

The State of Small and Medium-Sized Enterprises in Estonia on the Way to Accession

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Abstract

Crucial issues in the political and economic transformation in Estonia, as in other transition countries, are the creation of the private sector, the development of entrepreneurship and the creation of small and medium sized enterprises (SMEs). Emphasis in this process should be placed on the creation of a favourable environment in which enterprises can develop in order that the transformation of society towards a market economy can take place. In Estonia, the development of the SME sector was based on a liberal policy and facilitated initially by economic reforms including privatisation. The first steps in the development of SME support network were only made in the mid-1990s, and its influence is still rather modest. However, now that the positive effects of the initial factors that stimulated an increase in new private enterprises have diminished, the role of public policy in promoting SME development is gaining in importance. Integration into EU is an additional influence through the implementation of the *acquis communautaire*. In this context, it is important to identify where market failure limits the activity of small enterprises, in order to specify policy objectives with respect to SME development, identify target groups, and define appropriate strategies for the elimination or reduction of constraints on the ability of the SME sector to achieve its potential contribution. This chapter considers the contribution of SMEs to economic development in Estonia, changes in external environment for enterprise development over time, and the main threats and opportunities for SMEs in connection with EU accession. Whilst SMEs have

positively contributed to job creation and restructuring in Estonia and the government has made some efforts with respect to SME support, there is a need to re-assess the main policy priorities and specify the current and future support needs of entrepreneurs.

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1. Introduction

Following the independence in 1991, government policy in Estonia has been underpinned by a free market philosophy and a commitment to the institutionalisation of private ownership and market reforms. As a result of rapid privatisation, private ownership became dominant in the national economy relatively quickly as a whole, which meant that by 1995, 90% of all Estonian enterprises were privately owned. A relatively successful privatisation model also contributed to the initial increase in the number of private enterprises.

Estonia has also had a very liberal trade policy in which most trade barriers and tariffs have been abolished. This has led, on the one hand, to a growth in exports and, on the other, to an inflow of duty free imports, which have been exploited by manufacturers for both domestic and foreign production. The associated increase in competition in the domestic market has accelerated the pace of restructuring. An important enabling factor has been Estonia's success in attracting foreign investments, contributing to the success of its economic reforms and the structural transformation of the economy. This has been facilitated by the government's strong commitment to the rapid privatisation of manufacturing enterprises and the establishment of an open and transparent business environment.

As a result, on most indicators of market reform, Estonia scores highly in comparison with other Central and East European countries and former Soviet republics. For example, based on EBRD assessment, 75% of GDP in 2001 was contributed by the private sector. In addition, progress with small-scale privatisation and the development of a foreign exchange system was rated as 'meeting the standards and performance norms of advanced industrial countries' (EBRD, 2001). Estonia also scores highly on the 2002 Index of Economic Freedom, being ranked fourth in the world and classified overall as a 'free market economy' (O'Driscoll *et al*, 2002).

In interpreting the main trends in enterprise development in Estonia, it is necessary to note the effect of changes in legal regulations on the ownership and legal forms of enterprises over time. Changes in the economic and legislative environment in the early 1990s led to a rapid increase in the number of private enterprises in Estonia, encouraged by the relatively simple conditions for establishing enterprises. At the same time, this led to the registration of a large number of enterprises that either never started trading, or commenced trading but were unable to survive in the market. This means that the external environment has not always favoured the long-term development of firms' activities or stimulated the sustained growth of rates of new firm formation.

Until recently, direct support measures to support SME development in Estonia have been noticeable by their absence, with the role of government best characterised as one of limited intervention (Phare Report, 1999). This liberal market approach has emphasised the removal of trade barriers, the development of free trade agreements, the introduction of favourable fiscal and monetary policies and the creation of macroeconomic stability. Although market and trade liberalisation has not been specifically aimed at small firms, it has contributed to increased opportunities for them to sell in foreign markets and to find foreign partners.

Although government did not pay special attention to SMEs throughout most of the 1990s, foreign aid programmes (e.g. Phare, NUTEK) contributed to the establishment of business support centres. This led to the development of a number of programmes for SME support being approved by government in 1996/97, which offered credits through a Small Business Credit Fund, the development of training and consultancy programmes, financial support for the existing business advisory and entrepreneurship development centres, as well as some export support and support for innovation. In contrast to the initial stages of transition, by the late 1990s government policy

was beginning to place more explicit emphasis on encouraging and supporting SME development, although its impact on the ground appears to have been very limited, with surveys showing very small numbers of firms benefiting or even aware of these programmes (e.g. Smallbone *et al.*, 1998). More recently, the aim of SME policy has become increasingly linked to improving the competitiveness of firms in domestic and foreign markets (Estonian Ministry of Finance, 2000), associated with a need for institutional harmonisation with EU requirements. However, there are a number of problems, which need to be solved in order to improve business environment in Estonia.

The following section of the paper will discuss the contribution of SMEs to economic development in Estonia. This is followed by a discussion of the main characteristics of the external environment for enterprise development, and the main threats and opportunities for SMEs in connection with EU accession. Current policy priorities will be discussed with the aim of raising the competitiveness of enterprises in domestic as well as in foreign markets. The paper concludes with a summary of the state of SMEs in Estonia and policy issues that need to be addressed in order to create favourable conditions for enterprise development.

2. The Contribution of SMEs to Economic Development in Estonia

In January 2003, the central Commercial Register included a total of 79,220 units (20,563 sole proprietors and 58,657 enterprises), of which more than 90% were privately owned. By 2002, the majority of firms were registered as private limited companies (84% of all companies), because of the lower capital requirement for this type of enterprise compared with joint stock companies, making this type of legal form more suitable for small businesses. The share of private limited companies in total number of enterprises increased to 8% in the period of 1998-2002 with the decreasing share of public companies. This change is connected also with the Estonian Central Register of Securities Act (entered into force 1 January 2001), which requires registering of all public limited companies in the Central Register of Securities since January 2002. A number of smaller public companies have decided it more suitable to change their legal form and continue the activity as a private limited company. However, whilst the increase in the minimum capital requirements for public limited and private limited companies¹ reduced the number of 'off-

the-shelf' businesses, the Commercial Register still includes firms that are not active. Based on tax returns to the National Tax Board, the number of active enterprises in the beginning of 2002 was 33,346 (or 63% of those registered), excluding sole traders. Over two thousand sole traders (2158) actually paid VAT in 2001, although over 66,000 sole traders were actually registered in the National Tax Board.² Estimating the number of enterprises is not an exact science in any country, since it depends on the criteria used to define what constitutes an active enterprise.

Although the rapid increase in the number of private sector enterprises in Estonia through the 1990s is impressive, the level is still considerably below that of EU countries: 38 per 1000 inhabitants in Estonia in 2001³ compared to an average of 51 in the EU.

As in mature market economies, the vast majority of private enterprises are very small, micro enterprises employing less than 10 persons. On the basis of information supplied by the National Tax Board, 77% of the active enterprises in 2001 were micro-enterprises, 18% small and 3% medium-sized enterprises. In fact this figure understates the role of micro-businesses, because of the exclusion of a large number of sole traders from the database. In fact, the proportion of the total stock of enterprises consisting of small and very small enterprises has increased during the 1990s, particularly those employing less than 10. The absolute number of enterprises employing 10 or more decreased between 1995 and 2001, thus contributing to the increasing relative importance of small and very small firms (Table 1). As a result, an average size of active enterprises (excluding sole traders) decreased from 22 employees in 1994 to 13 employees per enterprise in 2001, calculated on the basis of Enterprise Register and National Tax Board information (Ettevõtteregister, 2001).

Table 1. Structure of Enterprises by Size Groups in 1994-2001

Number of employees	Structure of enterprises							
	1994	1995	1996	1997	1998	1999	2000	2001
0-9	66.6	70.7	71.3	72.2	72.3	69.5	74.7	77.0
10-49	25.6	23.1	23.1	22.6	22.7	21.0	19.5	18.4
50-249	6.5	5.4	4.9	4.6	4.4	4.1	3.6	3.4
> 250	1.3	0.8	0.7	0.7	0.6	0.6	0.6	0.5
Undetermined	0.0	0.0	0.0	0.0	0.0	4.7	1.6	0.7
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Note: Table excludes sole traders. Source: National Tax Board

Approximately two-thirds (66%) of the registered entrepreneurs (incl. enterprises and sole traders) at the end of 2002 were in services, 14% in manufacturing and 20% in primary sectors (mainly agriculture) (Centre of Registers, Ministry of Justice of Estonia, 2002). On the basis of the information of National Tax Board 5% of active enterprises are operating in primary sectors, 22% in manufacturing and 73% in services sectors. The concentration in services partly reflects the relatively low entry thresholds compared with manufacturing and partly the pattern of demand for services that were largely unobtainable during the Soviet period. In fact, new businesses that were first registered in 2000 were even more concentrated in services: 69% compared with 8% in secondary sectors and 19% in primary activities. These figures demonstrate that one of the roles of the emerging private sector in Estonia has been to contribute to changes in the economic structure, particularly with respect to the development of businesses in trade, transport, financial and other business services.

The contribution of SMEs to total employment can be best estimated on the basis of data from the National Tax Board, which shows that employment in SME⁴ accounted for about 55% of total employment in 2001.⁵ Total employment in the enterprise sector amounted to 419,000 jobs in Estonia in the year 2001⁶ of which 75% were found in SMEs (19% in micro-, 30% in small, 27% medium-sized) and 24% in large enterprises (Table 2). Moreover, the proportion of total employment in the enterprise sector found in small (and particularly very small) firms has increased considerably, whilst that in large and medium-sized firms has declined, partly because of a continued restructuring of medium and large enterprises and partly because of an increase in the number of very small firms.

Table 2. Employment in Enterprises by Enterprise Size Group in 1994-2001

Number of employees	Share of employees, %							
	1994	1995	1996	1997	1998	1999	2000	2001
0-9	10.7	14.1	14.9	15.9	16.5	17.4	18.7	19.4
10-49	25.1	27.2	28.6	29.4	30.5	29.7	29.8	29.8
50-249	30.1	30.3	28.9	28.1	27.7	26.9	26.2	26.5
>250	34.1	28.4	27.6	26.6	25.4	26.0	25.4	24.3
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: National Tax Board

The contribution of SMEs into economic development is reflected in their share of value added, which accounted for about 52%⁷ of Estonian GDP in 2000. 28% of value added was created in large firms, 31% in medium-sized enterprises, 26% in small firms and the remaining 15% in micro-firms, which is small in comparison with their share of the total number of enterprises. The distribution of value added between employment size groups is related to the distribution of enterprises across economic activities, since large and medium-sized enterprises are more represented in manufacturing, where a considerable part (23%) of total value added of the economy is created. However, an important part of value added (27%) is created also in services (trade, hotels, business services), where smaller enterprises are concentrated. The activities of smaller enterprises are more labour intensive and they have less means to invest in R&D to increase their competitiveness and value added.

Although large enterprises export a higher proportion of their total output than SMEs, the share of SMEs in total exports has been increasing in Estonia, accounting for 78% by value in 2001. It is small- and micro-enterprises (i.e. 0-49 employees) that have been increasing most their contribution to total exports, in absolute as well as in relative terms (from 34.7% in 1999 to 44.1% in 2001) (Statistical Office of Estonia, 1999; 2001). One of the potential roles of SMEs in economic development is the generation of external income through their foreign trade activities. On the basis of this evidence, the Estonian SME sector is making a growing contribution in this regard.

There are significant regional variations in enterprise development, reflected in the total stock of privately owned SMEs and also in the rate of new firm formation. This is not surprising since even in mature market economies, the more prosperous regions in the economic core may generate up to three times the number of new businesses per head annually compared with peripheral regions (Reynolds *et al.*, 1994). In Estonia, Tallinn and the surrounding Harju County accounted for 59% of operating businesses in 2001 compared with only 29% of the total population. As a result, the number of enterprises per 1000 population in 2001 was 42 (on the basis of National Tax Board) in Tallinn and Harju County, compared with just 10 in Ida-Viru County (an old industrial region). Moreover, the gap appears to be widening since Tallinn accounted for more than half of the total number of businesses actively operating in Estonia in 2001, compared with just 5% in Ida-Viru County (National Tax Board). The number of enterprises per 1000 inhabitants is relatively high also in

other larger towns like Tartu and Pärnu (23 both) and their surrounding area, based on the same data source.

Geographic variations in enterprise activity have implications for employment, since in counties where the number of enterprises per inhabitants is low, the unemployment rate is typically high. For example, in Ida-Viru County with the lowest number of enterprises the unemployment rate was 21% in 2000 compared to 11.5% in Harju County with higher number of enterprises per 1000 inhabitants (Statistical, 2001). Although the number of enterprises increased in all counties in 2001 (12% in total), employment increased only in 6 counties⁸, but decreased in 9 counties. Total employment has remained rather stable in enterprise sector on the basis of the information of the National Tax Board.

3. Changes in External Environment for Enterprise Development

In order to evaluate the factors that influence the ability of Estonian small enterprises to grow and survive, the opinions of managers and owners of enterprises were studied in different surveys (e.g. Smallbone *et al*, 1996, 1998; European Commission; Phare, 1999). These surveys suggest that the main obstacles to the development of small enterprises are mainly connected with market conditions (strong competition, weak domestic demand etc), financial difficulties (shortage of funds, high interest rates etc) and government policy (level of taxation, other regulations). In addition, there have been problems connected with production (equipment, development of products), labour force (qualification and training) management and infrastructure. Although the order of importance has been changing to some extent over the last decade, the first three factors mentioned above have remained among the main obstacles to enterprise development during the entire period.

Obstacles connected with market conditions are based to a large extent on Estonia's narrow home market and limited domestic purchasing power. As a consequence, foreign trade is a key factor contributing to economic growth, which government has sought to promote through a liberal foreign trade policy, with minimal intervention. This has contributed to strong competition in domestic market, particularly from imports, as a result of liberal trade policy. In this context, government support to export activity has focused on so-called 'soft' measures, such as improving access to information and

advice, through business support centres, rather than through the use of direct support measures and financial initiatives. This has also been supported by free trade agreements, agreements on trade and economic co-operation, on avoiding double taxation and agreements to foster business and trade (totally over 115 agreements). In 1999, Estonia became a member of the WTO, which provides equal treatment for Estonian exporters in the markets of other WTO members.

The supply of finance available to enterprises from banks has increased considerably since 1994 connected with changes in bank ownership, falling interest rates and widening range of financial products supplied to enterprises. Despite these developments, insufficient collateral remains a problem for SMEs, constraining their ability to access bank lending in many cases. One aspect is the size of the collateral that is required, which can be many times the value of the loan, because of a desire on the part of the banks to keep their exposure to risk to a minimum. As a consequence, bank finance remains particularly difficult to access for start-ups, although this is an issue that is not confined to transition economies. However, rapid development of the leasing market since 1993 has become an important funding alternative to bank loans for enterprises, which can help to overcome the effects of a shortage of collateral faced by many SMEs seeking bank loans.

The rapid restructuring of the Estonian economy, together with the implementation of new technologies requires an extension of knowledge and, in many cases, the re-training of workers. In this regard, employers have been reported to complain that despite the high qualifications of the Estonian workforce overall, the skills required by employers are typically in short supply. As a consequence, compilers of future scenarios in Estonia have pointed to a need to raise educational standards and for a greater commitment to lifelong learning as essential preconditions for “getting on to the Information Society development path” (Raagma and Terk, 1997). The Government seeks to encourage both employers and employees to commit themselves to training through exemptions from income tax. Although companies similarly may deduct employee training or retraining costs from their tax liability, in smaller firms particularly training is not always viewed as an immediate priority by entrepreneurs, because of more pressing problems affecting the firm’s ability to survive.

The development of an appropriate institutional framework is an important part of the process of market reform. In general, the

institutionalisation of business support includes the development of institutions at three levels: macro, meso and micro level (Welter, 1997). In Estonia, during the 1990s, five ministries were responsible for implementing the tasks connected with the support programmes for enterprises at the **macro level**. However, since 2000, the responsibility for enterprise support has been centralised under the Ministry of Economic Affairs, with the aim of making more effective use of the resources available for enterprise support, on a regional as well as on a sectoral basis.

Considerable progress has also been made in developing the institutional framework for enterprise development at the **meso level**. This includes the banking system, which, now largely under foreign ownership, is increasingly developing a range of financial products similar to those available to enterprises in a market economy. It also includes a number of unions, associations and chambers, established by special interests groups mainly on the basis of voluntary membership. Some of these, such as the Chamber of Trade and Commerce and specialised sector-based organisations have been the main source of support for businesses, particularly with respect to the process of exploiting foreign markets.

At the **micro level**, institutional development has focused on the development of a network of the business development centres. Most of these were founded between 1993-96 with foreign funds, supplemented subsequently with local resources. The issue of the sustainability of a business support network supported by foreign "donors" and local governments has been addressed through the Regional Development Programme and the establishment in 1997 of a specialised institution for their co-ordination, namely the Regional Development Agency (RDA). Although the effectiveness of services provided by these support centres has never been the subject of special assessment from a SME standpoint, some conclusions can be drawn from the evaluation of Phare-financed institutional programs in support of SMEs (Phare, 2000). As the largest item of Phare spending on institutional support, it was reported that the business advisory centres have played a positive role in supporting considerable numbers of SMEs into business and to gain access to finance. Despite this, many have had poor relationships with their local authorities and other relevant institutions (such as banks) and their impact within local business networks appears to have been weak. Other problems identified included the ongoing dependence of these business centres on subsidies, the poor advertising of their services and the fact that the main focus of their activities has been limited to start-ups.

In this context, the business support network has been the subject of reform, both to improve the quality and effectiveness of services delivered to SMEs but also to improve the administration, management and cost effectiveness of the support institutions. As a consequence, in the year 2000, the public business support infrastructure was restructured in an attempt to make it more efficient, transparent and accessible. Seven foundations together with the Tourist Board, which were previously under the administration of five different ministries, were integrated into two new organisations, namely *Kredex* and *Enterprise Estonia*.

Kredex is the State Credit and Export Guarantee Fund, established as a result of a merger of three existing state lending institutions, to offer loan guarantees to SMEs, Export Credit Guarantees and Housing guarantees. The mission of *Enterprise Estonia* (EE) is to support the development of Estonian enterprises by implementing public business support measures. EE is responsible for implementing regional development and business support programmes; for financing technology programmes, applied research and high-risk industrial development projects; creating a positive image of Estonia as a potential location for investment; the arrangement of export support events; developing tourism projects; and creating the preconditions for the effective use of EU Structural Funds.

Estonia is generally viewed as having very few restrictions on foreign investments, offering high levels of freedom to foreign investors and the protection of property rights. Throughout the 1990s, foreign investors and their investments were granted 'equal rights and obligations' with their domestic counterparts, with freedom to repatriate profits, dividends and invested capital. Estonia does not prohibit foreign investments in any sectors or activities, although certain activities remain subject to an 'activity licence', which are granted to Estonian and foreign companies under the same conditions. The criteria used relate to health, safety and environmental considerations, national security concerns, and the reliability of basic infrastructure. Foreign firms established in Estonia have equal access to government funds with their domestic counterparts and also benefit from the new income tax regime that excludes reinvested earnings of companies from the corporate income tax base.

Important policy issues for the creation of a favourable environment for SMEs also include improvements to the regulatory framework, tax policy, financial instruments, advisory services and regional enterprise promotion issues. Although considerable

improvements have been made to the regulatory framework for business in Estonia, there is an ongoing need to review the registration, licensing and administrative procedures. Administrative barriers can be a specific constraint at the start-up stage, particularly when a number of different government departments or agencies are involved. Rationalising the application forms for registration with the other demands for data by various government departments and agencies should be a key aim at the start-up stage. Another should be to keep the demands for data to a minimum that is compatible with the regulatory role that government needs to play in the economy. Although the total tax burden (mainly social security tax) is an important issue among the factors constraining business development, as well as frequent changes to tax laws and regulations, which can contribute significantly to increasing compliance costs, particularly for SMEs. The decision to exempt reinvested profits from corporate income tax since 2000 is to be welcomed, as a measure designed to stimulate investment.

4. Threats and Opportunities for SMEs in Connection with EU Accession

Accession to the EU will involve increasing integration across a variety of fields, with important potential implications for the external environment in which business is conducted in Estonia. These implications stem first from the need to adapt Estonian legislation, regulatory systems and methods of certification and standards to EU requirements and secondly from the continued process of transforming the Estonian economy into a market based system. Whilst integration processes have important potential implications for firms of all sizes, there are size-related characteristics of SMEs that can affect their ability to cope with potential threats and respond to new opportunities presented.

The first step towards the harmonisation of regulations and the business environment in Estonia with EU requirements was the introduction of a new Commercial Code, which came into force in September 1995. The most important changes introduced at that time were:

- ? the introduction of legal forms of entrepreneurship similar to mature market economies (based mainly on German regulations);

- ? the legalisation of two main categories of entrepreneurship, namely the entrepreneur (e.g. as a sole proprietor, which had not previously been legally recognised) and the company;
- ? raising the level of responsibility of enterprises by increasing the minimum capital requirements for public and limited liability companies;
- ? creating a new basis for the Business Register, together with the creation of a central database from the registry departments of city and county courts.

In a survey of manufacturing SMEs undertaken in 1998, managers were asked to evaluate the likely impact of joining the EU on their business (Phare, 1999). Nearly one-third of respondents judged that joining the EU would have a positive influence on their enterprise, with 18% expressing the opposite opinion and the rest stating either that it will have no influence or they did not have a clear opinion at the time. Significantly, however, only 16% of respondents thought that they had sufficient information about EU membership and the changes related to it. In addition, SME managers considered the process of obtaining information about the EU and accession to it more complicated compared with accessing information in other fields. Although the date of the survey may help to explain the high proportion of respondents that were uncertain about the effects of EU membership, the survey results underline the importance of providing rapid access to detailed information on this subject.

A more recent enterprise survey undertaken in 10 candidate countries in February-March 2001 illustrates the latest managers' opinion about EU enlargement and its consequences (Eurochambers, 2001). The results of the survey showed that the level of information of Estonian companies is low in comparison to other candidate countries: only 3% of respondents claimed to be fully informed on EU legislation, 40% partially, while 18% declared that they had no information at all concerning EU legislation. At the same time, a majority of respondents (69%) considered that they had enough information, although 21% of respondents declared that EU information was not available to them.

Three-quarters of the respondents considered that they would be able to comply with the *acquis-communautaire* by December 2002 in the area of work safety, and about two-thirds in the areas of labels, trademarks and patents, consumer protection and product certification. Estonian companies focus their planned accession-related activities on quality control and the training of managers and employees. Although

surveyed firms in Estonia were more optimistic than their counterparts in other accession states regarding their business prospects in an enlarged EU, they were the most concerned about the financial implications, requesting by far the longest periods for implementing the *Acquis*, compared with other countries.

SMEs will also be affected by changes in the business environment associated with being part of the EU internal market. This particularly applies to the effect of the harmonisation of legal and technical regulations and standards, which Estonian firms will have to comply with whether or not they are exporting. An investigation into the extent to which manufacturing enterprises are prepared for participation in the EU single market and the impact of accession on their activity, was undertaken in Tallinn in 2001, based on a sample of predominantly small and micro-enterprises (Rajasalu *et al*, 2001). Apart from providing further evidence of the insufficient provision of information about EU legislation to enterprises, the survey showed that less than one-fifth of respondents considered that their enterprises fully met the EU requirements. Few respondents considered that EU accession would contribute either to improvements in their business environment or to a significant increase in the threats. Although the results may have been influenced by the size structure of the sample and its predominantly domestic market orientation, few firms will remain unaffected by the process of harmonisation of technical regulations and standards with respect to spheres such as environmental protection, industrial safety, the certification of products, trade marks, consumer protection and competition rules.

The study carried out in the Estonian Institute of Economics at Tallinn Technical University, based on the analysis of the flows of workers and jobs in enterprises to explain demand side changes in the labour market, showed that a changing economic environment influences in several ways behaviour of enterprises, their entry to the labour market, choice of enterprise form and strategies, development of the activity structure and other activities. Creation and destruction of jobs in the labour market is a part of a considerably more extensive process of economic adaptation. Analysis of job creation and job destruction in Estonian enterprises in the period of 1995-2000 indicated that the Estonian labour market has been flexible to changes in the reference period (Venesaar, 2003). However, there have been great differences in the restructuring activity of enterprises over years and across groups of enterprises divided on the basis of various characteristics. If to decide after job relocation flows, the flexibility of the labour market has mostly diminished by the end of the period

indicating that the economic environment has turned less favourable for the development of entrepreneurship. This in turn refers to the need to find new possibilities to support enterprises to increase their competitiveness and implement EU requirements in enterprises. Based on the heterogeneity of the restructuring process of enterprises, elaboration and implementation of measures to support them need to consider peculiarities of different groups of enterprises.

Ensuing from the liberal economic policy of Estonia, all entrepreneurs are treated equally and the national policy has supported entrepreneurship development mostly indirectly, by stabilisation of entrepreneurship environment, rather than directly, by subsidisation, not to speak of solving problems faced by entrepreneurial groups with different needs. For example, female entrepreneurs confront problems connected with financial difficulties in starting an enterprise and finding collateral required by bank, which considerably influence availability of investment and working capital loans (Venesaar *et al.*, 2002). Other important market and product related problems in the opinion of female entrepreneurs were strong competition in the home market, adaptation to the quality standards and shadow economy. Therefore, it is needful to know thoroughly the problems of different groups of entrepreneurs and their need for support measures in order to use their potential in the development of enterprise sector.

The main goal of Estonian economic policy, expressed in the Pre-accession Economic Programme (2001), is to achieve sustainable economic growth that is regionally and socially balanced. Economic policy should also support the growth of productivity, thereby reducing the development gaps between Estonia and the EU and ensuring the fulfilment of the economic criteria for accession to the EU. Based on various studies, most foreign investors in Estonia are seeking access to neighbouring EU and Baltic markets (Varblane, 2001), although the relatively low production cost base is also a key attraction. According to the Pre-Accession Economic Programme of April 2001, the essential factor in attracting foreign investments into the country is Estonia's further integration with EU, which should improve the legal and institutional framework and provide Estonian enterprise access to European markets.

In addition, the basis of SME policy is embedded in the National Programme for the Adoption of Acquis 2002-2003 (NPAA), which includes a number of specific activities for 2002-2003, demonstrating how current policy is being affected by the Accession agenda. These include the use of pre-structural funds and other foreign assistance instruments to assist in the implementation of the Action Plan (i.e.

foreign assistance projects); offering state support services to start-up businesses, offer small loan guarantees, and develop an infrastructure for entrepreneurship supported through Phare projects; strengthening the capacity of institutional administration in preparation for receiving assistance through EU Structural Funds.

5. Current SME Policy Priorities

The main policy issues and priorities currently facing Estonia with respect to enterprise development are considered in relation to two sets of influences that are interrelated: first, those resulting from the ongoing process of market reform; and second, those associated with preparing Estonian enterprises for successful entry to the European Union.

Estonia's approach to SME policy shows increasing signs of the influence of expected entry to the EU. This is reflected in the latest *Estonian Enterprise Policy* document, covering the period 2002-2006, which recognises firstly that SMEs may suffer from size-related market failures in comparison with larger firms; and secondly, the potential contribution of SMEs to job generation and regional development. The stated aims of Enterprise Policy are:

- ? to promote entrepreneurship,
- ? to create new jobs,
- ? to improve the competitiveness of Estonian businesses.

In other words, the government recognises the potential contribution of SMEs to both economic competitiveness and social inclusion, which are currently the cornerstones of policy in the EU. It has also adopted the EU employment size categories of very small (0-9 employees); small (10-49 employees) and medium sized (50-249).

Several measures have been targeted at new business start-ups and potential entrepreneurs, as well as supporting existing enterprises. The main priority activities for SME policy are: *the development of human resources* with two main objectives: first, reducing regional and structural unemployment, and second, raising the quality of labour; *improved access to finance*, particularly for start-ups and existing businesses with high growth potential; *the development of the business support infrastructure*; *improved access to business information*, which includes information about state support measures, information about business-related developments in the EU and

possible co-operation partners through Euroinfocentres; and a reduction in administrative burdens.

The principles outlined above will form the basis of annual 3-year action plans, co-ordinated with the state budgeting process. These plans will include short-term objectives and priorities, together with the required funding sources and the procedures for monitoring and evaluation. The linking of a strategy to rolling action plans, which in turn are linked to the budgetary process may be seen as an innovative and positive step in policy development in Estonia, since it offers a mechanism for avoiding the trap of policy becoming more declarative than effective. At the same time, the government has little choice in this regard, if Estonia is to produce a Single Programming Document (SPD) that will be effective in drawing down resources from EU Structural Funds.

There is evidence that the commercial banks are beginning to develop a range of financial products that are geared to the needs of SMEs, although access to finance for start-ups and new businesses remains limited, because of insufficient collateral and the lack of a track record. The growth of the leasing market in Estonia is a positive step and information about the increasing variety of types of finance available to enterprises should be actively disseminated through the business support system. One of the main priority needs is an increase in the availability of seed capital for new technology-based firms where the level of risk involved combined with the time span before a product or service can be brought to market.

The re-organisation of advisory services is of particular importance for SMEs, which typically lack the internal resources and knowledge bases of large companies. The aim must be to develop an advisory support system for SMEs that is tuned to the needs of firms, delivering support at a guaranteed quality level. The approach adopted also needs to seek to work in partnership rather than competition with private sector providers, in order to assist in developing capacity within the market in the longer term.

A positive feature of the current policy environment in Estonia is the opportunities that exist for representative organisations of SMEs (such as the Chamber of Commerce and EVEA) to express their views on draft regulations and legislation, although it is difficult to establish to what extent their comments have influenced final decision making in practice. Nevertheless, the Ministry of Economic Affairs and Communications has made a good start with respect to improving channels of communication with SMEs through the SME Advisory Council. It has also set up round tables and forum to bring policy

makers, bankers and SMEs together to discuss topics of mutual interest.

Although the development of strategic approach to SME policy appears to be emerging, one of the priorities for future development is the need to increase co-ordination between SME policy and other policy areas, such as regional policy. Regional enterprise promotion is an area where greater attention needs to be paid if Estonia is really to develop as an enterprise based economy. Within the context of a need to raise the overall level of entrepreneurship, there is a particular need to prioritise new venture creation programmes in peripheral regions. The promotion of entrepreneurship is a potential key to reducing unemployment and increasing active participation in the economy, particularly in rural areas. At the same time, it must be kept in mind that regional variations in levels of income and wealth affect the level of entrepreneurship, through their influence on demand. The regional business centres have an important potential role to play in the promotion of entrepreneurship at a local level, although the capacity of many of them will need to be strengthened if they are to achieve this.

One aspect of this is a need to increase the capacity of local institutions to take on a role in enterprise support and economic development, which currently appears to be considerable below that of similar institutions in market economies. Whilst this ultimately depends on a reform of local and county government structures, short term steps could be taken to encourage greater co-operation and involvement of local government in business support centres, regional development agencies and the activities of Enterprise Estonia.

6. Conclusions

The pace of economic reforms and a liberal economic policy have contributed to huge changes in the Estonian economy, conducting to the country's progress towards a market-based economy. The rapid development of the private sector through the 1990s was facilitated by this process, although the role of government was more enabling than causal. However, the publication of a national policy document for SME development in Estonia for the period 2001-2006 represents a significant step forward in strategic thinking with respect to SME policy, with related measures and responsibilities for implementation. It is also encouraging to learn that strategic policy objectives are now being linked to specific action plans, tied into the budgetary process. It

is important that specific output criteria and targets are also developed and published in order that transparent monitoring and evaluation of the various programmes can be implemented. The rationalisation of the various agencies into *Enterprise Estonia* and *Kredex* would appear to be a positive step from an enterprise development standpoint, although it is too early to identify tangible practical benefits from this. The separation of responsibilities for policy formulation from its implementation are also welcomed.

At the same time, whilst the Ministry of Economic Affairs and Communications has recognised the need to assist SMEs in preparing for EU accession, there is little detailed knowledge concerning the needs of firms in this respect. Those data that are available suggest that many entrepreneurs are uncertain about how accession will affect their businesses. Although the harmonisation process with EU requirements has been rather successful at the macrolevel (e.g. legislation, institutions), it needs more work at the enterprise level not only by informing and training managers but also by improving the availability of financial resources to address these needs.

At the same time, a current priority is for the government to take steps to make inter-departmental co-operation with respect to enterprise policy more effective. Issues raised by entrepreneurs' organisations in the various forums include issues such as high social taxes and the need for improved vocational training. Neither are part of the direct responsibility of the Ministry of Economic Affairs and Communications, which appears to have limited ability to really influence the actions of other Ministries. There needs to be more than an invitation to comment on draft legislation. There must also be some mechanism for ensuring that any recommendations made following this process are taken into account and implemented where appropriate.

Another weakness in the current institutional arrangements for enterprise development are the county and local authorities, which in general do not have the capacity to be involved in local or regional economic development programmes. This is a major constraint to the development of central-local, public-private partnerships that are an essential development tool within the EU. In this context, the key policy priorities to achieve accelerated enterprise development with employment growth are to prioritise the development of institutional capacity in order to increase the effectiveness and impact of SME policy in Estonia within the context of EU membership.

Notes

1. The Commercial Code that was introduced in 1995 established a minimum capital requirement equivalent to Euro 26,667 for public limited companies and Euro 2667 for private limited companies, compared with the nominal Euro 20 that had existed previously
2. Some of the remaining 64,000 would have been trading but below the VAT threshold. The reason they would be registered for VAT is to enable them to reclaim any VAT paid on inputs. Others would be inactive enterprises.
3. This is based on data from the Centre of Registers, Ministry of Justice of Estonia, which includes some businesses that are temporarily not trading. If National Tax Board data are used the figure is 43 per 1000 inhabitants, since this is based on current tax returns which means that more non-trading businesses are excluded
4. These data only include active enterprises. Since sole traders are excluded, total employment in the enterprise sector is underestimated. However, one advantage of the database is that it avoids double accounting of people operating in more than one enterprise or activity
5. Employment by Estonian Labour Force Study was 5777.7 in 2001.
6. National Tax Board data
7. Information from the Statistical Office of Estonia; sole traders are not included
8. Harju, Pärnu, Tartu, Saare, Lääne and Lääne-Viru County.

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