi (1939), "Litsentsisüsteem ja Eesti importkaubandus", *Konjunktuur*, Vol. 5, No. 4/5, pp. 231-242.

¹¹ Rannes (1939), pp. 231-242.

¹² Klesment Martin (2000), "Eesti väliskaubanduspoliitikast kahe maailmasõja vahelisel perioodil (Eesti-Saksa kaubandussuhete näitel)", *Ajalooline Ajakiri*, Vol. 33, No. 1, p. 86.

¹³ Köll Anu Mai (1994), *Peasants on the World Market. Agricultural Experiences of Independent Estonia 1919-1939*, Stockholm, Almqvist & Wiksell, p. 100.

¹⁴ Köll, (1994), p. 101.

¹⁵ Pihlamägi Maie (2004), *Väikeriik maailmaturul: Eesti väliskaubandus 1918-1940*, Tallinn, Argo.

¹⁶ Pihlamägi, (2004), p. 385.

countries: exchange controls, licensing systems, the monopolisation of the export of agricultural products, as well as measures taken to ensure desirable levels of prices for agricultural products. The author finds that the approach that's been taken up until now – the one suggesting that the use of exchange control was something akin to the decision to not devalue the national currency after the peg had been removed from between the pound sterling and gold – isn't one that can be unequivocally made in this region.¹⁷ Denmark applied exchange control in addition to the immediate devaluation of the national currency right after the step taken by the UK. Estonia also employed exchange control after the devaluation of the kroon (Estonian crown) in 1933, as Latvia did as well, after the devaluation of the lat in 1936.

Valge has written on trade between Estonia and Latvia, and also on the topic of how state activities were used to regulate this. The author finds that the export of gasoline produced in Estonia was viable only thanks to aid provided by the government. To wit: thanks to an appendix added to a temporary economic agreement between the two countries, Estonia was given the right during the summer of 1931 to export 2300 tons of gasoline to Latvia duty-free. Since petroleum products were highly taxed in Latvia, this gave Estonian producers a distinct advantage on that market.¹⁸

Karnups, on the other hand, emphasises the structural similarity of Latvia's foreign trade to that of the Scandinavian countries. Karnups shows that in the case of Latvia, that country's foreign trade with other countries of this region was also of low significance in percentage terms, and that her primary partners – as was the case with Estonia as well – were Germany and the UK.¹⁹

This article consists of two parts. The objective of the first part is to provide a statistical snapshot of trade between Estonia and Latvia during the 1930s. Particular emphasis is placed on the dynamics and structure of foreign trade between the states during the aforementioned period. Materials of the League of Nations and the State Central Bureau of Statistics of Estonia are used. The data of the League of Nations enables one to convey the dynamics of foreign trade in constant prices. State Central Bureau of Statistics data are presented in current prices. The information

¹⁷ Stern Karl (2015), "Implementation of non-tariff measures in Estonia in the 1930s", *Scandinavian Economic History Review*, Vol. 63, No. 2, pp. 199-200.

¹⁸ Kõll Anu Mai, Valge Jaak (1998), *Economic nationalism and industrial growth : state and industry in Estonia 1934-39*, Stockholm, Almqvist & Wiksell, p. 106.

¹⁹ Karnups Viesturs Pauls (2004), *Latvian Foreign Trade with the Scandinavian Countries 1920-1940* (summary of the Dr. phil., diss., University of Latvia).

of the Central Bureau also enables the presenting of a detailed overview of the structure of trade between the two countries. The intent of the second part is to provide a sketch of the trade measures that regulated the trade relations of the two nations, and to help discern the factors that might have influenced trade between them.

Primary emphasis is placed on the measures that affected Estonian and Latvian trade directly, those being exchange control, quotas, licensing systems and the use of clearing in trade. Here the main sources are legislation, bilateral agreements, and correspondence between entrepreneurs and state agencies.

Foreign Trade in Figures

The Great Depression manifested itself in numbers and in the reduction of activity in trade. The volume in world trade contracted by 40% during the 1929-1932 period, while real world output fell by 20% during the same period.²⁰

Figure 1 provides an overview of the dynamics of trade volume for both countries during the 1930s.

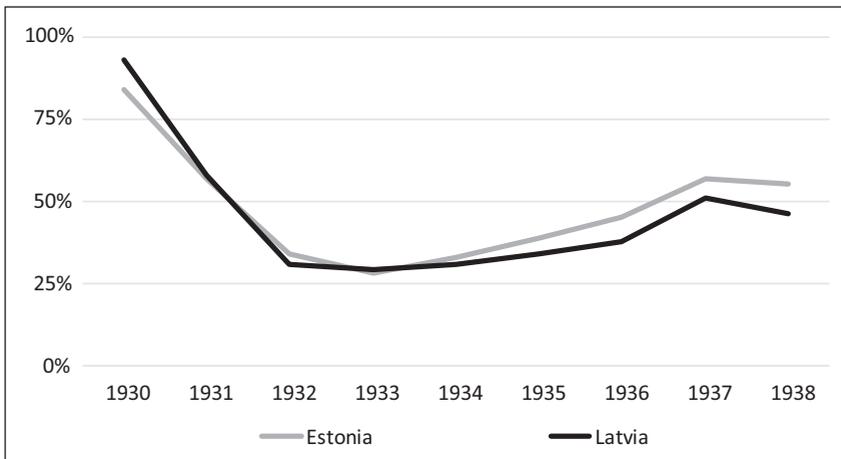


Figure 1 Dynamics of Volume in Estonian & Latvian Foreign Trade during 1930s – current prices (1928-1930=100)

Source: Composed by author, based on League of Nations. Statistical Yearbooks. 1932-33, p. 168; 1933-34, pp. 192-193; 1937-38, p. 225; 1939-40, p. 189.

²⁰ Irwin Douglas A. (1993) "Multilateral and bilateral trade policies in the world trading system: an historical perspective" in: J. De Melo/A. Panagariya (ed.), *New Dimensions in Regional Integration* (1993). Cambridge, Cambridge University Press, p. 112.

The effects of the economic crisis on the volume of Estonian and Latvian trade became apparent as early as in 1930. It should be noted that the pre-crisis high point in trade volume was reached in Estonia in 1928 and in 1929 in Latvia. During 1931 and 1932, the sharp decline in the foreign trade of both countries continued. The crisis bottomed out in 1933, when the volume of foreign trade of both countries had fallen to below 30% of the median level of the 1928-1930 period. Thereafter Estonia experienced a somewhat faster recovery in her levels of foreign trade with other countries than Latvia did. In 1937, Estonia reached 57% and Latvia 51% of the levels they had enjoyed during the 1928-1930 period. In 1938, Latvia's foreign trade volume fell once more to below 50% of the level it had been at from 1928-1930. Despite this, neither country was able to once again reach pre-crisis levels.

Work by economic historians shows that the activeness of foreign trade picked up again more robustly in the category of countries that had devalued their national currencies.²¹ Figure 1 lends credence to that line of reasoning. Estonia devalued the kroon in 1933, and by 1934, foreign trade had already picked up to a level 5% higher than during the previous year. In Latvia, the lat was devalued during the second half of 1936, and the next year brought a 13% rise in the level of activity of foreign trade.

Table 1, on the other hand, provides an outline of the structure of Estonia's and Latvia's foreign trade. Data from the League of Nations make it possible to present an overview of the pre-crisis year of 1928, and of the crisis year of 1932, and for 1934, when foreign trade showed signs of reviving. The main category of imports for both countries was finished products with a high level of value added. During the first half of the 1930s, finished products constituted something like half or even more than half of imports. The economic crisis was also accompanied by a significant change in the import structures of both countries. During six years, the proportional level of food, flavourings and beverages (referred to as *foodstuffs* from here on) fell three times in Estonia, and even by as much as a factor of five in Latvia. During the crisis years, the categories of semi-finished goods and raw materials (*materials* from here on in) rose in both countries to constitute the second-level tier of imports. During 1928, the structure of exports in Estonia was divided more or less equally between foodstuffs, materials, and finished products. In Latvia during 1928, materials constituted the most important category of exports, accounting for more than 50% of export as a whole. However, by 1932, the category

²¹ See, for instance, Eichengreen Barry, Irwin Douglas A. (2010), "The Slide to Protectionism in the Great Depression: Who Succumbed and Why?", *The Journal of Economic History*, Vol. 70, No. 4, pp. 871-897.

of foodstuffs dominated Estonia's exports by a factor of more than 50%. In contrast to that, the structure of Latvia's exports was more similar to what Estonia's structure had looked like in 1928, when three important categories of goods had constituted nearly a third of export in roughly equal parts. By 1934, the structure of exports in both countries had changed again. Generally speaking, Estonia's structure returned to the indicators that had prevailed in 1928, except for the fact that the category of materials had overtaken the foodstuffs category. Latvia also returned generally speaking to the indicators of 1928, except that the export of foodstuffs had grown by a couple of per cent at the expense of the materials category, this in comparison to the period prior to the crisis.

Table 1 Structure of Estonian and Latvian International Trade during 1928, 1932 and 1934

| | Import | | | | | Export | | | | | Year |
|---------|--------|------|------|------|-----|--------|------|------|------|-----|------|
| | I | II | III | IV | V | I | II | III | IV | V | |
| Estonia | 0.1 | 30.3 | 25.8 | 43.7 | 0.1 | 1.1 | 36.8 | 31.7 | 30 | 0.4 | 1928 |
| | | 11.9 | 28.9 | 58.9 | 0.3 | | 51.9 | 25.9 | 22.2 | | 1932 |
| | 0.1 | 9.7 | 35 | 55 | 0.2 | 1.8 | 32.2 | 39.9 | 26.1 | | 1934 |
| Latvia | 0.4 | 30.5 | 25.2 | 43.6 | 0.3 | 0.4 | 22.6 | 56.2 | 20.8 | | 1928 |
| | 0.8 | 13.2 | 36.5 | 49.1 | 0.4 | | 35 | 30.1 | 34.9 | | 1932 |
| | 1.3 | 6 | 41.7 | 50.8 | 0.2 | 1 | 26.1 | 51.7 | 21.2 | | 1934 |

Note: I – livestock II – food, III – materials, IV – manufactured articles, V – gold, silver.

Source: League of Nations. Statistical Yearbooks. 1930-31, pp. 169-170; 1933-34, pp. 192-193; 1935-36, pp. 223-224.

Figure 2 provides a picture of how significant a part Latvia's share played in Estonian import and export.

Figure 2 shows that during 1930, the share of both export and import in trade with Latvia was at a level beneath three per cent. As time went on, up until 1933, Latvia's share in Estonian imports rose above five per cent, and began to drop again after that, falling to a pre-crisis level in 1935. By 1938, Latvia's share of imports barely topped one per cent. In contrast to that, Latvia's share in Estonian exports fell in 1931, compared to 1930. After 1931, however, Latvia's share in Estonian exports grew, attaining a level of almost six per cent in 1934. In 1935, a sharp decline followed, sinking to the levels of 1931.

Table 2 provides an overview of Estonia's trade with Latvia in terms of which categories of trade were active during the 1930s. Before the crisis, Latvia was an important partner in the area of livestock imported into

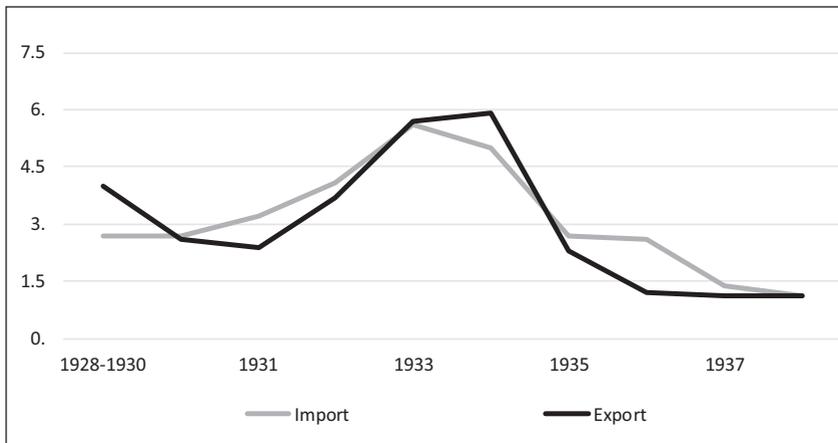


Figure 2 Latvia's Share in Estonian Import and Export During the 1930s (in %)

Source: Composed by author, based on Pihlamägi (2004), pp. 220, 222.

Table 2 Latvia's Share of Import and Export by Trade Categories (in %)

| Year | Import | | | | | Export | | | | |
|------|--------|------|-----|-----|-----|--------|-----|-----|------|------|
| | I | II | III | IV | V | I | II | III | IV | V |
| 1929 | 12 | 0.1 | 2.3 | 4.1 | 0.1 | 51.9 | 1.4 | 4.3 | 8.3 | |
| 1930 | 3.7 | 0.1 | 4 | 3.1 | 1.9 | 61.2 | 0.2 | 2.8 | 4.6 | 25 |
| 1931 | 80 | 0.1 | 4.6 | 3.5 | 2.9 | 9.3 | 0.2 | 3.9 | 4.2 | 81.4 |
| 1932 | 40.7 | 0.7 | 2.4 | 5.6 | 0.2 | 84.8 | 0.1 | 6.3 | 8.8 | |
| 1933 | 10.9 | 5.7 | 2.2 | 7.7 | | 92.7 | 0.2 | 4.7 | 16.5 | |
| 1934 | 10 | 7.4 | 0.7 | 7.3 | 0.1 | 4.2 | 0.4 | 4 | 15.6 | |
| 1935 | 9.6 | 10.3 | 0.3 | 2.8 | | 0.3 | 0.1 | 2.2 | 6.5 | 2.3 |
| 1936 | 4 | 9.7 | 0.1 | 2.5 | 0 | 0.3 | 0 | 2.5 | 1.5 | |
| 1937 | 19.7 | 0.8 | 0.5 | 2 | 0 | 0.2 | 0 | 1.6 | 1.9 | |
| 1938 | 12.6 | 0 | 0 | 1.7 | 0.2 | 0.3 | 0.1 | 1.6 | 2.8 | |

Note: I – livestock II – foodstuffs, III – materials, IV – finished products, V – precious stones, metals.

Sources: Composed by author, based on Eesti majandus. Viik XII-XXI. Väliskaubandus 1929-1938.a. Tallinn: Riigi Trüükikoda.

Estonia. In 1930, Latvia's share was the largest in the category of materials imported into Estonia. During the years that followed, with the exception of 1935 and 1936, the import of livestock was once again the segment that proved to be the most active. In 1931, Latvia's share of livestock being imported even reached the level of 80%. As concerns imports of materials, Latvia's share of materials being transported to Estonia was relatively more significant until 1933 (2.2-4.6%). Latvia's share of finished products imported into Estonia showed greater stability, never falling beneath one per cent. Latvia was an important partner for Estonia until 1933 in the category of livestock, and also in the rubric of precious stones and metals during 1930 and 1931. After the mid-1930s, Latvia's share of livestock imported into Estonia began to diminish. In reality, all export going to Latvia started to fall off, with the exception of materials and finished products, trade in which tended to not lessen as much as it did in the other categories. Latvia's share of export of materials to Estonia was relatively more significant until 1934 (2.8-6.3%). Latvia's top years in regard to the export of finished products were 1933 and 1934, when Estonia's southern neighbour's share reached as high as 16.5% and 15.6% respectively. Beginning in 1934, Latvia's share was the highest in fact in the category of export of finished products.

Since Table 2 shows Latvia's share in export and import in percentage points by category of goods, this could create the initial impression in the reader that large amounts of money were changing hands between

Table 3 Import and Export from Latvia in a Cross-section of Trade Categories in Thousands of Kroons

| Year | Import | | | | | Export | | | | |
|------|--------|-----|------|------|-----|--------|-----|------|------|----|
| | I | II | III | IV | V | I | II | III | IV | V |
| 1929 | 3 | 38 | 779 | 2131 | 0.5 | 232 | 640 | 1524 | 3044 | |
| 1930 | 1 | 18 | 1136 | 1471 | 4 | 186 | 64 | 672 | 1547 | 5 |
| 1931 | 4 | 5 | 808 | 1180 | 5 | 90 | 80 | 746 | 695 | 62 |
| 1932 | 7 | 29 | 253 | 1208 | 0.4 | 10 | 22 | 695 | 830 | |
| 1933 | 1 | 247 | 287 | 1661 | | 51 | 41 | 746 | 1761 | |
| 1934 | 3 | 400 | 145 | 2207 | 0 | 52 | 94 | 1098 | 2822 | |
| 1935 | 5 | 631 | 77 | 1129 | | 11 | 41 | 603 | 1195 | |
| 1936 | 16 | 950 | 23 | 1298 | 0 | 13 | 6 | 719 | 284 | |
| 1937 | 18 | 116 | 154 | 1275 | 0 | 10 | 9 | 662 | 433 | |
| 1938 | 3 | 3 | 11 | 1145 | 1 | 19 | 57 | 570 | 554 | |

Note: see Table 2.

Sources: Eesti majandus. Vihk XII-XXI. Väliskaubandus 1929-1938.a. Tallinn: Riigi Trükikoda..

the two countries as concerns cross-border trade in livestock. In order to clarify the actual value of Estonia's international trade with Latvia in a cross section of trade categories, the structure is presented in Table 3 in a monetary context as well.

Table 3 shows that finished products dominated in imports coming from Latvia. This was unquestionably the most important category of goods. More materials were also imported than previously, which category didn't relinquish second place to the category of foodstuffs until 1934-1936. In reality, the import of livestock was of marginal significance. The categories of Estonian export to Latvia that were of the greatest importance were finished products and materials.

Protectionism of the 1930s in Estonia's Foreign Trade with Latvia

Along with the outbreak of the economic crisis in 1929, international trade began to sink into protectionism. During the summer of 1929, tariff levels were raised in Germany, France and Italy, and by the end of the year, these had also gone up in other parts of Europe. During the summer of 1930, tariff levels were increased in the US, and European countries answered to this with a new round of increases in their levels.²²

NTMs began to be applied more extensively at the beginning of the 1930s. The use of quotas, licensing systems, exchange control, clearing agreements, state propaganda and the centralisation of trade all increased as a consequence of the application of protectionist policies.

On September 20, 1931, the UK devalued the pound sterling. This step influenced international trade so profoundly that the devalued national currency created a competitive advantage as concerns the supply of products on export markets, as well for domestically produced items, when juxtaposed against imported goods arriving from countries on the gold standard. The move by the UK forced Estonia and Latvia to also choose whether to follow the path of devaluing their national currencies or to seek other measures for protecting domestically produced goods from imported goods (that had been provided with a competitive advantage due to currency devaluations in countries that had chosen that alternative).²³ Both countries chose the protectionist option, and began to employ exchange control.

²² Irwin (1993), pp. 105-106.

²³ Stern (2015), p. 184.

The following section will demonstrate how exchange control combined with licensing systems developed into reins that enabled the State to control foreign trade in its entirety.

Two measures began to be used on a parallel basis. Two days after the decision of the UK, the Central Bank of Estonia took the decision to sell foreign currencies only to such parties as were intending to use such monies in the interests of the national economy.

It must be emphasised that at that point in time, Estonia was engaging above all in an operation to protect her currency, and was not motivated by a desire to protect Estonian production. More to the point: the decision by the UK affected the foreign currency holdings of the Bank of Estonia, which consisted of the pound sterling, reducing the value of these holdings by a third. The substantial loss of value in the currency that the kroon was pegged to thus forced Estonian authorities responsible for monetary policy to take steps to protect the kroon.

As the framework for exchange control was set up, the national bank obligated private banks to inform client importers that only such goods were to be imported that were indispensable for the Estonian economy, and that they were to refrain from bringing in luxury goods and goods that Estonia had the capability to produce domestically. Excessive importing was also to be avoided in respect to goods that the country truly required. Applications for foreign currency were to be given precedence based first on import needs, as those pertained in particular to industrial raw materials and to essential goods.²⁴

Foreign exchange regulations came into force in Estonia in November of 1931.²⁵ More precisely, an act had been passed by then that banned trading in foreign currency. The right to buy and sell foreign currency was granted to the Bank of Estonia and to a small number of licensed credit institutions.

The imposition of exchange control was further supported by a licensing system that had been enacted a few weeks earlier.²⁶ The licensing system gave the state the right to distribute permits for the importing of goods to a select group of entrepreneurs. The less import licenses that the Ministry of Economics (being the administrator of the licensing system) issued, the smaller the demand of the importers was also envisioned to be for foreign currency that needed to be obtained from the Bank of Estonia. To

²⁴ ERA, f. 1790, n. 1, s. 34 (22.10.1931), Eesti Panga kiri pankadele.

²⁵ Riigi Teataja (1931), Välismaksuvahendite ja väärtmetallide liikumise korraldamise seadus, Art. 695, No. 95, p. 1145.

²⁶ Riigi Teataja (1931), Kaupade sisseveo korralduse seadus, Art. 670, No. 90, p. 1109.

wit: the licensing system was also initially imposed with the objective of defending the national currency.

The use of the licensing system led to a substantial part of import trade being brought under the control of the government. For example, 44% of imports were brought under the control of the licensing system within a year.²⁷ Since foodstuffs were being consistently subjected to licensing at a level of 70%, the foodstuffs category was the one particular area that was controlled more than any other.²⁸ Approximately 40% of the materials category was also subject to licensing during the first years, while 30% of finished goods were licensed.²⁹

Latvia imposed exchange control on October 8, 1931. All persons and businesses that exported goods to foreign countries had to surrender the foreign currencies they'd received for the goods they'd sold to such private banks as had been designated by the Bank of Latvia to engage in operations of that kind. It wasn't permitted – without the permission of the Bank of Latvia – to trade one foreign currency for another when goods had been exported.³⁰

In a manner similar to that of Estonia, an exchange control mechanism was imposed in parallel with a licensing system. The Import Regulation Commission was the Latvian agency that began to issue import licenses. An importer had to first turn to the Import Regulation Commission and then to the Currency Board in order to be issued the foreign currency required for a transaction.³¹

In a manner that departed from the policies used by Estonia (but still remained within treaty obligations), Latvia also resorted to the curtailing of imports through the use of quotas.³² These quotas were used to regulate the importing of specified trade articles to a certain upper limit of items each year. During mid-October of 1931, Latvia used a directive to limit the numbers and amounts of glass items, fats, raisins, currants, cement, stones used for construction, light bulbs, valuable metals, leather

²⁷ Rannes (1939), p. 233.

²⁸ *Ibid.*

²⁹ *Ibid.*

³⁰ ERA, f. 957, n. 4, s. 188 (11.12.1931), Eesti Saatkond Riias Majandusministeeriumile. Instruktsioon eksporttehingute ülesandmise kohta, pp. 31-32.

³¹ Karnups (2006), et al., The 1936 Devaluation of the Lat and its Effect on Latvian Foreign Trade", p. 4.

³² Karnups (2004), p. 46.

uppers, radio receivers and radio components that were permitted to be imported.³³

The same directive stipulated that the quotas imposed would not pertain to other quotas that had previously been agreed to in international trade agreements.³⁴

In July of 1931, Latvia had amended her temporary economic agreement of 1928 with Estonia through an additional agreement that stated that the countries could reciprocally export certain goods up to a certain level without duties being imposed.³⁵ Latvia was permitted to export up to 1,000 tons of sugar, 35,000 barrels of cement (whereas the weight of a barrel was not to exceed 180 kilos) and winnowing machines and sorting devices for grain, but not beyond a total weight of 25 tons. Estonia, on the other hand, was permitted to export 35,000 barrels of cement to Latvia (whereas the weight of a barrel was not to exceed 180 kilos), 2,300 tons of gasoline, and central heating radiators up to a weight limit of 80 tons.³⁶ Both countries had the right to export cement customs-free in the future up to a limit of 6,000 net tons (whereas the previous limit had been approximately 6,300 tons). Estonia's gasoline quota remained unchanged, while the quota for radiators was raised to 200 tons. Latvia retained the right to export sugar to Estonia in the amount of 1,000 tons per year without customs fees being imposed. In addition to that, Latvia attained the right to export 2,000 bicycles to Estonia annually at a low rate of customs tariffs.³⁷

Both countries thus adopted measures right at the beginning of the 1930s that enabled the State to control its volumes of foreign trade. The protectionist measures were brought into force in order to limit the erosion of foreign currency reserves, but by the same token, they also put limits on the ability to stimulate the economy by being active on international markets. As a result of this, at least in part, a discussion went on in Estonia after the imposition of exchange control about the feasibility of possibly devaluing the national currency, with the objective of making

³³ ERA, f. 957, n. 4, s. 188. Eesti Saatkond Majandusministeeriumi Kaubanduse-Tööstuse Osakonnale. Määrused kauba impordi reguleerimise kohta, p. 19.

³⁴ *Ibid.*

³⁵ Among other things, the so-called Baltic Clause was also intended to stimulate the economies of neighboring states, stipulating that the favored status that Estonia had given or intended to give to Latvia, Lithuania, Finland or Russia would not be extended to other countries Estonia had agreements with. See: Klesment (2000), p. 82.

³⁶ Riigi Teataja (1931), Eesti-Läti ajutise majanduslepingu lisakokkulepe, selle lõpp-protokolli ja nootide kinnitamise seadus, Art. 439, No. 55, p. 810.

³⁷ Riigi Teataja (1932), Eesti-Läti vahelise ajutise majanduslepingu lisakokkuleppe täiendamise protokolli kinnitamise seadus, Art. 718, No. 92, p. 1018.

locally produced products more competitive on the world market. During the summer of 1933, the proponents of devaluation gained the upper hand in the Estonian parliament, and the kroon was devalued. An examination of the dynamics of volume in international trade shows that Estonian foreign trade picked up once this step had been taken. At this point, in an accompanying fashion, the State eased off on controls that had been imposed on imports. The share of goods affected by the licensing system shrunk to 30.9%.³⁸

During the coming period, foreign trade with Latvia would reach its highest level for Estonia during the decade in question. In terms of current prices, 1934 constituted the juncture when foreign trade peaked for the countries. From 1935 on, Latvia's share in Estonia's international trade fell (Figure 2), but the volume of trade nonetheless remained at a fairly high level for the next couple of years, if viewed in the context of the decade as a whole.

The devaluation of the kroon was certainly something that contributed to Estonia's growth in exports to Latvia, beginning in 1933. More precisely, Figure 2 shows that Estonian exports to Latvia picked up particularly in 1933. Latvia's share had in fact risen as early as in 1932, prior to the devaluation of the Estonian kroon, but this can be chalked up to the fact that Estonia had a harder time competing with her products in countries with "cheap" currencies, compared to Latvia, which also had an expensive currency. In monetary terms for 1932, Estonia's exports to Latvia actually fell in comparison to 1931.

Estonia's favourable attitude towards trade with Latvia is made apparent by correspondence between the Estonian Ministry of Economics and the Foreign Ministry, in which it is mentioned that the Bank of Estonia will not impede provision of foreign currency for trade with Latvia, but rather to the contrary, making it available to Estonian importers. In addition, a major discussion had taken place within the Bank of Estonia in the interests of facilitating purchases from Latvia.³⁹

Another step that was expected to stimulate trade between the two countries was the clearing agreement that was concluded between their central banks.⁴⁰ Such clearing type of trade had taken shape under circumstances under which countries selling commodities on a credit basis had developed significant problems in receiving payment from debtors. In

³⁸ Rannes (1939), p. 233.

³⁹ ERA, f. 969, n. 2, s. 206, Kirjavahetus Välisministeeriumi ja ettevõtete kaupa sisseveo ning valuuta korraldamise küsimuses, p. 7.

⁴⁰ ERA, f. 1790, n. 1, s. 135, Eesti panga valuuta erikomisjoni koosoleku protokollid. Tõlge Clearing kokkulepe Eesti Panga ja Läti Panga vahel.

cases in which the country that had incurred debts had also implemented exchange control, the prospect of receiving payment in foreign funds against goods sold became ever more hopeless. This brought about a situation in which countries that had previously provided credit subsequently resorted to arrangements under which one sold one's products to the other country, and was then reimbursed with products from the other nation, thus avoiding the need for the use of currency altogether.⁴¹ Mostly it was countries that had applied exchange control which utilised clearing agreements. If 12% of all of the world's trade took place in 1937 on the basis of clearing arrangements, then in the cases of Bulgaria, Germany, Romania and Hungary – countries that had imposed exchange control – the use of clearing agreements exceeded 50%.⁴² Merchants whose transactions transpired with countries that had clearing agreements in place were able to avoid applying for the provision of the required foreign currency altogether. What the clearing system allowed the Estonian importer to do was to make payment for goods into the account of the respective foreign country at the Bank of Estonia, and the money thus deposited was then used to reimburse an Estonian exporter who had sold goods to the land in question. The Central Bank then informed the bank of the other country about the deposit that had accrued to it, with which it then correspondingly compensated its exporter.⁴³ The clearing system was designed to stimulate a country employing exchange control to purchase goods from its clearing partner, since merchants – freed from the worry of having to acquire foreign currency – would at least hypothetically favour making purchases from that particular country.⁴⁴ Still, only such transactions were favoured that had previously received a go-ahead from the licensing commission.

In any event, the devaluation of the kroon didn't cause a breakdown of the system of trading policies that had been adopted by Estonia in 1931. In a manner similar to that of Denmark, which had devalued its krone and also implemented exchange control, the exchange control system as well as the license system too remained in use in Estonia. In March of 1934, Konstantin Päts – a person who had earlier been one of the main figures who had opposed the devaluation of the kroon – grabbed power in Estonia. As was the case with many of the Eastern European countries, Päts' authoritarian regime held a favourable attitude towards economic nationalism. From the middle of the 1930s, Estonia began to

⁴¹ Klesment (2000), p. 87.

⁴² League of Nations (1942), *Commercial Policy in the Interwar Period: International Proposals and National Policies*, Geneva, League of Nations, p. 70.

⁴³ Klesment (2000), p. 87.

⁴⁴ *Ibid.*

sink deeper into protectionism once more. Imports were again subjected to intensified controls. In 1934, the level of goods licensed for import had risen to the level of 36.2%, and beginning in 1935, the share of goods licensed for import had already reached nearly 50% of all imports being brought into the country.⁴⁵ The share of foodstuffs that were obligated to be imported on the basis of a license remained at a level near 70%, while the share of licensed goods brought in under the materials category during the second half of the 1930s was in the vicinity of 60% and 40% as concerns the category of finished goods.⁴⁶

Once the kroon had been devalued, the imposition of NTMs took on a character that had a trade policies purpose. Stimulation of more active trade relations took place through the use of NTMs, particularly as concerns countries that Estonia had a positive balance of trade with, or which were considered to be important partners for Estonia. When one trade partner or another ended up being in a negative trade balance situation with Estonia, the State was able to limit future purchases from such a country through the mechanism of the licensing commission. Trade measures were also employed in order to regulate the structure of imports. Purchases from Latvia in the materials category diminished during the second half of the 1930s (Table 3), which is reflected in the rise of goods being subjected to licensing from 40% to 60%.

Latvia, in her implementation of devaluation, followed the example of France. Two days after the devaluation of the franc, Latvia went off the gold standard on September 28, 1936, and the lat was devaluated to the tune of approximately 40%.⁴⁷ In a fashion similar to what had occurred in Estonia, a certain liberalisation of trade took place in Latvia after the devaluation of the national currency. The most substantial liberalisation was apparent in the area of provision of new quotas, and a number of goods disappeared from the list of items requiring licensing.⁴⁸ Latvia's international trade underwent a significant increase during the year after devaluation. As it turned out, 1937 was to constitute the high point in international trade for both Estonia and Latvia; in 1938 foreign trade fell again for these two (Figure 1). A general trend towards decline in trade had set in throughout the area, with international trade dropping off for Denmark, Finland, Sweden and Norway too. In 1939, this trend towards a logjam in trade

⁴⁵ Rannes (1939), p. 233.

⁴⁶ *Ibid.*

⁴⁷ Karnups (2006), p. 6.

⁴⁸ Latvian Chamber of Commerce and Industry (1937), "Latvia's financial policy", *Latvian economic review: a quarterly review of trade, industry and agriculture*. 1937, Vol. 2, No. 6, p. 6.

quietly continued. Of the countries mentioned above, foreign trade picked up only for Norway and Sweden.⁴⁹

The makeup of Latvia's international trade didn't change after the devaluation of the lat. Despite the appearance of some signs of liberalisation, the state didn't do away with the licensing system, exchange control or quotas.

Trade between Estonia and Latvia, which had showed some signs of invigoration after the first crisis years, began to dwindle again after the mid-30s (Figure 2).

There were a number of reasons for the downward turn in the trade relations of the two states, which were primarily a consequence of the situation existing in the landscape of trade politics of the time.

In a roundabout fashion, the decline was affected by the trade policies of Europe's large states. For example: after Estonia and the UK had renewed their trade agreement in 1934, imports of textile goods from the UK increased. Estonia was assertive in the defence of her domestic textile industry, but the treaty along with its additional secret protocols gave the UK a number of advantages, enabling increased export of textile goods to Estonia.⁵⁰ The share of the UK in the import of textile goods grew from 24.5% in 1934 to 49.2% in 1938.⁵¹ During the same period of time, Latvia's cut of textile industry products being imported by Estonia dropped. During 1934, Latvia's share of the textile industry products brought into Estonia had constituted more than 50% of import as a whole, with a total value of more than 1.5 million kroons.⁵² During the following year, the value of textile industry products being imported from Latvia fell to a half a million kroons, and beginning in 1936, the value of textile industry products from Latvia had dipped to beneath a quarter of a million kroons.⁵³

Another factor that put a brake on bilateral trade was Latvia's clearing debt of nearly two million kroons that had accumulated to the detriment of Estonia by the end of 1935.⁵⁴ After the devaluation of the kroon, Estonia's trade with Latvia had clearly become more active again. In 1934, goods were imported from Latvia in the amount of 2.76 million kroons,

⁴⁹ Statistical Yearbook of the League of Nations 1937-38 Geneva, League of Nations, p. 225; Statistical Yearbook of the League of Nations 1939-40 Geneva, League of Nations, p. 189.

⁵⁰ Pihlamägi (2004), pp. 287, 288.

⁵¹ *Ibid*, p 213.

⁵² Eesti majandus. Vihk XVII. Väliskaubandus 1934.a. (1935), Riigi Trükikoda, Tallinn, p. 17

⁵³ Eesti majandus. Vihk XIX. Väliskaubandus 1936.a. (1937), Riigi Trükikoda, Tallinn, p. 11.

⁵⁴ Postimees, No. 247, September 13, 1937.

while at the same time exports to Latvia reached the sum of 4.07 million kroons.⁵⁵ But since payment against invoices took place within the clearing framework, Latvia had by the end of 1935 accumulated the debt mentioned previously. It had been intended that this imbalance could be rectified to a greater or lesser extent through the mechanism of the clearing agreement signed by the two governments in April of 1935.⁵⁶ The agreement obligated both parties to permit the importation into their respective countries of all goods originating in the other nation that weren't banned for import (but nonetheless within the limitations fixed by internal quotas, as per the regulations that were in force at the time).⁵⁷ The parties also agreed that the goods in question were not be re-exported, and that they were also to be consumed or used only in the country into which they had been imported. An exception was made as concerns veneer and flaxseed from Latvia. Estonian merchants were given permission to resell these products to other countries. The hope was entertained that this exception might bring the balance of trade between the two countries back into parity.⁵⁸ Estonia then began, in her creditor's role, and having consented to the arrangement under which outstanding bills would be compensated in goods, to make such extraordinary purchases from Latvia.

The steps described previously and a lessening interest in exporting to Latvia – this in connection with the clearing debt that had piled up – both helped to rebalance trade relations between the two countries. By 1935, Estonia's trade surplus with Latvia amounted to a mere 8,000 kroons.⁵⁹ During the next year, Estonia's exchange of goods with Latvia became more passive. Imports from Latvia reached the level of 2.29 million kroons, while exports to Latvia diminished to the level of 1.02 million kroons.⁶⁰ In 1936, after the devaluation of the lat, Estonian products lost their price advantage on the Latvian market, meaning the advantage that had been afforded by the devaluation of the kroon, which also contributed to the decline in volume of exports.

⁵⁵ Eesti majandus. Vihk XVII. Väliskaubandus 1934.a. (1935), Riigi Trükikoda, Tallinn, pp. 17, 19.

⁵⁶ Clearing agreements had previously been concluded between the central banks of the two countries. See: Riigi Teataja (1935), Vabariigi Valitsuse otsus 17.04.1935. Eesti-Läti clearing kokkulepe, Art. 373, No. 39, p. 912 (the agreement went into effect on April 29, 1935).

⁵⁷ *Ibid.*

⁵⁸ Maa Hääl: maarahva ajaleht, No. 51, April 30, 1935.

⁵⁹ Author's calculation based on: Eesti majandus. Vihk XVIII. Väliskaubandus 1935.a. (1936), Riigi Trükikoda, Tallinn, pp. 15, 17.

⁶⁰ Eesti majandus. Vihk XIX. Väliskaubandus 1936.a. (1937), Riigi Trükikoda, Tallinn, pp. 11, 17.

In view of the situation that had developed, in which trade with Latvia had become less advantageous, Estonia decided to terminate the treaty amendment that had been agreed to with Latvia in June 1931, along with subsequent amendments, to include the treaty regulating clearing arrangements. Estonia's Ambassador to Latvia sent a note pertaining to this to the Finance Ministry of Latvia on May 13, 1937. By way of explanation to Latvia, it was stated that the aforementioned agreements no longer contributed to satisfactory trade relations between Estonia and Latvia. Estonia also declared that she was prepared to enter into negotiations that would regulate future trade relations.⁶¹

Estonia's step was indeed followed by the phase of trade negotiations. In July of 1937, talks began over the conditions of future arrangements.⁶² Regrettably, the negotiations were broken off because of differences of opinion. An additional cooling of relations was precipitated by the auxiliary Agreement on Trade and Shipping that Estonia and Finland had signed in September of 1937, in which Estonia granted the same benefits to Finland that had previously only been reserved for Latvia and Lithuania.⁶³ Latvia regarded Estonia's agreement with Finland as being in violation of the Baltic Clause. Estonia, on the other hand, held that the granting of favoured status to Finland had been in accordance with the Clause.

Differences of opinion became clearly visible in the trade relations of the two countries. In 1937, imports from Latvia fell to the level of 1.56 million kroons; while exports to Latvia continued at a level near to the low point marked in 1936, being measured at 1.11 million kroons.⁶⁴

In 1938 the trade negotiations did continue, but no treaty was reached. In the place of an agreement, the arrangement that had been technically terminated in May of 1937 was extended repeatedly on the basis of notes that the two parties exchanged.⁶⁵

In spring of 1939, the countries achieved an agreement valid until the end of the same year. The new trade agreement put quotas into place for several trade articles, with the opportunity to engage in trade on these from April 1 until December 31. Latvia was given the right, among other things, to export 50 tons of galoshes and overshoes, 10 tons of rubber shoes and 2,000 bicycles. Estonia was provided with quotas by Latvia that permitted Estonia to export, among other things, 200 tons of central

⁶¹ Postimees, No. 129, May 14, 1937.

⁶² Postimees, No. 180, July 8, 1937.

⁶³ Riigi Teataja (1937), Kaubandus- ja laevanduslepingu teine lisakokkulepe, Art 637, No. 77, p. 1429.

⁶⁴ Eesti majandus. Vihk XX. Väliskaubandus 1937.a. (1938), Riigi Trükikoda, Tallinn, pp. 11, 17.

⁶⁵ Postimees, No. 130, May 14, 1938; Postimees, No. 171, June 28, 1938.

heating radiators, iron and steel sheeting, 40 seeding machines, ten tons of dairy apparatus and 1,750 tons of various kinds of oil shale-based oils.⁶⁶

Be that as it may, the agreement failed to enliven trade between the two nations. To the contrary – during 1939, Latvia's share of import and export dropped to beneath one per cent for the first time during the years of independence.⁶⁷

Conclusion

The big economic crisis also left its mark on the volume of trade between Estonia and Latvia. During the second half of the 1930s, volume in both countries had only returned to about half of the levels that had been enjoyed prior to the crisis.

The most significant category of import goods during the first half of the 1930s consisted of finished goods. During the same period, the import of foodstuffs contracted by several increments to the benefit of other categories of goods. By 1934, the structure of exports returned for both countries to more or less the level that had existed prior to the crisis, this despite the turbulence they'd experienced during the crisis period. Considering that foodstuffs rose to be the most important export category during the crisis years in both Estonia and Latvia, by 1934 the structure of 1928 had been restored, meaning that the primary category of exports now consisted of materials.

Estonia imported mostly finished goods from her neighbour country, and for the most part exported finished goods and materials.

After the UK had taken the step of devaluing the pound, Estonia and Latvia quickly introduced exchange control and licensing systems. Since the national currencies of both countries were initially not devalued, the competitiveness of their products fell off on the markets of the countries that had carried out devaluations, and this boosted trading between Estonia and Latvia up to a point. Viewed from the ten-year perspective, the apogee of trade between the two arrived during the years of 1933 and 1934. The devaluation of the kroon during the summer of 1933 favoured exports from Estonia to Latvia with her expensive currency, and the Bank of Estonia didn't block forex transactions being conducted with Latvia. Hand in hand with this, a favourable attitude also prevailed towards granting of licenses for the conduct of trade with Latvia.

Nonetheless, trade between the two countries lessened during the second half of the 1930s. Estonia's positive balance of trade then

⁶⁶ Postimees, No. 169, June 28, 1939.

⁶⁷ Pihlamägi (2004), pp. 220, 222.

brought about Latvia's clearing debt, and the measures taken to lessen that debt led to a lessening of interest on the part of Estonia towards her southern neighbour. In 1936, the lat was devalued, with the result that products from Estonia lost their competitive edge on the Latvian market. During that year, Estonia's trade with Latvia was quite evidently passive. Estonia, which had ended up in an unfavourable position, reacted in 1937 by backing out of previous trade agreements. The trade negotiations between the two neighbours that followed dragged on for some time. At the same time, Estonia began moving towards improving relations with Finland, which country was extended the same favourable conditions that had previously been accorded only to Latvia and Lithuania.

Estonia's behaviour is indicative of the attitude that was prevalent during the 1930s, meaning that trade was directed towards countries with which one had either a balanced trade relationship, or a positive trade balance. The manoeuvring space available to small nations was lessened by the trade interests of Europe's large nations, but the opportunity to also expand that space was made available, up to a point, by the use of licensing systems and exchange control. Above all, it was possible to regulate trade relations with smaller countries that had a similar structure of exports. The drying up of trade with Latvia provides one with a clear case in point: the end of a period that was advantageous for Estonia led to a cooling of trade relations with her southern neighbour, and also to the beginning of an orientation that gravitated more towards Finland.

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THE PROBLEM OF DIMINISHING MARGINAL UTILITY OF 'GOOD' CORPORATE GOVERNANCE: FIRM PERFORMANCE AND SUPERVISORY BOARD GOVERNANCE OF GERMAN STOCK-LISTED COMPANIES

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Abstract

This article examines a sample of the largest 128 German stock-listed companies, whereby Germany can be seen as one of the most highly regulated countries concerning good corporate governance. According to agency theory, a positive relationship between company performance and 'good' corporate governance should exist. This article's objective is to answer the following questions: (1) Does 'good' corporate governance explain firm performance differences? (2) Which corporate governance characteristics distinguish performing from non-performing companies?

This article analyses the effect of supervisory board characteristics on firm performance. Twelve 'good corporate governance' variables such as number of committees, board independence, supervisory board compensation, supervisory board risk liability, etc. are examined concerning their effect on firm performance in terms of firm growth, profitability and total shareholder returns. Thus, bivariate correlations (Pearson's R, significance level at $p < .05$) and cumulative influences of all corporate governance characteristics on firm performance (multiple regression) are tested, as well as differences between groups clustered by 5-year total shareholder returns growth, resulting in a total shareholder return (TSR) top-30 group and TSR bottom-30 group.

The result is that the maximum fulfilment of good corporate governance standards shows no effect on firm performance. Instead, it is determined that growth outperformers comply to a lesser extent with German good corporate governance standards. Growth outperformers show lower management costs and supervisory board compensations, and they have smaller supervisory boards and less committees, while supervisory board compensation is not linked with firm performance and the risk liability of supervisory board members is lower. It is determined that the higher the number of exceptions to good corporate governance, the higher is the firm performance and the degree of shareholder interest fulfilment in terms of total shareholder returns. Therefore, the issue of diminishing marginal utility of good corporate governance specifications arises.

Keywords: Corporate Governance, Supervisory Board, Principal-Agent Theory, Firm Performance.

Introduction

The failure of several corporations such as Enron, Tyco, Parmalat, Skandia, Lehman Brothers, etc. in the last decade shows that firms should undertake additional modifications in their corporate governance (CG) to increase transparency and to assure shareholders' reliance on management (Hermalin & Weisbach, 2012, p. 326). A large consensus exists among both academics and professionals that new efforts are important to improve corporate governance practices to protect the shareholders' interests and to stabilise market economy basics, due to the fact that many scholars, economic analysts, and corporate practitioners have linked the severity and increasingly circular nature of financial and economic crises to corporate governance failures (Sun, Stewart, & Pollard, 2011, p. 1; Gupta, Chandrasekhar, & Tourani-Rad, 2013, p. 86).

The term *corporate governance* summarises efforts to optimise a company's management system and its monitoring and is based primarily on agency theory and the problem of information asymmetries (Schillhofer, 2003, p. 11). Agency theory's essence is the separation of management and monitoring. A manager, or an entrepreneur, raises funds from investors either to put them to productive use or to cash out shareholders or owners. The financiers need the manager's human capital to generate returns on their funds, and the manager needs the financiers, since he or she either does not have enough capital, does not want to take risks or has no entrepreneurial idea.

'Theory' of Corporate Governance

Governance is a historic term for the description, evaluation, and comparison of state governance. The term stood linguistically 'in competition' with the term government, and was as such often used as a synonym for government in political literature. However, the term *governance* was increasingly less used in the political context in the 20th century (Van den Berghe, 1999, pp. 220–221). However, in the 1970s, the concept of governance revived in American business language through the concept of *corporate governance* with the focus on corporate responsibility. A decade later, the World Bank introduced the term *good governance* and thus coined this phrase (Wouters & Ryngaert, 2005, p. 72).

Today, corporate governance defines the regulatory framework for the management and supervision of companies. The corporate governance framework is largely determined by legislators and owners (Spira, 2002, p. 11), whereas the actual corporate governance design is the supervisory board's responsibility. The company-specific corporate governance system consists of the totality of relevant laws, regulations, codes, letters of

intent, mission statement, and management habits, and monitoring (OECD, 2010, p. 34). However, there is still no common understanding or a single definition of what exactly corporate governance means or covers (Stiglbauer, 2010, p. 9).

The academic literature discusses good corporate governance and the improvement of existing corporate governance. Good corporate governance should ensure and guide a responsible, professional, and transparent business administration in the interest of owners, but also of external stakeholders (i.e., creditors, sales and procurement markets, society, citizens) (Spedding, 2009, pp. 500-503). The discussed characteristics of 'good' corporate governance are (1) appropriate risk management, (2) formal and transparent procedures for the proposal and election of board members, (3) functional organisational management, (4) management decisions focused on long-term value creation, (5) transparency in internal and external corporate communications, (6) safeguarding mechanisms to secure the interests of various groups (stakeholders), and, overall, (7) a clearly defined management and control structure (Passenheim, 2010, p. 11).

Governance relies on its effectiveness for the transparency of financial information and the transparency of management decisions so that external 'market' mechanisms can be effective through disciplinary effects on the company and thus on executive performance (Frederikslust & Ang, 2008, pp. 1-4). In addition to these external market monitoring mechanisms, the agency theory discourse has shaped the internal boardroom reform (Bratton, 2012, p. 102). Perhaps the most significant contributions in this context came in the form of the widespread adoption of performance-based executive compensation schemes (Bratton, 2012, pp. 111-115), which follows directly from the assumption that the executives self-interest must be aligned with the shareholders' interests, for example, through value-based key performance indicator systems, rewarding an increase of added economic value, etc. (Zarbafi, 2011, pp. 61-63).

The subject of 'good' corporate governance has gained in importance also in Germany since the 1990s. The German government passed the Law of Control and Transparency (KonTraG) in 1998, which was the first actual corporate governance law in Germany, which extended the liability of directors, supervisors and auditors. The core of this law is a provision forcing companies to introduce and operate company-wide early warning systems and to publish statements about risks and the company's risk structure in a special report attached to the annual report. In 2000, the federal government set up a government commission on the modernisation of company law, due to the bankruptcy of one of Germany's largest construction companies. Among other things, this commission recommended developing a 'Best Practice Code' for German

companies. For this end, the ‘Government Commission on the German Corporate Governance Code’ was formed as a self-regulation measure of the economy in 2001. The Commission is funded by the private sector and completely independent in their decisions. The government cannot give instructions for the design of the Code. (Jannott & Frodermann, 2014, pp. 266-268). The Commission does not include any representative of the government or politics and released the “German Corporate Governance Code” in 2002. Due to the subsequent publication in the *Federal Law Gazette*¹ the declaration obligation in Section 161 in the Stock Corporation Act applies for listed companies. The supervisory and executive boards of corporations are obliged annually to explain if

1. the Code is adopted as a whole (so-called consent or inheritance model),
2. the Code is rejected as a whole (so-called disclaimer or rejection model),
3. only parts of the Code are followed (so-called qualified deviation explanation or selection solution). (Jannott & Frodermann, 2014, pp. 266-268).

The declaration must be made permanently available to the shareholders and all other interested parties on the company’s website. Thus, the observance of its principles has a direct impact on a company’s public image and its relationship with shareholders and finally the capital market. In 2009, the Code was adapted to changes by the Management Board Compensation Adequacy Act. Further changes were concerning the board’s obligation on the ‘company’s interests’, the diversity in the composition of the supervisory board, in particular, and the participation of women on supervisory boards, and thus decided the independence of consultants serving on the board. In 2010, further significant changes were adopted affecting the professionalising of the supervisory board. In 2013, the Commission decided on cuts of the Code and also dealing with the management board remuneration. The most important point is the recommendation to limit the board remuneration including their variable parts. (Janocha, 2014, p. 2).

The German Corporate Governance Codex (DCGK) is a reaction to the criticisms of the German corporate ‘constitution’ expressed particularly from international investors such as, for example, the lack of transparency, as well as inadequate focus on shareholder interests and of board professionalism, diversity, and independence (Rode, 2009, p. 110). Confidence in the management of German companies and thus in the German capital market should be strengthened. The aim is also to unify

¹ Federal Law Gazette (Bundesgesetzblatt)

and standardise measures concerning the fulfilment of 'good' corporate governance. (Rode, 2009, p. 110).

Research Question, Data and Methods

Today, Germany can be seen as one of the most highly regulated countries concerning good corporate governance (OECD, 2015, p. 15). Companies must explain in detail, on a yearly basis, to which degree they comply or not with the regulations given by the jurisdiction. This allows collection of data not available in most other countries due to different regulations.

The overall objective of this study is to answer the following questions:

1. Does 'good' corporate governance explain firm performance differences?
2. Which corporate governance attributes distinguish performing (outperforming) from non-performing (underperforming) companies?

Firm performance, as the dependent variable in this study, is directly observable. Firm performance means, first, total shareholder return (TSR) growth, and, second, revenue growth and profitability (ROIC), so that three different perspectives are selected: (1) the shareholder view, (2) the market-based view with variable revenue growth as proxy for market success and (3) profitability as management performance, which should be a result of appropriate supervisory board activities.

Good corporate governance is observed mainly by deviations from the 'good' corporate governance codex as a benchmark provided by the German Corporate Governance Codex and is measured as total number of exceptions from the codex and as exceptions from selected core elements of the codex. Additionally, board size, number of committees, compensations, etc. are collected as well. Some data are calculated based on given financials, such as share of management costs to revenue.

The research process involves several steps and different statistical tests conducted with the total sample, as well as with subgroups. The total sample consists of 128 German stock-listed companies in the period 2005 to 2014, for which the necessary data is completely available. The reduction of the complete sample of 165 companies listed in the DAX30, MDAX, SDAX, and TecDAX results from the non-availability of corporate governance reports of the excluded companies, mainly because these companies were not stock-listed in 2010, so that they were not obliged to publish a corporate governance compliance statement from which the governance data are collected. However, the sample represents the largest German stock-listed companies.

The data source for firm performance metrics is Thomson ONE by Thomson Reuters and Morningstar. Both databases are widely used in business research. Thomson ONE combines data from both databases with up to 3,200 items (financial fundamentals and ratios and other firm data) per company. Companies, for which the data series in the given period are incomplete, are excluded from the total sample. The data for qualifying corporate governance are retrieved from corporate governance reports, containing the declaration of exceptions to the Corporate Governance Codex, and annual reports containing key performance metrics, the number of board members, board members' academic degrees, number of committees, performance-based supervisory board compensation, etc.

According to the German Corporate Governance Codex (DCGK), each stock-listed company must explain to what extent they comply with the DCGK rules. Thus, the DCGK represents a benchmark of 'good' corporate governance and allows collecting quantitative and comparable data to estimate corporate governance level without any subjective factors such as researcher classifications. The values are collected from the annual reports and corporate governance compliance statements for the years 2010 and 2014, converging with the financial data that refer on a 5-year period such as 5-year total shareholder return average, 5-year return growth (CAGR)², etc. The financial data are all scaled numerically, as are most corporate governance values. However for this purpose, only some data are nominally scaled. The main data analyses methods are bivariate correlations testing and tests for statistical differences (t-test), the latter in particular to find differences between groups clustered by their 5-year total shareholder return growth resulting in a TSR top-30 group and TSR bottom-30 group.

Based on this data, which is supplemented by several firm performance characteristics such as revenue growth, total shareholder growth, and financial leverage, the following tests were possible:

- 1. Testing Statistical Influence of Single Board Characteristics on Firm Performance among the Total Sample:** The collected data includes only two scale levels. The financial data are completely numerically scaled, while the corporate governance characteristics are dichotomously and numerically scaled. Therefore, the main data analysis applies Pearson's R as a correlation coefficient to analyse bivariate correlations or cumulative influences of corporate governance characteristics on firm performance through the application of the multivariate regression analysis.

² CAGR: Compound Annual Growth Rate.

2. **Testing Differences between TSR Performance Groups:** Additionally, not only bivariate correlations among the total sample are analysed, but also among different groups. The sample is clustered into two different groups. One group, which is named TSR top-30 group (TSR outperformers), includes the top-30 companies with the highest total shareholder returns among the total sample, while the second group, which is named TSR bottom-30 group (TSR underperformers), includes the 30 companies with the lowest total shareholder returns in a 5-year period among the total sample. Both groups are compared by applying a t-test, to determine the significance of group differences, while among both groups, the same tests are performed as with the total sample regarding bivariate correlations.
3. **Testing Multivariate Effects among the Total Sample:** All independent corporate governance variables are included in the final testing to examine their cumulative impact. The multivariate test is conducted to test the influence of the accumulated effects of all corporate governance variables on the total shareholder return (TSR).

Statistical Analysis

Descriptive Statistics of the Total Sample

The total sample includes all German companies listed in the DAX30, MDAX, SDAX, and TecDAX minus the companies for which corporate governance data were not available, as was explained in the data collection section of this article above. The 128 companies among this sample have generated total revenue of EUR 1,507,013m, respectively 1,507bn in 2014. The total sample's operating income is 107,197m, whereas the total sample's net income amounts to 69,634m, which is almost equal to the total sample's free cash flow. To provide a comparison: The largest global company by revenue is currently Royal Dutch Shell with revenue of EUR 356,142m. Thus, the sample's total revenue is almost four times greater than that of the largest global company. However, the average sample company generated EUR 11,774m in revenue in 2014, with an operating income of 837m and an average net income of EUR 544m. Accordingly, the sample's average net margin is 7%, which is slightly below the current S&P 500 net margin of 8.25% (CISMarket 2015). Therefore, it can be stated that the sample is, at least in terms of net margin, representative of the stock-listed companies in developed economies.

The same can be noticed regarding profitability, financial risk, and shareholder's return. This becomes, for example, evident in considering the financial risk expressed by the financial leverage. Financial leverage is calculated as total assets divided by total shareholders' equity.

The interpretation is: the higher the ratio, the more debt a company uses in its capital structure. The S&P 500 financial leverage, which is the average financial leverage of all S&P 500 companies, is currently 3.99 (CISMarket 2015), while the financial leverage of the research sample amounts to 4.05. Furthermore, it can be noted that the sample's sum of total assets is 3,290bn, which is nearly double the revenue of 1,507bn in 2014, while the average ROIC amounts to 12.34% and the average dividend per share is EUR 0.87 per share.

To sum up, this sample is, particularly in comparison with international key figures, a representative sample. However, it must be mentioned that the sample is dominated by comparable smaller companies due to the fact that already two indices are small companies' indices, namely the SDAX and TecDAX. The TecDAX is not defined by a market cap threshold, but by segment definition. Since Germany is not a country of larger tech companies, this sample is dominated by significantly smaller firms than the U.S. tech segment listed in the NASDAQ index. This leads to a slight dominance of small firms, which becomes visible in examining the quartiles in terms of revenue.

The sample's revenue median is EUR 1,765m so that 50% of the companies generate lesser than EUR 1,765m. Instead, the top quartile includes companies from EUR 14,534m up to EUR 202,445m. Additionally, 109 companies generate lesser than 20% of the revenue of the top company, which is Volkswagen AG with EUR 202,458m. However, from the shareholder's view, the sample is very profitable with the total sample's 5-year total shareholder return (TSR) average of 21.8%.

Furthermore, the sample's companies are managed highly profitably. With an average ROIC of 12.34%, the companies are, compared to the S&P 500, highly profitable. In the last decade, the S&P 500 bottom quartile realised an average ROIC of 6.7% (J. P. Morgan, 2014, p. 1), while the sample's top quartile companies realised an ROIC of 16.7%. Thus, it can be said that the sample is slightly dominated by smaller companies, which, however, are managed highly profitably and have generated a TSR, which is significantly higher than the risk-free rate, measured by long-term government bonds, such as Germany's 10-year yield bond, which currently provides a yield of 0.69% (Bloomberg 2015). Furthermore, the sample shows a significantly higher year-over-year growth rate in 2014 than the S&P 500. Whereas the sample's average is 10.3%, the S&P 500 year-over-year revenue growth is 2.83% (CSIMarket 2015).

Descriptive Statistics of the TSR-30:30-Sample

The TSR-30:30-sample consists of the top-30 companies and the bottom-30 companies in terms of the total shareholder return (TSR).

Thus, the TSR 30:30 sample consists of, from the shareholder's viewpoint, the most profitable companies and the companies with the lowest profitability. The TSR-top-30-companies show the highest degree of serving the shareholder's interest, labelled as TSR-outperformers and, vice versa, the TSR-bottom-30-companies are labelled as TSR-underperformers.

The main sample's difference in terms of 5-year TSR growth is very high (38.25% vs. -7.95%), while the differences in terms of 5-year revenue growth (12.17% vs. 6.10%) and profitability (ROIC: 11.13% vs. 6.27) are not as large. The revenue mean for the TSR top-30 group accounts for EUR 5.8bn (2014) and is lower compared with the TSR bottom-30 group (EUR 12bn).

Supervisory Board Characteristics (Total Sample)

The average size of the supervisory boards and the average size of the executive board of the total sample remain constant over the measurement period 2010 to 2014. Yet, the average compensation of supervisory board members and executive board members increased considerably during this period. For an average supervisory member, the compensation increased by EUR 260,000 on average, while the average executive board member's compensation increased by EUR 1.472m.

Since the supervisory board compensation is linked to the number of sessions, the number of supervisory board sessions is also interesting. Yet, the number of supervisory board meetings does not indicate a significant increase over the observation period (5.63 meetings in 2010, 5.74 meetings in 2014).

In this respect, it can be assumed that, in principle, the compensation increase reflects the increased control effort to a lesser degree. It may be assumed, however, that the supervisory board compensation increase is more aligned with the increase in the executive board compensation, which is in the most cases linked to company performance. However, the growth rates of both shows that the supervisory board increase exceeds the executive board compensation growth rate. While the average executive board compensation increases by 22%, the average supervisory board compensation increases by 30%.

'Good Corporate Governance' (DCGK Conformity) Characteristics (Total Sample)

The German Corporate Governance Codex comprehends 62 sections. Only a certain number of sections are selected, which are to be seen as essential parts of 'good' corporate governance, based on the factors derived from the empirical research discussed above. The following sections are selected:

1. **Overall Compliance with Corporate Governance Rules:** § 161 of the German Stock Corporate Act (AktG) determine that management

and supervisory boards of listed companies must issue an annual statement concerning the company's compliance with the German Corporate Governance Codex (DCGK). This declaration must contain the number and reasons for the exceptions explicitly. The number of exceptions can be obtained from the declaration of compliance, which is either provided in the annual report or published on the investor relation website.

2. **Risk Responsibility:** § 3 of the German Corporate Governance Codex (DCGK) § 3 regulates the cooperation between the executive management and supervisory board. However, 99% of the counted exceptions of this sample refer only to § 3.8. This section rules the own-risk deductible included in the directors and officers liability insurance (D&O insurance). The DCGK requires:

“If the company buys D&O insurance for the board, a deductible of at least 10% of the damage must be agreed up to at least a half times the fixed annual remuneration of the board member. In D&O insurance for the supervisory board, a similar deductible must be agreed upon.” (DCGK, 2015)

The ruling idea behind this regulation is to increase the liability of board members so that board members are; on the one hand, more risk averse and, on the other hand, exercise more caution in their supervisory activities.

3. **Division of Supervisory Board ‘Labour’:** § 5 of the German Corporate Governance Codex (DCGK) regulate the duties, responsibilities, competences, the formation of committees, the composition of the supervisory board and its compensation. § 5.3.2 determines that an audit committee must be established:

“The supervisory board shall set up an audit committee, which shall be concerned – as far as no other committee is empowered and – in particular with monitoring the accounting process, the effectiveness of the internal control system, the risk management system and the internal audit system, the audit, in particular the independence of the auditor, the assignment of the audit to the auditor, the determination of auditing focal points and the fee agreement and compliance. The chairman of the audit committee shall have specialist knowledge and experience in the application of accounting principles and internal control procedures. He should be independent and not a former board member of the company whose appointment ended less than two years.” (DCGK, 2015)

Accordingly, two main exceptions from the German Corporate Governance Codex (DCGK) lead to a count of an exception regarding

5.3.2: No audit committee was installed or the chairman was not independent. § 5.3.3 of the German Corporate Governance Codex (DCGK) determines that the supervisory board shall install a nomination committee composed exclusively of shareholder representatives. The nomination committee shall appoint suitable candidates to the supervisory board for his proposals to the annual general meeting for the election of supervisory board members. Thus, § 5.3.3 is an essential part in the supervisory board member recruiting process and the maintenance of monitoring quality. The assumption is that a standardised and regular process leads to a higher probability that supervisory board members are selected on objective reasons.

4. **Supervisory Board Independence:** § 5.4.2 of the German Corporate Governance Codex (DCGK) rules that the supervisory board should include an adequate number of independent members:

“A supervisory board member is in particular not to be considered to be independent in the sense of this recommendation if he has a personal or business relationship with the company, their organs, a controlling shareholder or is connected which establishes a significant and non-temporary conflict of interest.” (DCGK 2015)

Thus, exceptions to this paragraph signal that conflicts of interest may occur, which might interfere with the exercise of supervisory duties in the interest of all shareholders.

5. **Performance-based Compensation:** § 5.4.6, section 2 of the German Corporate Governance Codex (DCGK) determines that the

“members of the supervisory board shall receive a compensation that is commensurate to their duties and the company’s position. If the supervisory board members are promised performance-related compensation, it should be geared towards sustainable corporate development.” (DCGK 2015)

Thus, an exception to this rule shows that supervisory board compensation is not linked to corporate performance.

If one reviews the changes in the exceptions to the mentioned rules, it is obvious that the total number of exceptions have not changed significantly. The most significant changes are measured in three different areas. The number of exceptions concerning the D&O own-risk deductible (“# Excep. DCGK § 3”) decreased by 28%, while the number of exceptions concerning the link between corporate performance and supervisory compensation (“# Excep. DCGK § 5.4.6 Sec. 2”) decreased by 24%. Instead, the number of exceptions concerning the independence of supervisory members (“# Excep. DCGK § 5.4.2”) increased by 125%, however, starting from a low base level. Thus, it can be determined that

the sample's companies increased the subsequent risk for supervisory activities and tied the supervisory compensation more closely to firm performance. Instead, the board structure characteristics regarding the committees and the overall structure of cooperation between executive board and supervisory board, the independence of members, etc. remained more or less on the same level. Therefore, it can be stated that the regulatory intentions 'good' corporate governance are increasingly met by the sample's companies.

Bivariate Analysis (Total Sample)

The correlation matrix shows only few significant correlations between performance measures (TSR growth, revenue growth, ROIC). Only a single governance variable shows a significant correlation with TSR growth, which represents the number of committees ($r = -0.185$; $p = 0.037$), indicating that the lower the number of committees, the higher is the TSR growth. The highest significant correlation between a governance variable and revenue growth exists regarding the number of committees ($r = -0.384$; $p = 0.00$), indicating that the lower the number of committees, the higher is the revenue growth. Other significant correlations ($p < 0.05$; $r > 0.25$) between governance variables and revenue growth are supervisory board size ($r = -0.329$, $p = 0.00$), executive board size ($r = -0.334$; $p = 0.00$), supervisory board compensation ($r = -0.278$; $p = 0.00$) and executive board compensation ($r = -0.271$; $p = 0.02$), and the number of supervisory board members with board mandates in other companies ($r = -0.258$). All these correlations are negative, indicating that (1) the lower the supervisory board size, the supervisory board and executive board compensation, etc., the higher is the revenue growth. Only one correlation is positive, which is the correlation between the total number of exceptions from the DCGK ($r = 0.334$; $p = 0.00$) and revenue growth, indicating that the companies complaining to a lower degree with the DCGK have a higher revenue growth.

Group Differences (TSR 30:30 Sample)

The descriptive statistics of the group comparison shows that the TSR top-30 companies' supervisory board has, on average, three members less than the TSR bottom-30 companies' supervisory board. Accordingly, the TSR top-30 companies have fewer committees and show, thus, a higher number of exemptions regarding the DCGK § 5. The TSR top-30 group shows a lower mean regarding the number of committees (2.4 vs. 3.5) and a higher mean regarding the number of DCGK § 5 exceptions (2.9 vs. 2.2) and, furthermore, regarding the total number exceptions (6.2. vs. 4.4).

To sum up, the group statistics of the TSR-30:30-sample indicates that the TSR top-30 companies have smaller supervisory boards, fewer committees and smaller executive boards, pay smaller supervisory board compensations and executive board compensations, but comply lesser with the DCGK ("Number of Except. § 161") than the TSR bottom-30 companies. However, the TSR top-30 group shows a 5-year TSR growth of 38% against -8% among the TSR bottom-30 group. Furthermore, the TSR top-30 group shows a double 5-year revenue growth compared with the TSR bottom-30 group.

Multivariate Regression Analysis (Total Sample)

All independent corporate governance variables are included in the final testing to examine their cumulative impact. The multivariate test is conducted to test the influence of the accumulated effects of all corporate governance variables on the total shareholder return (TSR). Thus, it can be measured to which degree the 'good' corporate governance parameters influence shareholder benefit in terms of TSR. The multivariate test is executed with the control variables revenue growth, ROIC, and firm size (revenue 2014 in EUR mil.), because the bivariate tests have indicated that, for example, the number of committees, the number of exclusion, etc. also depend, at least partly, on firm size (in revenue 2014 in EUR mil.). The model summary shows that the exception from DCGK § 3 is the only variable explaining TSR growth. As mentioned above, this exception results in at least 99% from exceptions to § 3.8. This section rules that an own-risk deductible should be included in the directors and officers liability insurance (D&O insurance) with the objective to increase risk-taking costs. However, the results of the multivariate test do not explain the direction of influence. Therefore, the question remains regarding whether the absence or the existence of an own-risk deductible influences firm performance in the sense of a causal relationship.

The t-test descriptive statistics show that 70 companies of the total sample declare non-compliance with § 3.8 while 57 companies have concluded a D&O insurance contract containing an own-risk deductible. The comparison of the group with D&O insurance contracts containing an own-risk deductible and the group without the own-risk deductible reveals that the group without risk-sharing agreements perform better with a TSR growth of 18% while companies with risk-sharing show considerably lower TSR growth of 8.7% (t-test group statistics). The group differences are highly significant with $p < 0.002$ (independent sample test). Thus, it may be concluded that the own-risk deductible leads to risk-averse supervisory board behaviour and thus to lower TSR growth. However, on the other hand, it must be noted that this factor has only a low explanatory

power regarding the total shareholder return growth, as the results of the multivariate regression analysis has shown.

Conclusions

The quantitative data analysis leads to the following conclusions:

1. A certain governance standard equilibrium is reached and a trend to a higher level of 'good' corporate governance is not observed in the sample. Changes occur mostly in distressed situations or at random, due to specific factors, which are visible in the justification statements contained in the corporate governance compliance statements of the sample's companies.
2. The selected parameters of 'good' corporate governance are not relevant for revenue growth and total shareholder return growth as the results of all bivariate analyses of the total sample indicate that none of the single factors show a higher ($r > 0.5$) and significant correlation with firm performance indicators. However, this does not mean that they are irrelevant. Rather, it must be stated that the level of corporate governance shows a high temporal stability.
3. Performing companies have smaller supervisory boards, fewer committees and smaller executive boards, pay smaller supervisory board compensations and executive board compensations, but comply lesser with the DCGK ("Number of Except. § 161") than low performing companies in the sample.
4. The multivariate regression analysis indicates that even the cumulated influence of all variables is negligible, except the issue of risk sharing of the supervisory board measured by the number of the exceptions to DCGK § 3.8 regulating the own-risk deductibles for supervisory board members. The comparison of the group among the total sample with D&O insurance contracts containing an own-risk deductible and the group without an own-risk deductible reveals that the group without risk-sharing agreements perform better with a TSR growth of 18% while companies with risk-sharing show considerably lower TSR growth of 8.7%.

Suggestions

From the conclusions above, it is suggested that the increase of governance regulation shall not be continued indefinitely to avoid serious disadvantages, particularly in the form of decreasing risk-taking tolerance. Additional regulations may result only in a diminishing marginal utility at the expense of firm growth and total shareholder return growth.

Appendix (SPSS Output Tables)

Group Statistics (TSR 30:30-Sample)

| Top30 =1; Bottom30=2 | | N | Mean | Std. Deviation | Std. Error Mean |
|-------------------------------------|-----------|----|-----------|----------------|-----------------|
| 5y-TSR Growth | Top 30 | 30 | 38.2493 | 15.20116 | 2.77534 |
| | Bottom 30 | 30 | -7.9533 | 8.12019 | 1.48254 |
| 5y- Rev. Growth | Top 30 | 30 | 12.1683 | 19.27009 | 3.51822 |
| | Bottom 30 | 30 | 6.0987 | 9.14848 | 1.67028 |
| Sup. Board Size | Top 30 | 30 | 9.233 | 5.4373 | .9927 |
| | Bottom 30 | 30 | 12.300 | 6.4228 | 1.1726 |
| Exec. Board Size | Top 30 | 30 | 3.733 | 1.7991 | .3285 |
| | Bottom 30 | 30 | 4.500 | 1.5029 | .2744 |
| Sup. Board Comp. TEUR | Top 30 | 30 | 519.500 | 611.7080 | 111.6821 |
| | Bottom 30 | 30 | 1085.133 | 1161.2743 | 212.0187 |
| Exec. Board Comp. TEUR | Top 30 | 30 | 3448.767 | 4040.3610 | 737.6656 |
| | Bottom 30 | 30 | 6890.600 | 5436.6526 | 992.5924 |
| Number Board Meetings | Top 30 | 30 | 5.400 | 2.2682 | .4141 |
| | Bottom 30 | 30 | 5.533 | 1.9954 | .3643 |
| Number Sup. Board Memb. with PhD | Top 30 | 30 | 3.200 | 2.2954 | .4191 |
| | Bottom 30 | 30 | 3.933 | 2.5316 | .4622 |
| Number of Committees | Top 30 | 30 | 2.367 | 1.9737 | .3603 |
| | Bottom 30 | 30 | 3.467 | 1.5477 | .2826 |
| Numb. SB-Members with oth. Mandates | Top 30 | 30 | 4.967 | 4.6497 | .8489 |
| | Bottom 30 | 30 | 7.400 | 6.0777 | 1.1096 |
| Number of Excep. § 161 AktG | Top 30 | 30 | 6.167 | 3.5241 | .6434 |
| | Bottom 30 | 30 | 4.433 | 4.0995 | .7485 |
| Number of Excep. DCGK § 3 | Top 30 | 30 | .833 | .9129 | .1667 |
| | Bottom 30 | 30 | .500 | .6823 | .1246 |
| Number of Excep. DCGK § 5 | Top 30 | 30 | 2.900 | 2.1391 | .3905 |
| | Bottom 30 | 30 | 2.233 | 2.4870 | .4541 |
| 5y Average ROIC | Top 30 | 30 | 11.1315 | 8.5325 | 1.5578 |
| | Bottom 30 | 30 | 6.2656 | 8.1281 | 1.4840 |
| Exec. Comp/Rev. Ratio | Top 30 | 29 | 0.0068 | 0.0077 | 0.0014 |
| | Bottom 30 | 30 | 0.0040 | 0.0053 | 0.0010 |
| 5y Average Finan. Lev. | Top 30 | 30 | 3.3183 | 1.6671 | 0.3044 |
| | Bottom 30 | 30 | 3.2147 | 1.8720 | 0.3418 |
| Revenue 2014 (EUR Mil) | Top 30 | 30 | 5792.167 | 13220.4075 | 2413.7051 |
| | Bottom 30 | 30 | 11963.767 | 24371.3851 | 4449.5858 |

Bivariate Correlation Matrix for all Numerical Variables (Total Sample)

| | | TSR Growth 5y-Average | Revenue Growth CAGR | ROIC 5y- Average | Rev. Share Mgmt Costs | Financ. Lev. 5y-Average |
|---|------------------------|--------------------------|---------------------------|---------------------|-----------------------------|----------------------------|
| TSR Growth 5y-Average | Pearson Correlation | 1 | .160 | .165 | .034 | .010 |
| | Sig. (2-tailed) | | .071 | .063 | .703 | .909 |
| | N | 128 | 128 | 128 | 127 | 128 |
| Revenue Growth CAGR | Pearson Correlation | .160 | 1 | -.021 | .112 | -.112 |
| | Sig. (2-tailed) | .071 | | .812 | .209 | .209 |
| | N | 128 | 128 | 128 | 127 | 128 |
| Sup. Board Size | Pearson Correlation | -.085 | -.329** | -.072 | -.399** | .197* |
| | Sig. (2-tailed) | .339 | .000 | .419 | .000 | .026 |
| | N | 128 | 128 | 128 | 127 | 128 |
| Exec. Board Size | Pearson Correlation | -.107 | -.334** | -.088 | -.294** | .224* |
| | Sig. (2-tailed) | .230 | .000 | .323 | .001 | .011 |
| | N | 128 | 128 | 128 | 127 | 128 |
| Sup. Board Compensatio n | Pearson Correlation | -.111 | -.278** | -.025 | -.344** | .146 |
| | Sig. (2-tailed) | .212 | .001 | .778 | .000 | .100 |
| | N | 128 | 128 | 128 | 127 | 128 |
| Exec. Board Compensatio n | Pearson Correlation | -.091 | -.271** | -.030 | -.279** | .182* |
| | Sig. (2-tailed) | .307 | .002 | .736 | .001 | .039 |
| | N | 128 | 128 | 128 | 127 | 128 |
| Number Sup. Board Meetings | Pearson Correlation | -.071 | -.030 | .150 | .017 | .027 |
| | Sig. (2-tailed) | .429 | .738 | .091 | .853 | .764 |
| | N | 128 | 128 | 128 | 127 | 128 |
| Number Sup. Board Memb. with PhD | Pearson Correlation | -.125 | -.241** | -.200* | -.296** | .075 |
| | Sig. (2-tailed) | .161 | .006 | .023 | .001 | .398 |
| | N | 128 | 128 | 128 | 127 | 128 |
| Number Committees | Pearson Correlation | -.185* | -.384** | -.143 | -.335** | .191* |
| | Sig. (2-tailed) | .037 | .000 | .107 | .000 | .031 |
| | N | 128 | 128 | 128 | 127 | 128 |
| Numb. SB- Members with oth. Mandates | Pearson Correlation | -.144 | -.258** | -.219* | -.281** | .244** |
| | Sig. (2-tailed) | .106 | .003 | .013 | .001 | .005 |
| | N | 128 | 128 | 128 | 127 | 128 |
| Number Excep. § 161 AktG | Pearson Correlation | .035 | .334** | .068 | .186* | -.049 |
| | Sig. (2-tailed) | .695 | .000 | .446 | .036 | .583 |
| | N | 128 | 128 | 128 | 127 | 128 |
| Number Excep. DCGK § 5 | Pearson Correlation | .072 | .248** | .055 | .208* | -.102 |
| | Sig. (2-tailed) | .421 | .005 | .538 | .019 | .254 |
| | N | 128 | 128 | 128 | 127 | 128 |
| Number Excep. DCGK § 3 | Pearson Correlation | -.029 | .108 | .063 | .119 | .017 |
| | Sig. (2-tailed) | .744 | .226 | .483 | .184 | .846 |
| | N | 128 | 128 | 128 | 127 | 128 |
| ROIC 5y- Average | Pearson Correlation | .165 | -.021 | 1 | .036 | .057 |
| | Sig. (2-tailed) | .063 | .812 | | .685 | .524 |
| | N | 128 | 128 | 128 | 127 | 128 |
| Rev. Share Mgmt Costs | Pearson Correlation | .034 | .112 | .036 | 1 | -.084 |
| | Sig. (2-tailed) | .703 | .209 | .685 | | .347 |
| | N | 127 | 127 | 127 | 127 | 127 |
| Financ. Lev. 5y-Average | Pearson Correlation | .010 | -.112 | .057 | -.084 | 1 |
| | Sig. (2-tailed) | .909 | .209 | .524 | .347 | |
| | N | 128 | 128 | 128 | 127 | 128 |

* Correlation is significant at the 0.05 level (2-tailed).

** Correlation is significant at the 0.01 level (2-tailed).

Multivariate Analysis (Total Sample)

Descriptive Statistics

| | Mean | Std. Deviation |
|---|----------|----------------|
| 5y-TSR Growth | 14.36 | 18.46 |
| 5y Average ROIC | 10.67 | 8.79 |
| 5y- Rev. Growth | 8.78 | 11.51 |
| Revenue 2014 (EUR Mil) | 11865.74 | 26804.24 |
| Sup. Board Size | 10.98 | 5.80 |
| Exec. Board Size | 4.35 | 1.82 |
| Number Board Meetings | 5.61 | 2.08 |
| Number Sup. Board Memb. with PhD | 3.39 | 2.26 |
| Number of Committees | 2.98 | 1.90 |
| Nomination Committee (yes=1, no=0) | 0.63 | 0.48 |
| Audit Committee (yes/no) | 0.78 | 0.42 |
| Strategy Committee (yes=1, no=0) | 0.20 | 0.40 |
| Excep. § 161 AktG (Ranked) | 59.27 | 39.29 |
| Excep. DCGK § 3 (yes=1, no=0) | 0.59 | 0.63 |
| Excep. DCGK § 5 (Ranked) | 53.90 | 41.59 |
| Exceptions to DCGK Zif. 5.4.2 (yes=1, no=0) | 0.03 | 0.18 |
| Excep. DCGK § 5.4.6 Abs. 2, (yes=1, no=0) | 0.29 | 0.46 |
| Exec. Comp/Rev. Ratio | 0.0046 | 0.01 |

Model Summary and Change Statistics

| Model | Variables Entered | Method | R | R Square | Adjusted R Square | Std. Error of the Estimate | R Square Change | F Change | df1 | df2 | Sig. F Change |
|-------|---|---|-------------------|----------|-------------------|----------------------------|-----------------|----------|-----|-----|---------------|
| 1 | Revenue 2014 (EUR Mil), 5y Average ROIC, 5y- Rev. Growth ^b | Enter | .468 ^a | .219 | .200 | 16.50865 | .219 | 11.510 | 3 | 123 | .000 |
| 2 | Excep. DCGK § 3 (yes=1, no=0) | Stepwise (Criteria: Probability-of-F-to-enter <= .050, Probability-of-F-to-remove >= .100). | .515 ^b | .265 | .241 | 16.08576 | .046 | 7.552 | 1 | 122 | .007 |

a. Dependent Variable: 5y-TSR Growth

b. All requested variables entered.

Excluded Variables

| Model | | Beta In | t | Sig. | Partial Correlation | Collinearity Statistics |
|-------|---|--------------------|--------|------|---------------------|-------------------------|
| | | | | | | Tolerance |
| 2 | Sup. Board Size | .020 ^c | .213 | .832 | .019 | .676 |
| | Exec. Board Size | -.020 ^c | -.196 | .845 | -.018 | .581 |
| | Number Board Meetings | -.083 ^c | -1.049 | .296 | -.095 | .966 |
| | Number Sup. Board Memb. with PhD | .017 ^c | .177 | .860 | .016 | .697 |
| | Number of Committees | -.035 ^c | -.375 | .709 | -.034 | .692 |
| | Nomination Committee (yes=1, no=0) | .026 ^c | .296 | .768 | .027 | .796 |
| | Audit Committee (yes/no) | -.040 ^c | -.455 | .650 | -.041 | .782 |
| | Strategy Committee (yes=1, no=0) | -.036 ^c | -.451 | .653 | -.041 | .947 |
| | Excep. § 161 AktG (Ranked) | -.003 ^c | -.026 | .980 | -.002 | .565 |
| | Excep. DCGK § 5 (Ranked) | .025 ^c | .274 | .785 | .025 | .747 |
| | Exceptions to DCGK Zif. 5.4.2 (yes=1, no=0) | .050 ^c | .609 | .544 | .055 | .891 |
| | Excep. DCGK § 5.4.6 Abs. 2, (yes=1, no=0) | .030 ^c | .375 | .708 | .034 | .921 |
| | Exec. Comp/Rev. Ratio | .054 ^c | .655 | .514 | .059 | .904 |

T-Test Regarding Groups with and without Own-Risk Deductible for Supervisory Board Members (Total Sample)

Group Statistics

| Excep. DCGK § 3 (yes=1, no=0) | N | Mean | Std. Deviation | Std. Error Mean |
|-------------------------------|-----|---------|----------------|-----------------|
| 5y-TSR Growth | 1,0 | 18.8573 | 18.27275 | 2.18401 |
| | ,0 | 8.7314 | 17.16062 | 2.27298 |

Independent Samples Test

| | | Levene's Test for Equality of Variances | | t-test for Equality of Means | | | | | | |
|---------------|-----------------------------|---|------|------------------------------|--------|-----------------|-----------------|-----------------------|-----------------|----------|
| | | F | Sig. | t | df | Sig. (2-tailed) | Mean Difference | Std. Error Difference | Interval of the | |
| | | | | | | | | | Lower | Upper |
| 5y-TSR Growth | Equal variances assumed | .014 | .906 | 3.192 | 125 | .002 | 10.12588 | 3.17266 | 3.84680 | 16.40497 |
| | Equal variances not assumed | | | 3.212 | 122.44 | .002 | 10.12588 | 3.15220 | 3.88602 | 16.36575 |

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OVERALL INFLUENCE OF SOLVENCY II ON LATVIAN INSURANCE MARKET CHANGES

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Abstract

The purpose of the article is to analyse the positive and negative overall performance for the last seven years of the Latvian insurance market (changes of premium amount, losses amount, loss ratios etc.), as well as the operation of insurance companies as such (companies amount increasing/shrinking, or consolidation/merger, and bankruptcy) from the perspective of the Solvency II preparation and implementation process. Taking into account that 70% of the premium insurance companies are gaining from the Non-life insurance (examples: Motor Own Damage – MOD (or KASKO), Motor Third Party Liability – MTPL (or OCTA), Property etc.) the study will be oriented only on the Non-life insurance industry.

The task of the article is to identify in what sense the Solvency II implementation process has influenced overall changes in the Latvian insurance market, what has taken place during last 5 years. Taking into account that the insurance industry has an effect on the Latvian economy; the study gives the possibility to evaluate if SII implementation had a significant impact, or it was only one part of the factors of influence in the economy.

In this article the quantitative research method is used, the available Latvian insurance market statistics, as well as Insurance companies' balance sheets are analysed.

During the research process will be analysed positive and negative changes in the Latvian insurance market, as well as the Solvency II implementation process level of impact on these changes.

Key words: Solvency II directive, insurance, Non-life insurance, Latvian insurance market changes.

Introduction

The insurance industry has an important impact on the overall country economy situation. Starting from 1 January 2016, the EU insurance market will have changes in the solvency legislation. The so-called Solvency II (SII) is an EU legislative programme expected to be implemented in all 28 Member States, including the UK, by 1 January 2016. It introduces a new, harmonised EU-wide insurance regulatory regime. The legislation replaces 14 EU insurance directives.

The Solvency I Directive 73/239/EEC was introduced in 1973. Already after introducing this directive, EU Solvency regime understood that changes in risk management are needed, and started to prepare the Solvency II Directive. During the last 5 years the insurance industry started to feel the SII influence on the overall operation of companies.

The Solvency II Directive is a world-leading standard that requires insurers to focus on managing all of the risks facing their organisation. It offers European insurers a real opportunity to improve their risk adjusted performance and operational efficiency, which is likely to be good news for policyholders, for the insurance industry, and the European Union (EU) economy as a whole.¹

The aim of this article is to analyse the Latvian insurance market performance during last seven years and to see if there are were any significant changes, which could be the consequence of the Solvency II preparation process.

Research results and discussion

Insurance Market Analysis

During last seven years (looking at the period 2007-2015), the number of Latvian companies has decreased. For Non-life insurance the number of Latvian companies decreased from six (6) companies in 2009 to two (2) companies in 2015. For Life insurance – from three (3) companies in 2009 to one (1) company in 2015. That does not mean that companies left the Latvian market. Some companies went bankrupt, such as Balva in 2014². Some of the companies were bought by big Insurance groups, like Balta was bought by PZU Group³, and Baltikums with BTA were bought by the VIG (Vienna Insurance Group)⁴. The tendency of medium-sized companies to sell their portfolios to a big player with much greater capital could be explained with the new Solvency II requirements. According to the new Solvency II regime companies should calculate Solvency level for every line of businesses separately in order to cover all the risks that they hold. Therefore small and middle-sized companies with quite big portfolios (these companies are market leaders in Non-life insurance in different lines of businesses) were forced to look into risk relocation.

¹ <https://www.kpmg.com/US/en/IssuesAndInsights/ArticlesPublications/Documents/solvency-II.pdf>

² <http://www.balva.lv/lv/news/2013/aprilis/2013/17062013-lv/>

³ <https://www.balta.lv/lv/pzu>

⁴ http://www.vig.com/en/investor-relations/ir-newsad-hoc-news/detail/vienna-insurance-group-continues-expansion-in-the-baltics-1.html?tx_ttnews%5Byear%5D=2015

Some of the companies bought reinsurance programs, and in such a way relocating their signed risks to the reinsurance company, but for some it would not work and help keep the company from the bankruptcy, therefore the management decisions were to sell the company.

In relation to overall Insurance market performance, Non-Life insurance shows far worse results than life insurance comparing the Combined Loss Ratios (LR)⁵.

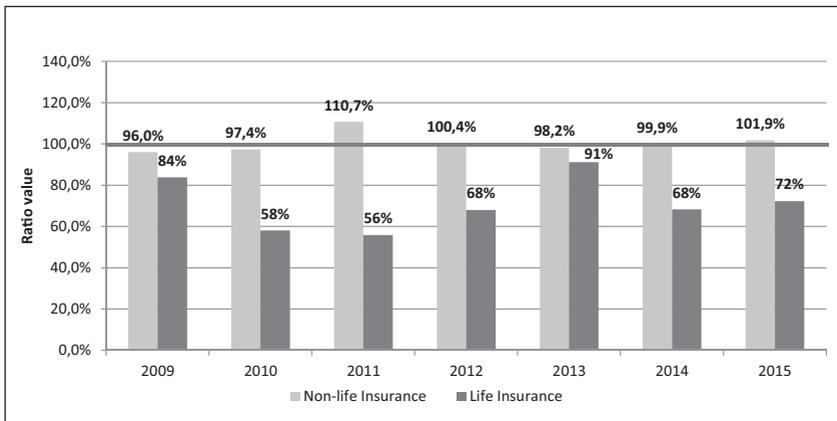


Figure 1 Combined Loss Ratio (%)

Source: author's construction based on <http://www.fktk.lv/lv/statistika/apdrosinasana/ceturksna-parskati.html>

Figure 1 shows the Combined LR level separately for Non-Life and Life insurance sectors during last seven years. Combining them together at a first glance it could be said that the level of the Combined Loss Ratio is around 70%-75% and Insurance Companies still are left with the 30%-25% profit. But before making such a conclusion it should be taken into account that the biggest number of the companies in the Latvian market are operating only in the Non-Life insurance sector. That is explained by the fact that for the Non-Life insurance sector is earned 87% of the whole Insurance premium, and only 13% in Life insurance.

⁵ Combined Loss Ration = Loss Ratio + Expense ratio (%)

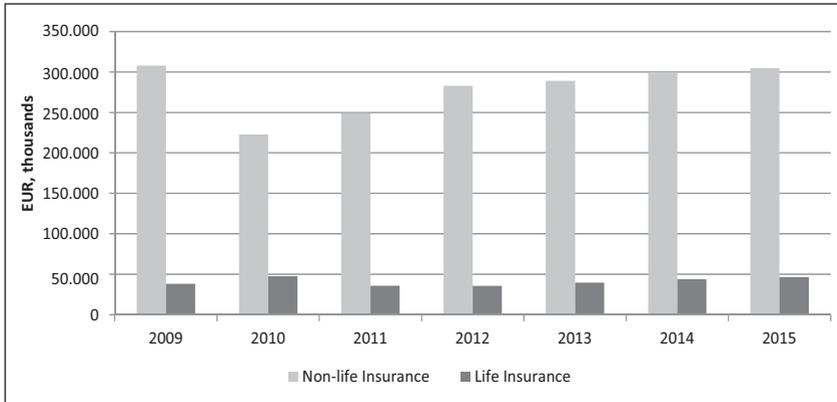


Figure 2 Earned premium for period 2009-2015, EUR thous

Source: author's construction based on <http://www.fktk.lv/lv/statistika/apdrosinasana/ceturksna-parskati.html>

Figure 2 shows the Earned premium distribution between insurance sectors. The importance of the shown Combined Loss Ratio in Figure 1 is more evident. Having such a large Loss ratio index in the future companies could face a problem with their obligation of fulfilment against policyholders. That is one of the reasons why the number of Latvian companies decreased.

Conclusions, proposals, recommendations

The Solvency II development process encouraged Insurance companies to make calculations inside their companies with the purpose to see if there is enough capital according to the new Solvency requirements. This process stimulated companies' management to look deeper into existing portfolios in their companies and to see if there are any problems separately by line of businesses. Concluding it should be said, that the Solvency II implementation process had a visible influence on the Latvian insurance market. Mainly it is because the Latvian market is quite small and in the market is operating small and middle-sized companies. Under the Solvency II requirements middle and small-sized insurance businesses were forced either to sell their business, or shrink the portfolio size. The greater number of the companies' management chose the first option – sell their business, otherwise the shrinking option would bring company to the bankruptcy.

In relation to the influence to the Latvian economy, it could be concluded that there is only a positive influence from big insurance groups coming to

the market. Firstly, it brings more protection to the policyholders. Secondly, as shown in Figure 2, the Earned premium amount increased during recent times, which mean that more taxes came into Latvia's budget.

It could be said that during the process of the Solvency II implementation, the Latvian insurance market became more stable and knowledgeable, and has started to develop and grow. There are some bankruptcy stories in the market, but there cannot be any changes without some losses.

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A CONSIDERATION OF SUSTAINABLE HR MANAGEMENT IMPLEMENTATION IN A SME CONTEXT: THE T OPTIMUS CASE

Džiugas Petruškevičius

B.Sc.

Abstract

Sustainable human resource management (SHRM) practices implementation in small and medium enterprises (SMEs) context is examined in this article. Various scientific articles and books, which analyse SHRM practices, were reviewed in the literature analysis. The scientific literature review allowed the identification of the problem that on the scientific level the majority of publications, which analyse SHRM practices, focus only on multinational enterprises (MNEs). As many authors agree, one of the main reasons behind the insufficient amount of publications regarding SHRM implementation in a SME context is the mistaken assumption that SMEs are just scaled down versions of MNEs. Analysis of the situation was performed in a Lithuanian family owned SME called T Optimus. This company sells chemical equipment for laboratories and provides consultations for its clients. At this time, 6 employees work in the company. Five interviews with employees of the company were conducted. The interviews were conducted using semi-structured method, which offers a certain degree of freedom and discovery. All interviews were recorded in the Lithuanian language, and later transcribed and then translated into English. Because of the small company size, the interviewees have been chosen in the best way to represent the different employees' opinions towards SHRM practices in the company's daily activities. The results of the qualitative research have shown that T Optimus perfectly corresponds to the SME traits that were mentioned by several authors – the company has an informal HRM system, a close relationship among employees is normal practice, and employees have flexible working conditions. Furthermore, despite the fact that the company's owner tries to implement some SHRM practices that are mainly related to work-life balance and health management issues, these practices are not sufficient and do not solve crucial problems such as frequent job burnouts, lack of expertise, retention of employees, limited career development and weak leadership, which are the issues that many authors distinguish as challenges that stops SMEs from achieving a better performance in the long run. The recommendations mainly focus on solving the company's current issues regarding the use of SHRM practices and offer an opportunity for T Optimus to implement SHRM practices in its daily operations using a composite model.

Keywords: management, sustainable human resource management, sustainability, small and medium enterprises, human resource management practice, corporate social responsibility.

Introduction

There is evidence (Darcy, Hill, McCabe, McGovern, 2014) in the scientific field that multinational enterprises (MNEs) are shifting away from an economic and organisational growth focus by adopting sustainable practices into their daily activities. The sustainable growth oriented companies, normally build management systems that take into account the triple bottom line (TBL) standard (Enhert, 2009; Spooner and Kaine, 2010), which encompasses not only economic, but environmental and social aspects as well. The whole idea of corporate sustainability has been developed for a long time. Primarily it was understood from only an ecological perspective, but recently the importance of sustainable human resource management (SHRM) has been recognised. However, the majority of publications in the scientific field focus only MNEs, assuming that small and medium enterprises (SMEs) are just scaled down versions of MNEs (Darcy, Hill, McCabe, McGovern, 2014). Lack of focus on the SMEs has led to the situation, where in scientific literature there is not enough research, which seeks to examine SHRM practices in the context of SMEs. Despite insufficient SMEs coverage in the scientific area, HRM remains an important practice, which in a constantly changing environment allows both SMEs and MNEs to respond to new challenges. As some authors (Bakanauskienė & Brasaitė, 2015) state, HRM practices have become one of the main forces that drive organisations.

For a small country like Lithuania that has a limited amount of natural resources, development and implementation of SHRM practices in an organisational context are very important. Furthermore, in most of the European industries SMEs account at least 99% of the businesses (European Commission, 2014). Therefore, the aim of this article is to investigate the implementation of SHRM practices in a Lithuanian family owned SME called T Optimus. This will be done by determining which SHRM issues this particular SME is facing and that will be solved by finding the right instruments, which could be implemented in the company environment, in order to respond to those challenges. The main *objectives* for this paper have been set to reach the research goal:

- Perform a scientific literature analysis on the SHRM phenomenon in order to identify the challenges and instruments that could be used in the context of SMEs and as a tool to respond to them;
- To identify what challenges of the SHRM are significant to this particular SME and what instruments, could be applied in order to overcome these challenges.

The *research methods* applied: literature review, semi structured interview.

Theoretical background for exploring SHRM in context of SMEs

In this part of the article the literature on sustainable human resource management practices and implementation will be analysed focusing on small and medium sized enterprises. The challenges and opportunities for implementing sustainable human resource will be identified. The model of sustainable human resource management practices implementation in a SME will be explained.

Human resources in small and medium enterprises

Definition of small and medium enterprise (SME)

The definition of a small and medium enterprise (SME) varies from one country to another and comprises a variety of undertakings. In Europe, SMEs are defined in the *EU recommendation 2003/361*. According to that (EU Recommendation, 2003) the main factors determining if a company can be defined as SME are the number of employees and the companies' turnover as one can see from the following table (see Table 1):

Table 1 Company classification according to the European Union

| Company category | Employees | Turnover | Balance sheet total |
|------------------|-----------|--------------------|---------------------|
| Medium-sized | <250 | <= 50 million euro | <= 43 million |
| Small | <50 | <= 10 million euro | <= 10 million |
| Micro | <10 | <= 2 million euro | <= 2 million |

Source: EU Recommendation (2003) no. 2003/361/EC.

SME in Human Resource context: challenges and opportunities

According to the literature, the SMEs human resource context is very different from the one that characterises bigger firms. First of all, the main feature of small firm HRM systems is the presence of *informal HRM* practices handled by owners-managers. Indeed, employment relations in SMEs are based on the unwritten customs and the tacit understandings that arise out of the interaction of the parties at work. The close working proximity and mutual dependence of employer and employees leads to informal accommodation and *flexibility* (Ram et al., 2001). Therefore, Informal HRM is based on this *close link between the manager and the employees* and this relationship can have direct influence on the HRM practice. In particular, the way owner-managers influence employees' motivation has also direct influence on the productivity of the organisation.

Challenges. This informality could lead to some drawbacks such as: hidden conflict, these conditions offer indeed greater opportunities

for inter-personal conflicts (Jones et al., 1992), instability, authoritarian management and the lack of formal policy can also lead to uncoordinated management of resources and loss of time. Therefore, main problems related to HRM in small companies are usually related to owner-manager behaviour or lack of financial resources to implement a more structured HR system. Indeed, the literature shows that one of the main problems is related to the owners' resistance to regulation as they find employment legislation complex and obscure (EU Recommendation, 2003); they are then largely ignorant of the legislation. As a consequence, their lack of attention in developing and formalising HRM systems may create barriers to organisational growth and productivity.

Employees' involvement is also a major issue in the development of SMEs. Few employees feel involved in decisions or that managers take cognizance of their view. Managers often inform employees about work changes, but do not consult or engage with them on decisions, which go against the fact that small companies have usually an informal structure that should make the relationship between employer and employees easier and closer, instead of creating conflicts. Furthermore, the literature also showed how lack of special expertise and lack of impact could be one of the causes of the lack of HRM practices in SME (Miles et al. 1997; Westhead and Birley, 1995).

Opportunities. This HR system can have some advantages such as: harmonious team work, little bureaucracy, simplified human resource, employees' view the company as a team or family and also the company success is shared by all employees. It also allows employees to develop their own developmental programs or researches. Moreover, small firms do offer more varied work roles and greater opportunities for close face-to-face relations in a flexible social setting with less bureaucracy of the larger enterprises. All of this gives power and motivates employee by giving them a reason to thrive inside the organisation, to innovate and perform better.

Sustainable human resource management

Concept of "sustainability"

The concept of SHRM has recently emerged in the HRM as an answer to an always more changing environment and to a shift in the working needs of people. Indeed, the long-term socially and economically efficient recruitment, retainment and disemployment of employees will be the hardest challenge of future human resource management in a dynamic external environment (Zaugg, Blum and Thom, 2001) and it will specifically impact strongly small firms that have less resources to handle this constant change. However, there is also an internal context that has been changing in relation to people's new working priorities such as the work-life balance,

the importance to find a “call-job” where they can identify themselves with the company’s culture, which affects their motivation and the likelihood to remain in the company. These two dimensions, along with the rising importance of environmental issues and stakeholder theory (Freeman, 1984) can explain the reason why the recent human resource literature is now trying to find theoretical frameworks to define this new human resources dimension.

In order to better understand what sustainable human resources are, one firstly has to define what the word “sustainable” means. Indeed, this term has been used with many different meanings in the common language, but was born with a social meaning that became popular after the definition of the United Nation World Commission on the Environment and Development (also called the Brundtland Commission): “Sustainable development is a development that meets the needs of the present without compromising the ability of future generations to meet their own needs.” (as cited in Ehnert, 2009).

Therefore, some key concepts related to sustainability can be derived from the above definition: sustainability must refer to maintaining, renewing or restoring something specific (Sutton, 1999), but it also includes an ethical concept of fairness in the trade-off between current economic goals and future societal and environmental needs (Wilkinson, Hill, Gollan, 2001). This concept was later applied to businesses by Elkingson (as cited in Ehnert, 2009) in its “*triple bottom line*” approach where he advanced the idea that in the organisations there are three “sustainability principles” – economic prosperity, environmental integrity and social equity. These principles have been discussed in the literature for their possible incompatibility and their maybe too optimistic view of business internal dynamics, but are still globally accepted by human resources scholars. Once defined what sustainable means, it is now easier to understand how the concept can be associated with human resources management.

Sustainability in HRM

The theory of sustainability in HRM grew from the debate related to the role of human resources (HR) inside the organisation. Indeed, the perception of the role of human capital inside organisations has been changing in the recent history. For instance, consider Taylorism and the scientific human resource management that saw the human capital barely as a factor to finalise tasks and reaching organisational goals. This view has been constantly criticised by those who, on the contrary, believed that employees are assets that have to be developed and cherished (Brewster and Larsen, 2000). However, even in this second view of HR,

they still imply that human resources are not valuable if they do not contribute to financial performances while sustainable human resource management aspires to see them as more than some financially useful assets (Ehnert, 2009).

Also Ehnert (2009) categorised the meaning of sustainability in the HRM context in these three different ways: normative, efficiency-oriented and substance-oriented.

The “normative” definition interprets sustainability as a moral, ethical value derived from the Brundtland Commission definition and it follows the idea that companies are responsible for their employees and have a social duty for current and potential employees by taking into account well-being, health and to reduce the impact of work on employees. This is a crucial aspect for attracting a new work force and to retain them since it is proved that current young talents expect their employers to be sustainable and socially responsible (Rendell, Michael, 2007).

The “efficiency-oriented” interpretation of human resources sustainability tries to see sustainability as an economic principle that minimises the impact of the organisations on natural or social resources. This perspective is closely linked to environmental management and the objectives are related to reduce costs or creating value by optimising resources.

The last one, *“substance-oriented”*, wants to sustain the corporate resources based on achieving long-term balance of resources consumption and reproduction. If this approach is implemented in a human resource context, the organisation has to balance consumption and reproduction of human capital by fostering the regeneration of human resources. This vision offers strategic potential for HR because it encourages the company to think about the long-term role of HR in the organisation (Ehnert, 2009).

Concept of sustainable enterprise in the context of SMEs

Traditionally, the SMEs context was believed to be local and segregated from other markets, especially from the international competitive environment (Etemad, 2005). However, globalisation, the rise of the Internet and digital communications has modified the competitive landscape creating an increasingly competitive pressure for small firms. As a consequence, it is fundamental for SMEs to learn how to compete in an efficient way in order to survive. For this reason, they have to face a huge challenge of competition and changing environment given the small amount of resources they have. At the same time however, they have an informal and flexible environment that, if well leveraged, can lead to their success through the right valorisation of their key resources.

Therefore, in the small firm context, the importance of sustainable human resource management as a strategic function seems to have an even bigger role to play than in bigger firms due to the limited resources that they can deploy and for this reason is strongly related to the resource based view. Indeed, given contemporary financial markets constraints and limited growth in demand, small firms are focusing increasingly on how to use existing resources more efficiently and effectively (Gallego et al., 2012), such as for instance human resources. Therefore, a sustainable management of employees (both in the normative, and efficient oriented and substance-oriented perspective of the definitions above) can be the key for sustainable performance.

Thus, in order to be effective, sustainable human resource management has to be linked with the company strategy (SHRM, 2011). This also is because sustainable human resources practices are focusing on a long run perspective that in order to bring results has to be placed inside the strategic framework of the company.

Moreover, a sustainable SME should combine economic, social and ecological sustainability, i.e. to provide decent working conditions and socially and environmentally responsible practices. Sustainable enterprises are productive and competitive, prepared to innovate and to adopt technologies, organisational and business processes that enable them to provide product and services at prices.

In particular, human and social capitals of the enterprise are sources of long-term competitive advantage of enterprises (Hirsig et al., 2014). Social capital enables employees and the enterprise's extended network to act together consistently within the relevant competition laws, to create synergies and build teamwork and partnerships. It also sets the context in which human capital can be developed through various learning processes. By human capital, we mean the skills, knowledge, competencies and attitudes that reside in the individual employee; while social capital is the trust and confidence, communication, cooperative working dynamics and interaction, partnership, shared values, teamwork, etc. among these.

In a sustainable enterprise, HRM is based on the core principles such as involvement and participation; labour-management partnership; respect and recognition; equality and non-discrimination; enabling the human resources through good work design and organisation; competency and skills development and providing good working conditions; sharing gains. The sustainable enterprise could be achieved through the combination of three "drivers" at the state, society and enterprise level:

- On the state level, laws and regulations providing a good business-enabling environment for SMEs are necessary.

- On the society level, social dialogue between the various stakeholders such as government representatives, employers and worker's associations, through all kind of negotiations, consultations, or simply information-sharing mechanisms are key to achieving better working condition. These measures are very cost-saving for the SMEs and completely rely on management's will and ability to create a climate of trust, respect and value within the company.
- On the enterprise level, the company can promote *sustainable management* through corporate social responsibility (CSR).

How does CSR help to achieve SMEs competitiveness and sustained productivity?

Thanks to CSR practices, the improvement in the products and production processes results in a better customer satisfaction and loyalty. Moreover, higher motivation and loyalty of the workers brings more creativity and innovativeness. Also, CSR creates good publicity due to the award of prizes and enhanced word-of-the mouth. Thanks to a better company image, it ensures an enhanced position on the labour market and better networking with business partners and authorities, including better access to public funds. Finally, "CSR brings cost savings and increased profitability due to a more efficient deployment of human and production resources, and an increased turnover due to a competitive advantage derived from the above." (Bacon and Hoque, 2005).

The actions companies already take in the field of social responsibility can be reinforced by explicitly creating awareness on the benefits of CSR for SMEs. These include "establishing closer links with entities with which they share values, such as business associations and multilateral organisations. They can also directly communicate with consumers through environmental and social labels and decrease operation costs through environmental efficiency measures and improve productivity and quality through better management encouraged by CSR" (Cici and Ranghieri, 2008).

A good point is that a family-owned SME can usually take quick decisions on implementation thanks to its simple structure so it should take advantage of the internal human and social capital that enterprises need for the long-term. Productivity and competitiveness can precisely be achieved by hiring the right people according to non-discriminatory criteria, and irrespective of their gender, ethnic origin, status, health condition or other social characteristics irrelevant to performing the tasks. Furthermore, enabling them through good work organisation, work environment and management practices, as well as providing opportunities for continuous training to build and upgrade their knowledge and capabilities through

formal and informal learning will be the key to develop a corporate culture of mutual trust and confidence. This will retain the employees by making them feel more committed, motivated and engaged. In SMEs, sustainable enterprise processes and management greatly contributes to improve not only working and living conditions of workers, but also enterprise productivity in the long run.

How to achieve sustainable HRM in SMEs?

“Decent work” (Hirsig et al., 2014) is a key indicator of good sustainable human resource practices. It is essential to achieve the CSR approach and is characterised by promoting social dialogue, workplace cooperation, developing skills, employee employability, creating a safe working environment, ensuring equality, improving general conditions of work and by respecting human rights at the workplace.

Promotion of social dialogue and workplace cooperation: meeting the stakeholders' concerns and applications through social dialogue helps to increase quality and productivity through stronger personal commitment, reduce absenteeism and labour turnover, lower risk of labour disputes, a safer working environment and overall increased job satisfaction.

Development of skills and employability: in order to develop and sustain the high level of competence, the enterprise must integrate human resource development in its business strategy. It must also ensure equal treatment of men and women in developing their skills, competencies and productivity. Moreover, as job training is quite expensive, companies should be encouraged to perform different tasks and not just to specialise on a single one. They will be gain a better understanding of the enterprise's processes, operations and goals, which will result in a higher motivation and boost innovation.

Creating a safe working environment: the active prevention of accidents inside the enterprise protects employees' health and represents a key component of savings for the SMEs. The employees of an enterprise, both workers and managers alike, must be provided a safe and healthy environment. It reflects the enterprise's concern for the welfare and well-being of its human resource. People respond to this with greater identification with the enterprise and thus with increased willingness and commitment to contribute better to improvement of its economic and environmental performance.

Ensuring equality of treatment and non-discrimination: enterprises must eliminate any form of discrimination at every level, e.g., providing training to all workers on the importance of eliminating discrimination in the workplace. Management must make sure that remuneration, terms and conditions of employment are not influenced by race, colour, sex,

religion, political opinion, nationality, or social origin. Harassment can't be tolerated at the workplace. An explicit policy of non-discrimination and equality of opportunity setting out the shared values, expected behaviour and practical measures involved has to be adopted. Management should not base decisions concerning selection of employees or apprentices, promotion, transfer or dismissal on any of the following criteria: race, colour, sex, religion, political opinion, nationality, social origin, or marital or family status, nor discriminate against other categories of workers, such as HIV-positive employees. The sustainable enterprise does not only ensure non-discrimination, but goes one step further and encourages diversity within its workforce improving general condition of work.

Improving general conditions of work – work design, working time: arrangements, leaves and days off, remuneration arrangements, etc. should comply with national labour regulations, provide the rest and recuperation needed and take into consideration the special arrangement required by family concerns and special groups while at the same time meeting the needs of the enterprise. The company should ensure that employees are able to get a sufficient amount of rest between shifts; that total weekly hours are kept within reasonable limits and overtime is compensated both financially and with additional periods of rest; and that workers are given a minimum period of annual leave to recuperate and spend time with family, friends and community.

Taking active measures to ensure production and supply chains do not involve child labour or forced labour: the worst forms of child labour threaten the child's life, physical development, and/or moral well-being. Companies must adopt a clear policy to not use or support child or forced labour in any form. Further, management must take adequate steps to ensure that any product of child or forced labour does not end up in any part of their supply chain; this includes entering into agreements with suppliers and the periodic monitoring to ensure compliance with agreements. The enterprise can take proactive steps to assist the community in combating child labour, such as contributing to funding of nearby schools.

Developing a sustainable SME HRM model

In this section sustainable HRM practices implementation into a SME context will be analysed using C. Darcy's, J. Hill's, T. McCabe's and P. McGovern's (2014) composite model (Appendix 1). This model demonstrates organisational sustainability practices development in the SMEs context based on a resource-based view. To develop this model the authors (Darcy, Hill, McCabe, McGovern, 2014) have merged several different theoretical frameworks that were developed for SMEs and

offered by different academics (Carson, 1990; Wright et al., 2001). This model represents how SMEs can achieve organisational sustainability by developing the elements of effectiveness, impact and efficiency (Y-axis), and by going through the evolutionary stages (X-axis). The model itself consists of 2 main interrelated parts: stages of sustainability development (reactive stage, tinkering stage entrepreneurial stage and proactive stage) and three anchor points (employee relationship and behaviours, people management practices and well stocked HC pool).

The first part of the model is adapted from the *business life-cycle* model (Carson, 1990) and is concerned with actual organisational sustainability implementation into practice starting with the company's establishment and its future development cycles:

Reactive stage. This stage is concerned with initial human resources management activity. New SME that enter the markets, start their HRM activities based on the industry context norms. In almost every case, all HRM activities are being done by the owner himself or by hired manager based on an instinctive or intuitive approach which may seem to be effective at the very beginning (Darcy, Hill, McCabe, McGovern, 2014). In other words, it can be stated, that HRM in these SMEs does not exist, or at best is done in very primitive ways. The company is highly focused on an operational focus.

Tinkering stage. This stage can be identified as HRM that occurs because of the need to motivate employees, but these activities are more random and disjointed because they are done spontaneously. The driver that forces the company's owner or manager to think about HRM is the need to increase sales and continue to grow as a company. Even though company demonstrates the shift in its HRM activities it still focuses on the operational level.

Entrepreneurial stage. This is the stage where HRM is identified as a value generating activity but which is still carried on by the manager or director as part as his / her responsibilities at the company. At this stage HRM management becomes a more formalised approach to deal with crises or aspects that are related with organisation's survival (Darcy, Hill, McCabe, McGovern, 2014). The shift of thinking also could happen because of company's management decisions to acquire, use and develop a talent pool. This stage demonstrates the HRM shift from an operational focus or orientation to a more strategic one.

Proactive stage. This stage could be defined as a moment where HRM is being controlled by a HRM expert or a specialist employed by the company. The HRM activity in this stage is identified and developed as integrative and proactive approach by ensuring better company's governance and

devotion towards the achievement of clear short-term/long-term goals. In short this stage can be identified as professional HRM.

The second framework part was adapted from the Wright et al.'s (2001) model, which originally was designed to indicate the shift as a company grows from operational to strategic focus. Each of the elements is reviewed below:

Employee relationship and behaviours. This component could be considered as operational focus activity. However, it is very important if the organisation's owner/manager that is responsible for HRM wants to have committed and loyal employees, who will be willing to do extra jobs if needed to achieve organisational goals. According to Wright et al. (2001) in order to increase employees' commitment owner/managers in SMEs could consider signing a psychological contract or implementing organisational citizenship practices.

People management practices. This operational focus concept includes formal structures and processes in place which drive and reward desired behaviour amongst those staff in the human capital (HC) pool. However, in

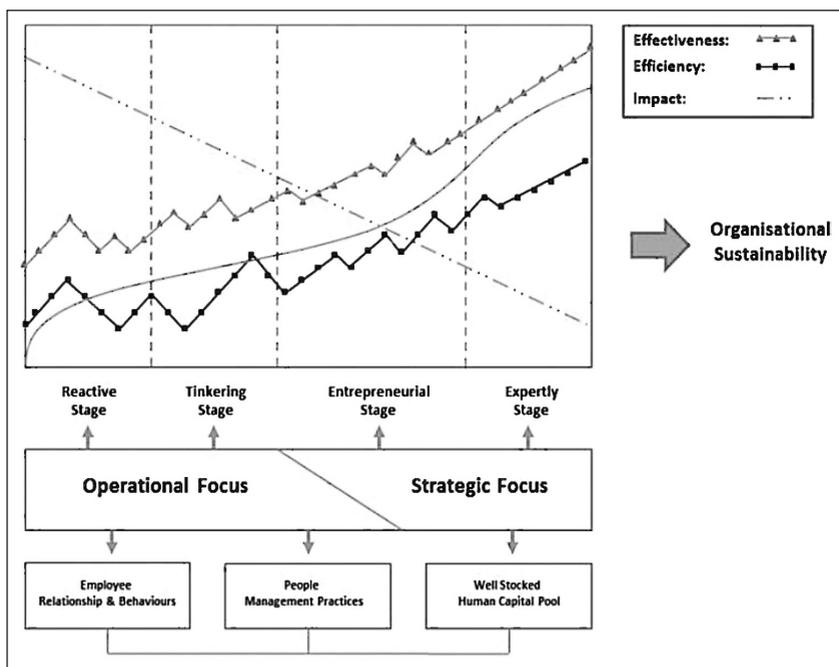


Figure 1 Composite model

Source: Colette Darcy, Jimmy Hill, TJ McCabe, Philip McGovern, (2014).

SMEs the formalisation is quite low, so owner/managers should consider if there is a need to implement formalisation of HR structures and process within small firms.

Well-stocked HC pool. This element could be identified as one that creates competitive advantage among other companies. Since SME does not have huge capacity to carry long employees' introduction periods or training, they from the beginning should be placed in position where they could generate value and do a significant contribution to the company work. One of the most important responsibilities of owner/managers in SMEs during this phase is to consider the development direction of human capital pool which would allow to develop general and organisational related levels of skills or to achieve better alignment between HC skills and the organisation's strategy. According to Wright et al. (2001) in order to develop HC employees' owner/managers in SMEs should consider their employees' knowledge, skills and abilities improvement.

Research methodology

In this section the methodology of the conducted research is described. This article investigates a possibility of SHRM implementation in a SME context with an example of particular Lithuanian company – T Optimus, and therefore a project part could be identified as an organisational case study. T Optimus is a small company, a family business, which is located in Kaunas, the second largest city in Lithuania. The company mainly sells chemical equipment for laboratories and gives consultations to its clients. At this moment, 6 employees work in the company.

According to the *EU recommendation 2003/361* this company could be considered a SME. The main specialties at the company are: a director who is also responsible for HRM, a project manager, a chemist-metrologist, a financier and two managers, one is responsible for marketing and communication with external stakeholders, while the other is responsible for communication with biology related clients and partners.

In order to answer the research question “Why do SMEs usually not implement sustainable human resource management practices, why they should and how could they do it?” and reach its goals, a qualitative research method was used. The method is analytical and applied to the specific company. As a result of the analysis it is expected to generate a systematic overview of the indicated area of the research. Five interviews with employees of the company have been conducted. All interviews were recorded in the Lithuanian language, transcribed and then translated into English. Since the company has only 6 employees, the interviewees have been chosen in the best way to represent the different employees' opinions

towards sustainable human resources management and possibility to implement it in the company's daily operations.

The interviews were conducted as semi-structured, allowing for a certain degree of freedom and discovery. All interviews started with general questions about the interviewee's current position at the company with little bit of history how he/she has started their career at the company; later on the interview was followed using the interview guide. It is worth to mention, that the interview guideline was differently prepared for the employees and director of the company. In this company case, the director is responsible for HRM at the company, so she was asked deeper questions in order to get a broader view about the situation in the company. In order to get exact view of the variety of the ideas and feelings interviewees share, most of the interview questions were open. The reason for choosing this type of research is partly due to the research goals that were set at the beginning and partly due to the fact that in this research it was expected to emphasise the meaning of SHRM in the SME context, to understand the challenges that SMEs have to face in order to implement sustainable HRM practices and what advantages the decision to implement sustainable HRM would bring to the organisation. With the described research method, it was expected to find a connection between the SHRM practices implementation in a SME context and positive long-term effects in the process of organisational changes.

In order to get representative results from the interviewees, most of the questions were based on the books and articles that were analysed in the literature review and the characteristics of the organisation. The further qualitative data analysis consists of results analysis and interpretation. Finally, showing the findings of the empirical research, a guideline will be established for a future T Optimus action plan and recommendations.

Empirical analysis of T Optimus HRM practices

Presentation of interview results

In the following sections the findings of the interviews are presented in three divided categories: approach to achieve HRM practices at the company, approach to achieve sustainable practices at the company and other issues concerning human resource management in T Optimus.

Human resource management practices in T Optimus

The interviews revealed and gave some insights about the organisational structure of T Optimus. The organisational structure of T Optimus is presented in Figure 2. As it can be seen from Figure 2 the structure of the company is simple. The idea is that owners formulate the main

areas of work and main directions and all other staff according to their competences tries to complete their work tasks. All the employees have their own responsibilities. Managers are responsible for marketing and communication with external stakeholders. The chemist-metrologist is responsible for calibrating the equipment the company is selling and making summaries of the equipment and electronics that were imported by the company and sending it to governmental institutions. Financier is responsible for all the activities that are related with the financial situation of the company and accounting. The project manager is responsible for the maintenance and delivery of the laboratory equipment.

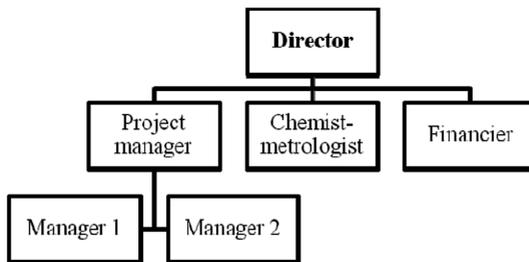


Figure 2 Organisational structure of T Optimus

Source: compiled by author

At the current stage of the company the HR department or the human resource manager is not needed as the company is small and all the activities related with human resource management are performed by the director of the company. Therefore, there is no need for an employee dedicated to carrying only the tasks that are related with human resource management. If the company was growing, established some branches in other cities or countries and became bigger then a new employee responsible for human resource management would be essential. Everybody among the personnel seems satisfied with the current way of human resource management in the company.

Interviews revealed that both formal and informal HRM practices exist in the company. Formal practices do exist to the extent that they comply with national laws, which require designating someone in the staff to be responsible for fulfilment of employee's needs (this role has been attributed to the project manager). He has to ensure that the needs of the employees are represented properly. Furthermore, there is a document available to the employees with the labour laws. The director of the company is formally in charge of the human resource management in the company. Every two years the company asks each staff member to check his health

due to the work environment. Moreover, written commands are released in the company when someone goes on vacation or on a business trip.

Still, informal practices are very common as it is a small family business. According to the employees, the most important moment of the day related to information and communication is the coffee time before the work starts at the beginning of the day. This coffee time with colleagues before the workday serves the company as an informal meeting. There are no formal and official meetings in the company. At the beginning of the week the company has an informal meeting about the tasks and activities of the week. They want their people to feel good so they communicate during all day. If a problem occurs, they try to solve it by themselves at first. If it's impossible or if the purpose needs a financial decision, they then refer to the director. The informal human resource management practices also include after-work activities such as various trips and events like theatre's performances. Moreover, the relations between employees are not formalised and that sometimes creates tension between employees because some of them are family members with different roles at home.

The information is transmitted also through the usual tools: e-mail, phone or face-to-face conversations. The formality degree depends on the situation. For example, if some tasks need to be completed by chemist-metrologist, they usually communicate by e-mail. In this way, she knows what tasks have to be done and what are the comments about that. For another example, the requirements of their laws are done in a way of written commands. When somebody goes on vacation or on a business trip, they release a command in a company. In this way other employees know which employees they are substituting.

Sustainable human resource management practices in T Optimus

The interviews gave answers and some insights into the approach to SHRM management practices in the T Optimus case. SHRM practices include safe working conditions and environment with health check-ups, well-being of employees, work-life balance, involvement in pursuing social and ecological goals, and talent pool.

Safe working conditions and environment. The director of the company mentioned that the company tries to keep safe working conditions and environment, which also include health check-ups. All employees of the company must check their health once in a two years period. The interviews also revealed that employees are provided with additional health insurance and they can get additional health services and can vaccinate against influenza if they wish to. The company is trying to provide as best health conditions as possible. All the employees are provided with the safety tools such as work clothes and gloves, and other ones

like trolleys to avoid injuries. The company usually evaluates the sanitary environment. More exactly, it evaluates what is the level of radiation and lighting, etc. in the company's office. To keep the working environment safer, they change electronic equipment regularly to meet safety standards.

Well-being. The well-being of employees is closely related with safe working conditions and environment and is very important in this company. The company ensures sufficient opportunities for recovery both during work breaks and after work. Employees can take a free hour from work and go out to deal with personal questions. In order to keep a positive well-being and atmosphere in the company all the employees are communicating a lot. All employees can express their opinion freely without any hesitations. To boost well-being of employees various trips are organised and various events are prepared. Work-related questions are usually discussed during the coffee break in the morning as a type of an informal meeting. A positive and informal atmosphere in the company also helps to boost well-being of employees. Some employees describe the working atmosphere in the company as perfect or really good. However, as the company is a small family business and as the relations are not formalised this sometimes creates tension between employees because some of them are family members with different roles at home. As the number of staff is small, all employees know each other and are able to trust each other. According to one of the managers "because all of the employees are trustworthy and know each other well, the atmosphere is mostly good, unless there is a big crisis in the company".

Work-life balance. The company offers an opportunity to manage work-life balance for the employees themselves. The company is flexible and dynamic therefore employees can easily take some time off in order to deal with personal issues. The organisation ensures sufficient opportunities for recovery of both mind and physical powers. The employees who work part time do not have any issues related with work-life balance. Part time employees are allowed to do and finish their work when they are able to do that; they only need to follow the deadlines. Work-life balance question is more important for employees who work full time. Full time employees are not always able to manage the work-life balance and sometimes it is even impossible when there is a lot of work especially before the Christmas period. According to the director these two employees "work as much as it is needed and when it is needed". At the end of the accounting year, from October to December, all employees get some extra work that must be done and which is not directly related with their position at the company. Therefore, it is harder to keep a balance between work and personal life.

Talent pool. The concept of talent pool in T Optimus case involves training of employees, qualified staff, and investments into studies and

development of employees. Since the company operates in food industry and scientific sector, it really needs qualified staff. Therefore, the company encourages additional learning. T Optimus gives its employees equal opportunities to increase their knowledge and expertise during training sessions and seminars, which are considered to be very useful. However, not all positions require training and development equally because of different line of work. Qualified staff is essential for the company to ensure its main functions. Therefore, the company encourages additional learning and supports the studies of two employees. The company employs young and talented people who can develop and grow in the company and creates the conditions for them to learn. Some employees go on business trips and other seminars, exhibitions and training courses abroad. According to the director “this process is constant and is happening all the time”. Only the training courses are not done regularly. Employees usually can participate in these training once or twice a year and most of the costs are covered by the company.

Social and ecological goals. As the project manager says “the company of course is trying to be conscious” and is involved in the fulfilment of social and ecological goals. Although the company is small it provides support for various social projects every year. As director of the company states, “we are open to the needs of the society”. The company supports orphanages, church, students’ trips to various conferences and exhibitions. The company usually tries to support the field it is working in. In the area of the ecology, the company is recycling and accounting for packing, as the products of the company are potential pollutants. The company imports electronic equipment and packing and therefore it is obligated to account and hand in the packing. The ecological requirements, which are being controlled by various governmental institutions and the Manufacturers and Importers associations, are quite strict. The company is also trying not to pollute environment and to save both natural and human resources.

Other issues concerning Human Resource Management in T Optimus

Among the other findings, the most relevant ones are the job-burnouts at the company. Since the growth rate of the company is quite slow, regarding the fact that the last employee was recruited several years ago, T Optimus has chosen to emphasise an employment model in which most employees are part-time workers. This leads to the situation where the director and project manager, who work at the company as full time employees, have to carry most of the job on themselves. The interviewees pointed out some insights about the current T Optimus employment model – in normal occasions this model works fine and every employee is able to finish his/her work on time. However, during some periods

(Christmas, Easter period, etc.) the amount of tasks increases greatly, and that leads to the situation when the director and the project manager have to carry most of the work on themselves. This leads to a situation where two people at the company repeatedly face job-burnouts. Moreover, since during some periods the amount of work and duties are not consistent. Three major themes were identified as sources of some employees' burnouts:

1. *Lack of planned allocation of work.* The workloads increase during distinct periods of time and splitting the job is not consistent. Only 2 full-time employees are doing most of the work, which sometimes is not even directly related to their positions.
2. *Too strong focus on part time employees.* Company's director identified that she would love to see part-time employees who are studying at the moment as the full-time workers. However, one of them during the interview mentioned, that he still is not sure about the career in this company.
3. *Wrong assumptions about current employment model.* The issue here is that the director of the company, who is also responsible for human resources management, thinks that current HRM model suits the current company's needs.

The company plans to solve this issue in a long run by turning the two studying employees into full-time workers.

The director of the company clearly identified that the competition at chemical equipment distribution sector is quite intense and they are looking for new products or opportunities, which would allow gaining a competitive advantage. On the other hand, director clearly pointed out that she is afraid to think about growth since the 2008 crisis hit hard the laboratory equipment market and the unstable bilateral relations between Lithuania and Russia, which caused an embargo on Lithuanian dairy products and had huge negative impact on dairy sector, and which is one of the main company's target markets. In this situation one can identify a possible paradox – main management of the company is talking about possible growth, but at the same time they are not willing to fulfil these plans.

With regard to possible company's expansion, company director stated that they mostly employ the members of their family and friends. The main idea behind this is the faith that relatives and friends are more loyal. Their qualities do not play the most important role during employment process, because director believes that most of the skills and qualifications can be developed over the time, while the same does not apply for motivation and loyalty.

Discussion of interview results and recommendations for T Optimus

In this part of the article the SHRM practices and their implementation in T Optimus case will be discussed. The recommendations for the company about the further steps in sustainable human resource management practices will be provided.

Interpretation of interview results

After having presented the results of the conducted interviews by the main topics of interest, this section deals with interpreting and analysing the research results in terms of SWOT analysis (strengths, weaknesses, opportunities, and threats) of the human resource management situation in the company with the focus on sustainable human resource management. The results of SWOT analysis are provided in Table 2.

Table 2 SWOT analysis of human resource management in T Optimus

| Strengths | Weaknesses |
|---|---|
| <ol style="list-style-type: none"> 1. Training programs and sessions are available to all employees; 2. Established practices to take care of employees' health; 3. Communication between all employees; 4. Positive well-being of employees; 5. Involvement in sociological and ecological goals. | <ol style="list-style-type: none"> 1. Job burnouts faced by full time employees; 2. Limited career development; 3. Shortage of employees; 4. Paradox – talk about possible growth and lack of self-confidence for growth plans. |
| Opportunities | Threats |
| <ol style="list-style-type: none"> 1. Company's growth; 2. Employment of human resource manager and additional number of employees; 3. Implementation of employment criteria and guidelines; 4. Development of long-term strategic plan involving human resource management; 5. Cooperation with NGOs. | <ol style="list-style-type: none"> 1. Fierce competition in the sector; 2. Not stable political environment in the country; 3. Shortage of qualified employees in the market. |

Source: compiled by author

Strengths. Training programs and sessions are available to all employees upon the need and request. This shows that T Optimus focuses on employees' development and learning. In this way the company not only develops an employee, but also improves the performance of the company,

as it needs very qualified employees in order to be able to survive. Other strength is that established practices to take care of employees' health exist in the company, which is closely related with the positive well-being of employees in the company. This goes hand in hand with the normative definition of sustainability by Ehnert (2009) that companies are responsible for their employees and have a social duty for current and potential employees by taking into account employee well-being, health and reduction of work's impact on employees. Company's involvement and fulfilment of sociological and ecological goals support the efficiency-oriented interpretation of sustainable human resource management by Ehnert (2009) according to which company tries to minimise its impact on natural or social resources. The company is saving both natural and human resources; tries not to waste them and of course, it is recycling.

Weaknesses. One of the most important weaknesses is that full time employees suffer from job-burnouts. This means that the company is not able to ensure well-balanced working conditions for full time employees. In this case the company cannot ensure decent working conditions exactly in the area of working time. The paradox that exists in the company can be also considered as a weakness. The director is not neglecting potential growth of the company however the lack of self-confidence for the fulfilment of growth plans exists. Such ambiguity exist that a company is wishing to grow however it is not willing to risk. As a company is a small family business the limited career opportunities can be identified. Few employees were employed as assistants at the beginning and they were promoted to the positions of the managers. However, as the company is small, there is no space for the career growth.

Opportunities. The interviews also revealed some opportunities for further development of human resource management in T Optimus. The most important opportunity for the company would be the growth. As the company grows it would get more activities related with human resource management therefore another opportunity would be to employ a human resource manager in the company. Additional number of employees would be the opportunity for the company to solve the problem of job-burnouts for full time employees. The development of long-term strategic plan involving human resource management would help the company to clarify its both short-term and long-term goals and to develop its sustainable human resource management plan. As company does not have such a plan at this moment it is hard for it to specify its activities that are related with sustainable human resource management. With such plan it would be easier for the company to clarify its specific goals and to reach them. One of the opportunities for the company would be collaboration with non-governmental organisations and trade unions. According to Cici

and Ranghieri (2008) business associations and multilateral organisations help to reinforce and create awareness on the benefits of corporate social responsibility and sustainability for small companies.

Threats. There are a few threats that have been identified during the interviews. One of the threats is the fierce competition in the sector. The theory (Etemad, 2005) also supports the fact that increasing competitive pressure is especially noticeable for smaller firms. In such a competitive environment small companies need to learn how to compete in an efficient way in order to survive. Sustainability can be one of the tools of the competition in the market for small and medium sized enterprises. As theory (Ehnert, 2009) suggests, sustainable enterprises are productive and competitive, prepared to innovate and to adopt technologies into organisational and business processes. Another threat of the company is not stable political environment. The laws in Lithuania related with various aspects are changing all the time. Therefore, it is sometimes hard to plan the operations and costs of the company when the political environment in the country is changing so fast and often. Therefore, this is threatening the company's effort to be sustainable.

Implementing a composite model in the T Optimus context and recommendations

After having presented the result of the interviews by categorising into the main topics of interest, this section deals with interpreting and analysing the research results in terms of applying C. Darcy's, J. Hill's, T. McCabe's and P. McGovern's (2014) composite model (Appendix 1) to T Optimus' context. The model can be divided into two sections: *business life-cycle* and *company's shift* frameworks.

Regarding *business life-cycle* framework the author can state that the company already crossed the reactive stage when human resources management has been understood in very primitive ways and all the activities related to HRM are at an initial level. In the T Optimus case, during the interviews, the director pointed out that there was a focus on both short term and long term goals. This answer indicates that the company's management is focusing on both operational and strategic level activities. Moreover, this company could be identified as one which is in the middle of tinkering and entrepreneurial stages, since the HRM is being understood as value generating activity. The importance of HRM activities shows the director's statement that company needs qualified and loyal employees in order to achieve its goals in the long run, which prove a management reflexion to acquire, use and develop a talent pool. However, T Optimus cannot be fully identified as a company that reached

entrepreneurial stage, since some of the HRM activities are disjointed and lack formalisation.

Furthermore, C. Darcy's, J. Hill's, T. McCabe's and P. McGovern's (2014) composite model consists of three aspects, which allows to review the changes in company's mind-set when an enterprise moves from operational to strategic focus. In order to reach further composite model stages T Optimus should review and improve following issues:

Employee relationship and behaviours. All interviewees pointed out that only two full time employees: the director and project manager, have to carry most of the job on themselves. This leads to the situation when the amount of tasks increases they are facing job-burnouts. Moreover, during some periods the amount of work and duties are not consistent. Three major themes were identified as sources of some employees' burnouts. This situation could be identified as a lack of HRM activity, which would ensure committed employees, who would be willing to do extra job if needed to achieve organisational goals. In order to solve this situation, the employment process should be reviewed; allocation of work should be redistributed. Moreover, Wright et al. (2001) points out that employees' engagement or motivation could be increased by signing psychological contract or implementing organisational citizenship practices.

People management practices. Most of the practices and organisational structure are formalised to the extent that Lithuanian national laws require, so most of the activities including meetings, allocation of work are being done in informal manner. The lack of formalisation identifies that the company has a lack of focus on strategy and focuses on operations. Wright et al. (2001) mentions that formal structures and processes in place which drive and reward desired behaviour amongst those staff in the HC pool.

Well-stocked HC pool. This concept of well stocked human capital pool in T Optimus case involves training of employees, qualified staff, and investments into studies and development of employees. Since the company operates in the food industry and scientific sector, it really needs qualified staff. Therefore, the company encourages additional learning. T Optimus gives its employees equal opportunities to increase their knowledge and expertise during various training sessions. According to Wright et al. (2001) in order to develop HC employees' owner/managers in SMEs should consider their employees' knowledge, skills and abilities' improvement. In T Optimus case, it could be mentioned that the development direction of human capital pool is organisationally related and allows achieving better alignment between HC skills and the organisation's strategy.

Conclusions

The purpose of this article was to answer the following research question: “Why do SMEs usually do not implement SHRM practices into their daily operations, why they should and how they could?” This was done by reviewing academic sources and then applying the theoretical findings to the T Optimus company in order to get an empirical observation using qualitative research.

According to the findings in the scientific literature, the reasons why SME do not implement SHRM practices are usually related to the lack of financial resources or expertise, the leadership misjudgement on the importance of SHRM and also the external hostile context of the firm (such as the legal requirements etc.). However, the author’s literature research highlights how the human resources system of SMEs is characterised by a high level of informal and close relationships between stakeholders, flexibility and by the importance of the management leadership role to create the culture. Those characteristics can be leveraged through SHRM practices in order to overcome SMEs challenges and achieve better sustainable performance in the long run. In order to achieve that, scholars underline how each small firms should see the HRM as core strategic function in SMEs and implement some SHRM practices according to the development stage that the SMEs is facing.

Once theoretical findings were understood about the topic, the empirical case of T Optimus was developed, which allowed the confirmation of some of the findings in the scientific literature. The results of the qualitative research have shown that “T Optimus” perfectly corresponds to the SME traits that were mentioned by several authors – the company has an informal HRM system, a close relationship among employees is normal practice, employees have flexible working conditions. Furthermore, the despite the fact that the company’s owner tries to implement some SHRM practices that are related mainly to work-life balance and health management issues, these practices are not sufficient and do not solve crucial problems such as frequent job burnouts, lack of expertise, retention of employees, limited career development and weak leadership, which are the issues that many authors distinguish as challenges that stops SMEs form achieving better performance in the long run. The findings of the qualitative research study allowed the author to identify at which stage the T Optimus is right now. When the composite model was applied to T Optimus case, it was identified that currently the company is between tinkering and entrepreneurial stage and from this acknowledgement it was suggested some recommendations for reaching the next stage. The recommendations were mainly focusing on solving current issues using SHRM practices, to think of SHRM as strategic and

formalised practices and finally work on the leadership role. A key point here seems to be the leadership role because in the SMEs context it can be the key to change the company culture, create a climate of confidence and willingness to thrive inside the organisation that can spread around thanks to the informality and close relationship of people in that company. This will help in motivating employees and make them thrive and be willing to stay in the company.

Finally, after having worked on this article, the author would like to suggest further research in the SMEs context focusing on the role of the leadership as a solution that could make a difference and make the company grow and achieve better performance.

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