

## **2. ESTONIAN SMEs IN THE CONTEXT OF AN ENLARGED EUROPE**

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### **Abstract**

The rapid development of the SME sector in Estonia during the 1990s has been assessed as one of the positive factors in Estonia's recent economic development. At the same time, certain structural weaknesses associated with the relatively short time that has elapsed since the start of the transformation process, together with the new challenges faced by SMEs as a result of Estonia's entry into the EU, make this an appropriate time to review the current state of SME development in the country and the priorities for the future of the sector. The main empirical evidence on which the paper is based is drawn from a large-scale telephone survey of 1,912 SMEs undertaken in December 2002. The analysis includes: the manager's assessment of the current constraints on business development as well as their competitive strengths; issues related to workforce skills and the efficiency of the operation of Estonian labour markets from an SME perspective; access to finance of different types; access to different types of information, including that which is directly related to the EU internal market; awareness and use of state support measures and agencies; administrative and regulatory issues. The survey revealed some positive (e.g., structural development, penetration of foreign markets) as well as negative (e.g., low birthrate, modest impact of

public policy measures) aspects in SME development. The paper will conclude with a summary of the implications of the analysis for SME policy in Estonia.

## **Introduction**

This paper is concerned with the characteristics, strategies and development problems of Estonian SMEs prior to Estonia's accession to the EU. Particular attention is paid to the constraints identified by entrepreneurs on their ability to develop their businesses, sources of finance and awareness and use of business services. It complements previous papers dealing with the nature of the challenges facing SMEs in the EU's new member states (Smallbone and Rogut, 2003; Smallbone and Venesaar, 2004), which included a review of institutional changes in Estonia relevant to entrepreneurship and SME development. The present paper complements these earlier papers by presenting evidence of the current state of the SME sector, based on the largest business survey ever undertaken in Estonia.

Estonia is an interesting case, because, unlike the new EU members from Central Europe, Estonia is a former Soviet republic, with a very short recent history of private sector development, yet with a rapid increase in the number of SMEs associated with a very liberal market approach to economic and trade policy. The context for the paper is that the rapid development of the SME sector in Estonia during the 1990s has been assessed as one of the positive factors in Estonia's recent economic development. For example, as a result of the growth of the SME sector, the share of employment in SMEs achieved nearly 76% of total employment in the business sector in 2002. At the same time, certain structural weaknesses associated with the relatively short period of time that has elapsed since the start of the transformation process, together the new challenges faced by SMEs as a result of Estonia's entry to the EU, make this an appropriate time to review the current state

of SME development in the country and the priorities for the future development of the sector.

The paper draws on empirical evidence from a large-scale telephone survey of 1912 SMEs, undertaken in December 2002, which was designed by David Smallbone and implemented by a market research company on behalf of the Estonian Ministry of Economic Affairs. To be eligible for inclusion in the survey, enterprises needed to be independently owned, employ less than 250 and operate in either the secondary or tertiary sectors. All sectors were included, except for those engaged in agriculture, fishing and forestry. Respondents were sampled from two databases of the Commercial Register (i.e. on businesses and sole proprietorships). A stratified random sampling design was used, with the actual results from the sample survey weighted to make them representative of the total population of SMEs in the country<sup>1</sup>, based on quotas for 28 cells (i.e. 4 size groups: 0, 1–9, 10–49, and 50–249 employees and 7 fields of activity based on the NACE classification).

Since the survey was designed to enable some comparisons to be made firstly with a previous survey of Estonian manufacturing enterprises, undertaken in 1998; and secondly, with the ENSR survey reported in the Sixth EU SME Observatory report, it is possible to assess the current state of SME development in Estonia, both historically and, to some extent, in comparison with the existing EU member states. The assessment selectively uses survey results with respect to managers' assessment of the constraints they face in developing their businesses, as well as their assessment of any competitive strengths, labour-related issues, access to finance, access to information, awareness and use of state programmes and agencies, and administrative burdens and regulatory issues.

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<sup>1</sup> The weighting was undertaken in three stages, taking into account size categories, fields of activity and regions.

## Profile of Estonian SMEs

The *size distribution* of Estonian enterprises does not look significantly different from that in a mature market economy, which is reflected in the weighted survey results: 79% were very small firms (0–9 employees) (27% with no employees other than the owner), 17% were small firms (i.e. 10–49 employees) and a further 4% were medium-sized firms (i.e. 50–249 employees). In the UK, by comparison, 99.1% of the total stock of 3.8m businesses are small firms, employing less than 50 (DTI, 2003). In terms of *sectors*, services (i.e. accommodation, catering, finance) accounted for the largest proportion of firms (27%), followed by retailing (20%), manufacturing (17%), wholesaling (14%), education and health care (8%), transport and communications (9%), and construction (7%).

In terms of *age*, 20% were less than three years old at the time of the survey, having first started trading between 2000 and 2002; a further 35% between 4 and 7 years old, 33% between 8 and 11 years old in 2002, and 9% were 12 years old or more. Although still lacking in terms of the number of well-established SMEs that exist in a more mature market economy, the age profile of the Estonian SME sector is maturing in comparison with the mid-1990s, when it consisted mainly of very young firms.

Two key *performance indicators* included in the survey were firstly, sales turnover in 2002 compared with the previous year and secondly, whether or not the firm was profitable in the last year, which are combined in summary form in Table 1. Although crude, accurate financial data are notoriously difficult to obtain from SMEs, which means that the use of simple nominal categories for profit/breakeven/loss and increasing/decreasing/stable turnover are justifiable indicators of SME performance. Table 1 shows that slightly less than half of all the surveyed firms had been able to increase sales in 2002 and in 20% sales had actually declined. This is not a particularly healthy situation, since some

growth is almost certainly necessary for firms to survive in the longer term.

**Table 1.** Summarizing the performance of surveyed SMEs 2001–2002

	<b>Increased sales</b>	<b>%</b>	<b>Stable sales</b>	<b>%</b>	<b>Decreased sales</b>	<b>%</b>	<b>No</b>	<b>%</b>
Profit	570	32	414	23	253	14	1237	68
Breakeven	64	4	105	6	43	2	212	12
Loss	179	10	119	7	65	4	363	20
All firms	813	45	638	35	361	20	1812	100

Not surprisingly perhaps, differences in business performance can be observed between different enterprise size groups, with very small firms (0–9 employees) being outperformed by small firms (10–49 employees), which in turn were outperformed by medium-sized firms (50–249 employees). This is reflected in the proportion of firms in the different size groups to report profits in 2001: from 65% of very small firms to 79% of small to 82% of medium-sized companies. It is also reflected in the proportion of firms to have increased sales in 2002 compared with 2001: 42%; 55% and 59%, respectively.

One in five SMEs is involved in making some *sales in foreign markets*, although predictably there are significant differences between firm size groups in this regard (0.001 level), ranging from 17% of very small firms, to 35% of small firms to 55% of medium-sized enterprises. This compares with 25% of businesses in a comparable survey of SMEs in the UK that were generating 6% of total annual sales from foreign sources (Michaelis *et al.*, 2001). There are also significant sectoral differences in the propensity of SMEs to be involved in export markets (0.001 level): highest in manufacturing (47%), transport and communications (31%) and wholesaling (26%), and lowest in education, healthcare and other services, retailing and construction (8% each). Clearly, for SMEs in manufacturing particularly, the small size of Esto-

nia's domestic market means that foreign market sales are almost a necessity for many enterprises. Whilst this particularly applies to small and medium-sized manufacturing enterprises (60% and 86% of which respectively reported some export sales), even among very small manufacturing enterprises, 32% were exporting.

Less than one in five Estonian SMEs (19%) belong to some form of *business association or employer's organisation*, although predictably the rate varies significantly between firm size groups and also between sectors. Whereas a majority of medium-sized firms were members of such an organisation (63%), only a minority of small firms (29%) and a small minority of micro-enterprises were represented in this way. In sectoral terms, it was firms in the manufacturing, education/health care/other services and transport/communications sectors that showed an above average propensity to be members of such an association.

## **Manager's assessment of the main constraints facing their businesses**

### **Changes in perceived barriers over time**

One of the indicators of the extent to which the transformation process has contributed to the emergence of market-based conditions and institutions is the nature and scope of the constraints on business activities reported by entrepreneurs. In the SME survey undertaken in late 2002, entrepreneurs were asked to assess the importance of a number of potential constraints on their businesses during the 12 months prior to the interviews, on a 5-point Likert scale from 'a very important problem' at one extreme to 'not a problem at all' at the other.

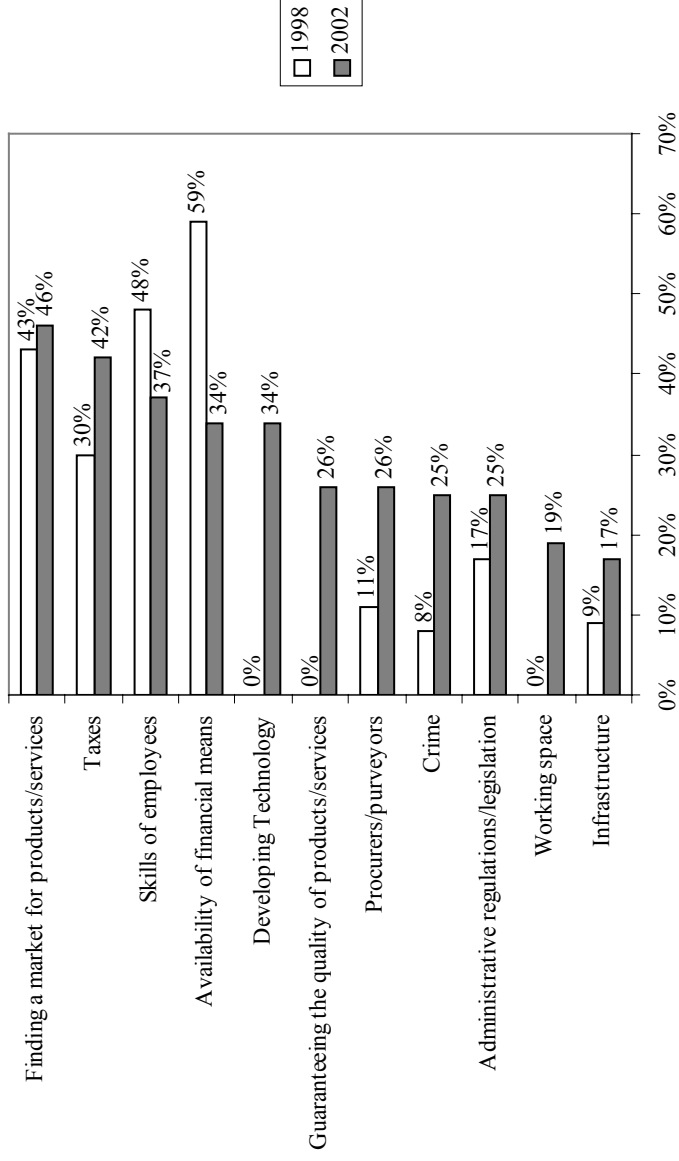
The main constraints identified by SMEs across all sectors in the 2002 survey were: 'finding a market' (which 42% rated as a problem/important problem), taxes, availability of finance, crime,

labour skills, and administrative/regulatory burdens. All of the listed factors were identified by at least 25% of respondents. Since similar questions were asked in two previous surveys of manufacturing SMEs, 2002 survey responses for manufacturing are separately identified in Figure 1, which shows that the most frequently mentioned problems were broadly similar to those for all sectors, namely:

- Finding markets (by 42% of firms, including 11% for whom it was rated as ‘a very important problem’);
- Taxation (by 36% of firms, including 7% who rated it as ‘a very important problem’);
- Accessing finance (by 34% of firms, including 12% for whom it was rated as ‘a very important problem’);
- Crime (by 30% of firms, including 8% for whom it was rated as ‘a very important problem’).

A comparison of the results from the two surveys indicates that ‘finding markets’ has remained a consistently reported concern of entrepreneurs in manufacturing firms. At the same time, taxes, supply issues, administrative barriers and infrastructure have grown in relative importance, while workforce skills and the availability of finance have significantly decreased as problem issues.

In an earlier survey in 1995, involving manufacturing SMEs in Poland and the Baltic States, the most commonly mentioned constraints identified by the 100 Estonian entrepreneurs interviewed were the level of taxation (by 39%), weak domestic demand (by 32%), the strength of competition in the domestic market (30%), the need to modernise equipment (30%), and a shortage of external finance (by 22%) (Smallbone *et al.*, 1997). This comparison shows that although taxation remains a concern for Estonian entrepreneurs, over time it has been replaced by market-related factors as the most commonly perceived constraint, with crime emerging as an increasingly significant problem.



**Figure 1.** Constraints on business development identified by surveyed firms in 2002 (Manufacturing). (Jurgenson *et al.*, 2003)

With 6.5% real GDP growth in 2001 and 7.2 in 2002<sup>2</sup>, it is difficult to explain the rise in the relative importance of demand and market-related factors primarily in terms of short-term macroeconomic conditions. It would seem that the concerns of Estonian entrepreneurs increasingly reflect growing competition associated with emerging market conditions, as well as the commonly reported weaknesses of SMEs with respect to marketing. It is significant that problems associated with finding markets for products/services were consistently reported across the firm size groups.

### **Labor-related constraints**

Employee skills-related issues were identified as a problem by 26% of the firms surveyed in 2002, with a small minority (i.e. 7%) considering it a major problem. Not surprisingly perhaps, more detailed analysis shows that this is an issue which is significantly related to firm size; for example, 57% of firms employing between 50–249 employees identified it as a problem, compared with 21% of very small enterprises (i.e. 0–9 employees). This is compatible with the results of previous research in mature market economies, because of the tendency for most human resource-related problems to increase in importance with increasing firm size, at least until the human resource management function begins to become more formalised and, ultimately, separately identified and managed (Atkinson and Meager, 1993).

When managers were specifically asked to evaluate the degree of ease or difficulty with respect to recruiting particular types of employee on the labour market, 42% referred to the difficulties in recruiting skilled workers, with 22% describing it as very difficult. If the firms stating they had no need for skilled workers are excluded, the proportions rise to 60% and 32%, respectively. Not surprisingly perhaps, the problem is sectorally concentrated with

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<sup>2</sup> <http://www.eestipank/info/> (September 2005)

skills-related problems highest in manufacturing (74% referring to 'difficulties' and 39% describing it as 'very difficult', construction (67% and 34%, respectively), and wholesale firms (65% and 38%). There are also significant spatial variations (0.05 level) in the reported frequency of skilled labour shortages, with firms located in towns outside Tallinn and the larger centres appearing to experience the most problems: 69% and 37%, respectively; compared with large towns, such as Tartu, Pärnu and Narva (63% and 33%); Tallinn (57% and 29%); and rural areas (53% and 30%)<sup>3</sup>.

These results suggest that there is an ongoing mismatch between the supply and demand for labour in Estonia, emphasising the importance of prioritising the reform of the vocational training system. However, since this is likely to take some time to produce results, the short-term solution may be to encourage business owners to train their existing employees. In this regard, when asked what proportion of their employees had been involved in in-service training during the previous 12 months, 59% of the respondents reported having trained at least some of their employees, and 47% to having trained at least some of their managers. Not surprisingly, there was a high degree of correlation between firm size and the propensity of firms to have been involved in management and/or employee training.

Comparison of the extent to which Estonian enterprises have been involved in training their employees in 2001–2002 with results from a similar survey of enterprises in EU member states during 1998 (European Commission, 2000) shows Estonian firms to have been more likely to be involved in training their employees. This might reflect the reported shortage of workers with the required skills, as well as the legacy of transition in Estonia, where the labour market is still adjusting to the needs of the emerging market

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<sup>3</sup> All these percentages are based on firms that stated they had no need for skilled workers being excluded.

economy. At the same time, the survey results provide some evidence to suggest that a culture of training is beginning to develop in the Estonian SME sector, which in the majority of cases involves external organisations delivering formal training courses. Significantly, this is an aspect that has grown in importance since the EMOR survey of manufacturing enterprises in 1998 (Phare, 1998), when only 43% of firms reported using courses run by an external training organisation, compared with 70% of manufacturing enterprises in the 2002 survey; moreover, 60% reported using in-house training, without external help in 1998, compared with 50% in the 2002 survey.

## **Sources of finance**

Although access to finance was the third most commonly perceived constraint by Estonian entrepreneurs (by one third of respondents), comparison with the survey results from the existing EU countries suggests that the problem may not be significantly worse than in mature market economies, at least as far as established SMEs are concerned. While this may reflect the rapid development of the Estonian banking system, associated with a high degree of foreign participation, this does not mean that financial markets in Estonia operate perfectly as far as SMEs are concerned. Nevertheless, it is an aspect of institutional reform where recent progress has contributed to increasing convergence with mature market economies.

The 2002 survey revealed that, as in mature market economies, only a minority of Estonian SMEs received external finance at start-up. For example, in order to give an up-to-date picture of the sources of finance used at start-up, businesses founded in, or after, 2000 were asked to identify the main sources of finance used when the businesses were started. The results show that only 32% of all new businesses had received some form of external finance at start-up, and the figure falls to 21% if loans from family and

friends are excluded. This is significantly below the level of start-ups in a UK context, where approximately 35–40% of start-ups access bank loans (cf. Ram *et al.*, 2002). As a result, the vast majority of new business start-ups in Estonia are still reliant on self-financing, in a context where the scope for accumulated or inherited wealth is less than in most mature market economies.

Where some external finance (other than from family and friends) was accessed, it was typically in the form of a bank loan (52% of all new firms reporting some form of external finance, representing just 11% of all new firms), equity from local sources (25% and 5%, respectively), some form of state financing (i.e. a loan, a loan guarantee or a grant) (by 11% and 2%, respectively), and foreign shareholders (9% and 2%, respectively). Although the overall pattern of distribution between sources of finance is not significantly different from that in a mature market economy, the overall level of dependence on self-financing, including family and friends is higher than in a country such as the UK. While bank finance is very much the exception for Estonian start-ups, in 40% of the minority of firms that attracted it, more than half the initial funding came from this source, with the rest typically contributed by the personal equity stake of the entrepreneur.

### **Sources of finance for established SMEs**

In order to obtain an indication of the current/recent level of expressed demand for bank finance by Estonian SMEs, all the surveyed respondents were asked if they had applied for bank finance during the three years prior to the interviews. In practice, 25% of all firms reported seeking bank finance on at least one occasion during this period, with the propensity to report this increasing with the age of firms: for example, 19% of young firms that had started trading between 2000–2002 had sought bank finance on at least one occasion, compared with 25% of those who started trading in 1996–1999; 29% of those who started in

1992–1995; and 33% of those in the oldest age group (i.e. those who commenced trading before 1992).

Firms seeking bank loans also tended to be the larger enterprises (46% of SMEs compared with 20% of self-employed and micro-enterprises). There was also significant variation between sectors, with manufacturing, energy and resource based industries (32%), retail (29%), and transport and communications (29%) at one extreme, and construction at the other. Almost two in five firms that had sought some bank finance during this three-year period had done so on more than one occasion (39% or 4% of all firms). However, it appears that the majority of firms applying for bank finance (82%) actually received at least part of what they were seeking, although it may have taken them more than one attempt to achieve it. In fact, more than two thirds of firms received all they were asking for on each occasion, with only 19% being completely unsuccessful the first time. These results suggest that access to finance, which approximately one third of the surveyed firms identified as a constraint on business development, is not mainly a supply side failure, as far as established SMEs are concerned, unless a high proportion of businesses are being put off applying for external finance because they believe their application will be refused. The results reported in the subsequent paragraph suggest that there may be demand-side deficiencies, with a need to educate Estonian business owners about the importance of adequate financing for their businesses, if they are to operate successfully, with a potential to grow. When firms that had not sought bank loans were asked the reasons, the overwhelming response was that entrepreneurs did not perceive any need for external finance (74%).

In fact, only 29% of firms where entrepreneurs identified the availability of finance as a problem had actually sought bank finance during the 2000–2002 period, compared with 24% of those who had not identified financial constraints. Although it can be argued that a strong perception among SME owners that

applications for bank finance are likely to be turned down is likely to contribute to reducing the incentive to apply, the reported evidence is, firstly, that most entrepreneurs in Estonia actually applying for bank finance receive at least some of what they are looking for, and secondly, that most entrepreneurs who do not apply for bank loans explain this in terms of a lack of perceived need. The results confirm that any attempts to increase the supply and availability of different types of finance in Estonia need to be at least matched by initiatives designed to increase the level of effective demand for it, linked to a wider strategy of building the competitive capacity of Estonian SMEs.

**Table 2.** Sources of external finance used by surveyed firms: 1999–2002

Source	No	%
Leasing company	543	28
Bank (Loan)	398	21
Family & friends	169	9
Factoring	49	3
Foreign mortgage	30	2
Other foreign sources	46	2
Other local sources	36	2
State grant	17	1
Guaranteed loan	12	1
Other sources	7	–
At least one external source	985	52
At least one formal external source <sup>4</sup>	891	47
No of respondents	1912	100

Source: 2002 survey data.

Respondents were also asked if their business had actually used external funds from a range of specified sources during the three years prior to the interview. As Table 2 shows, 52% of all the sur-

<sup>4</sup> i.e. excluding family and friends.

veyed firms reported having used some form of external finance during this period, or 47% if family and friends are excluded. The table emphasises the increasing role played by leasing in the Estonian market for SME finance, since this was the most frequently mentioned source. Not surprisingly, the table also shows that it was common for firms to be accessing finance from a number of sources, since 985 businesses received funds from 1,307 external sources during this period.

### **Investment finance**

Almost two thirds of the surveyed firms reported investing in some form of capital asset in 2002 (e.g. machinery and production equipment; office equipment, vehicles or premises). However, this conceals a significant difference (0.01 level) between firm size groups: from just over half of micro-enterprises (57%) to the vast majority of small (87%) and medium-sized firms (93%). There were also significant differences in the propensity to invest between sector groups, from manufacturing (75%) and transport and communications (72%) at one extreme to retail sales (51%) at the other. Not surprisingly, there were also marked sectoral differences in the targets for investment; for example, machinery and production equipment in manufacturing and construction; office equipment, particularly in business services; vehicles, particularly in the transport/communications and wholesaling sectors; and premises, particularly in retailing. In a majority of cases, (54%), the amount invested totalled less than 100,000 kroons (Euro 6,400 approx), although in 10% of cases, it was more than 1m kroons (Euro 64,000 approx).

The most commonly reported sources of finance for investment in 2002 were reinvested profits (78% of the firms investing, or 49% of all firms; leasing (18% and 12%, respectively); loans from family and friends (8% and 5%, respectively); bank loans (8% and 5%, respectively) and additional equity from shareholders (8%) and 5%, respectively). Significantly perhaps, 43% of those

investing claimed that tax exemption on reinvested profits<sup>5</sup> had encouraged them to make the investment, although 47% stated that it had not and a further 10% did not seem to know, which probably means they were unaware of this concession. Small (55%) and medium-sized enterprises (64%) appeared to have been more positively influenced to invest by the tax exemption on reinvested profits than micro-enterprises (38%).

Respondents were also asked if they were currently seeking external sources of funding to finance investment. In fact, only 17% of all the respondents stated that they were, which may partly reflect the low level of future investment plans, but also a high propensity to self-finance any investment that is undertaken

## **Access to information and business advice**

The most commonly reported source of information about potential business clients was 'word of mouth' (60%), followed by the Internet (30%) and 'other media' (27%). Formal business support organisations, such as Chambers of Commerce, business and professional associations, and local enterprise centres were only mentioned by a handful of respondents as a source of potential clients (*circa* 2% in total). The emphasis on 'word of mouth' suggests that informal network contacts are the predominant means of obtaining information about customers in Estonia and by SMEs of all sizes: medium (69%), as well by small (61%) and micro-enterprises (59%). The Internet is gaining in importance for this purpose, although, once again, there is a positive association between firm size and reported use of the Internet.

Only 21% of the firms could recall searching for information about public sector grant programmes, with significant differences between firm size and sector groups (0.001 level). In terms of

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<sup>5</sup> This is a current policy measure in Estonia designed to encourage firms to invest in modernising equipment.

size, 34% of medium-sized firms reported actively seeking out grant information, compared with 26% of small and 19% of very small enterprises. In terms of sector, manufacturing firms were the most active sector group in this regard, with transport and communications the least active (12%). Not surprisingly perhaps, the sources of information about public sector grant programmes were quite different from those reported as a source of information about potential customers. In the case of state grant programmes, it was the Internet (58% of those seeking grant information), other media (27%), local enterprise centres (12%) and training courses (5%) that featured most prominently, with 'word of mouth' being mentioned by a modest 11% of firms.

When the respondents were asked about any types of information they experienced difficulties in obtaining, the two most commonly mentioned are both under the influence of the state: firstly, information about state regulations and legislation; and secondly, information about state financial support schemes. Information about potential customers and new markets, which is in third place, was mentioned by far fewer respondents than state regulations and programmes. Certainly, there would appear to be a need to improve the availability of information about both state regulations and public support programmes, on the basis of this evidence.

One of the ways in which SMEs can overcome some of their internal management resource constraints is through the effective use of external advice and consultancy. The survey results indicate that 39% of Estonian SMEs reported using some form of external advice in 2002, which is significantly less than the 56% reported in a recent survey of SMEs in the UK. Although the propensity of firms to have used external advice increased with increasing firm size, there is little sectoral variation. When firms that had not used external advice or consultancy were asked why not, by far the most common reason given was that there was 'no

need' (86%), with the cost and 'lack of suitable consultants' also mentioned by a small minority (7% each).

Significantly, the most frequently mentioned fields of advice used were legal advice, accounting and taxation, which are all mainly linked to the daily operation of businesses rather than to business development and/or strategic issues. The most commonly used sources of advice and consultancy were private consultants (42% of users), business partners (35%) and friends/family members (19%) rather than banks and accountants (9% each), which are the most commonly used sources in some mature market economies, such as the UK.

It is clear from these results that the market for business advice and consultancy is still developing in Estonia, with deficiencies apparent on both the demand and supply sides of the market. The results also suggest a rather 'arms-length' type of relationship between banks and SMEs in Estonia, reflected in the very low level of use of bank managers as sources of business advice, as well as the limited development hitherto of recognition by Estonian entrepreneurs of the potential benefits of professional advice and consultancy to the development of their businesses.

## **The public policy dimension**

### **Awareness and use of public policy measures**

More than three quarters (77%) of enterprises reported knowing of the existence of state support measures, although only 12% claimed to have a good knowledge. At the same time, the survey revealed that only a very small proportion of the respondents had ever benefited from some form of state support programme (3%), such as start-up assistance (1.3%), a training subsidy (1.3%), a loan guarantee (0.6%), and/or infrastructural support (0.4%). A small proportion of firms had benefited from more than one of these. Part of the problem would appear to be that Estonian entre-

preneurs are simply unaware of what is available, although this is less of a problem with start-up assistance (where 25% were unaware) compared with other types of support. For example, in the case of infrastructural support, more than half of the respondents (59%) were unaware: 47% in the case of the loan guarantee scheme and 39% in the case of training subsidies. Moreover, the information gap is wider than it appears from these figures, since approximately half of those respondents that were aware of support measures had only a very vague knowledge of what was on offer. Clearly, one of the weaknesses of the current SME policy revealed by the survey is the low level of entrepreneur's awareness of what is on offer.

Interestingly, although small and medium-sized firms showed a higher level of overall awareness of state support measures, compared with micro-enterprises (83% and 76%, respectively, or 16% and 11% claiming a good knowledge), the difference between the size groups in terms of actual take-up was much greater (6.0% and 1.0%, respectively)<sup>6</sup>. Although a majority of the respondents claimed some awareness of state support measures, there was less specific knowledge about which agencies or organisations to use, in order to access them. For example, 71% of the respondents stated that they did not know which organisation to approach if their firm wanted to use one of the specified state support measures in the future. Those respondents that claimed to know which agency to approach mainly referred to their local enterprise centre (10%) or Enterprise Estonia (7%), the Ministry of Economic Affairs (3%), the Internet (3%), Kredex (2%), and a bank (2%). Self-employed people and micro-enterprises were typically less able to name an appropriate agency than SMEs.

Although survey respondents did not necessarily associate a local enterprise centre with access to a government business support

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<sup>6</sup> Significant at 0.001 level, when the 0–9 employee group is compared with the 10–249 employee group (based on total company employment).

programme, 51% of all the respondents were able to name the local enterprise centre that is closest to them. However, only 12% had ever made use of the services of their local centre (and almost half of these within the previous year). While a majority of users (72%) described their last contact as useful (or very useful), a significant minority (25%) described it as not useful, although there was some variation in user's assessment between different types of use. For example, although client firms were generally positive about the use of local enterprise centres for training (8% of those receiving it) and seminars (all the participants), approximately 30% of those seeking information, applying for assistance and receiving counselling or consultancy rated the local enterprise centre assistance as 'not useful'. Although the small numbers involved affect the statistical significance of the training and seminar results, policy makers in Estonia should be concerned that a significant minority of users of core services of local enterprise centres (i.e. information and consultancy) rated the assistance they received as not useful. In the case of those applying for financial support, it is likely that the dissatisfaction they expressed with local enterprise centres may be associated with an unsuccessful application for support.

The creation of the information portal "Aktiva" is a good initiative on the part of Enterprise Estonia and a potentially useful tool for disseminating various types of information to businesses. It should contribute over time to increasing awareness and knowledge among entrepreneurs about state support programmes. This is particularly the case since the survey shows almost all Estonian SMEs (91%) now have Internet connections, although less than a third of these reported being aware of the "Aktiva" site (30% of Internet users, or 27% of all firms). Predictably, a smaller number had actually used the "Aktiva" site (31% of those knowing about it, or 9% of all firms), although about one quarter of those that had made use of it (72%) judged it to be a useful facility. Clearly, the satisfaction of existing users is an aspect that Enterprise Estonia should actively promote in order to increase awareness levels

overall and to encourage more of those knowing of the existence of the site to actually make use of it.

### **Administrative burdens and regulatory issues**

Businesses set up during or after 2000 were asked to assess how long the initial registration and licensing procedures had taken. In a majority of cases (55%), these procedures were reported to have taken less than 1 month, with a further 31% reporting the process took between 1–2 months. In 9% of cases, respondents reported experiencing delays of more than 2 months. The most time-consuming procedure at the start-up stage was reported to be entry into the Business Register, which was mentioned by 24% of the qualifying group. The speedy and efficient registration of new businesses is a current priority for enterprise policy in the EU. In this regard, a recent study reported that the average time for completing the administration of new business start-ups in the EU was 12 days for individual enterprises (highest 35 days; lowest 1 day) and 24 days for private limited companies (from 35 days maximum to 7 days minimum) (Centre for Strategy and Evaluation Services, 2002), suggesting that although moving forward, Estonia still has some way to go to achieve average EU standards.

In order to assess the extent to which regulatory compliance was an ongoing issue for businesses once they had become established, all survey respondents were asked if legal or regulatory issues had constrained their business activity. Unlike the early stages of transition, when legal and administrative barriers are typically one of the most frequently reported constraints on SME development, only 26% of the surveyed respondents reported that some law or regulation was constraining their business activities, varying from 23% of micro-enterprises, 28% of small, and 35% of medium-sized enterprises. Although no single area of regulation dominated, apart from taxation, from a small business perspective, it is the total regulatory burden that needs to be monitored and evaluated, and not just the impact of individual regulations.

Overall, it is small and medium enterprises (i.e. 10–249 employees) that showed a higher propensity to report a regulatory burden than self-employed or micro-enterprises. This particularly applied to their greater tendency to point to problems with health and safety (associated with their larger workforce), and customs (associated with their higher propensity to export compared with smaller enterprises), but also to environmental protection and licensing.

## **Conclusions and implications for policy**

In reviewing the state of the SME sector at the time of Estonia's entry into the EU, it is necessary to take into account both the relatively short period of time that has elapsed since Estonia was operating under the conditions of a command economy, but also the significant challenges that lie ahead, associated with the threats and opportunities facing them in the enlarged internal market. In this regard, some positive features can be identified from the survey results, but also some causes of concern, which policy makers need to pay attention to if the achievements of the last decade are to be further developed and sustained.

The descriptive profile presented in the first part of the paper indicates that the SME sector in Estonia is maturing, with a size distribution that looks increasingly similar to the typical pattern in mature market economies, with a predominance of micro-enterprises and a minority of medium-sized firms. The age distribution of enterprises emerging from the survey shows that, unlike the mid-1990s, Estonia now has an emerging number of established enterprises, albeit a smaller proportion that is normal in a mature market economy. The relatively young age profile is still a feature of the Estonian SME sector, which is relevant to an understanding of some of its problems and behavioural characteristics. The survey also emphasises the importance of recognising the heterogeneity of the SME sector, broadly defined, since as in other coun-

tries, the characteristics and needs of the self-employed and micro-enterprises often look distinctively different from those of their larger SME counterparts.

The survey provides some evidence that the SME sector in Estonia is going through a fairly difficult period. Finding markets was the most commonly reported constraint by entrepreneurs and less than half the firms surveyed had been able to increase sales in 2001–2002. While some of this may be due to short-term factors, increasing competition does help to expose underlying weaknesses in marketing, as well as underlying factors influencing competitiveness, which increasing integration into the EU market may further exacerbate. The survey confirms the importance of foreign markets to Estonian SMEs (particularly those involved in manufacturing), because of the limited size and scope of the domestic market, underlining the importance of both public policy makers and entrepreneurs taking these issues seriously. For example, it could be used to justify a state programme of subsidised consultancy and training in marketing for SME managers, targeted at businesses at different stages of marketing development.

The pattern of constraints on business development reported by entrepreneurs shows a change in emphasis from the mid-1990s when institutional constraints predominated. While many of these (e.g., taxation) remain a concern for entrepreneurs, it is now competition and market-related issues that have grown in importance, reflecting the progress that has been achieved in the process of transformation towards a market economy. However, this underlines the importance of raising marketing knowledge and skills in SMEs in order to equip them better to cope with market pressures as well as to exploit emerging, new market opportunities.

Another aspect of the change in the balance of constraints reported by entrepreneurs relates to finance, which was not perceived as such a major constraint by SME owners in 2002 as it was in the 1990s, at least as far as established SMEs are concerned. The 2002 survey results show that most firms actively

seeking bank finance received at least some of what they were looking for. The results also show that the overall pattern of distribution between sources of finance is not significantly different from that in a mature market economy, although the overall level of dependence on self-financing, including family and friends, is higher than in a country such as the UK. This particularly applies at start-up where only about 1 in 5 firms appears to be accessing external finance from formal sources. The degree of reliance on self-financing is an issue when the effect of relatively low income levels compared with more advanced EU countries is considered on the ability of new entrepreneurs to accumulate sufficient start-up capital. However, since part of the problem seems to be the low proportion of entrepreneurs actually seeking external finance, this suggests that any attempts to increase the supply and availability of different types of finance in Estonia need to be at least matched by initiatives designed to increase the level of effective demand for it, linked to a wider strategy of building the competitive capacity of Estonian SMEs.

The survey also confirms the existence of mismatches in the labour market, with a gap between the supply of workforce skills available and the types of skill required by the emerging SME sector. It emphasises the importance of prioritising the reform of the vocational training system, paying attention to the specific training needs of SMEs in particular sectors. Improvements to the vocational training system also need to incorporate a spatial component, since the survey evidence demonstrates the particular problems experienced by SMEs in smaller towns. This issue emphasises the importance of 'joining up' policies between different government departments. Improving the availability and take-up of appropriately skilled workers is a priority for enterprise policy, not least because it is a particular problem for medium-sized businesses. Medium-sized companies are a potentially important segment of the business population, affecting Estonia's ability to exploit the opportunities and respond to the threats from membership of an enlarged EU. The current penetration level of foreign

markets by medium-sized manufacturing firms, for example, illustrates this.

Although considerable progress has been made with respect to the institutionalisation of SME policy in Estonia, the low level of membership of business associations and similar organisations means that the majority of SMEs are not part of this process. The Ministry of Economic Affairs and Communications and its partners might encourage more businesses to join business associations by actively promoting their contact and communications with these organisations, particularly when tangible potential benefits for businesses emerge from such dialogue. These organisations can also act as intermediaries in terms of helping firms to access external consultants.

The survey also reveals the underdeveloped state of the market for business information, advice and consultancy in Estonia, with both demand and supply side deficiencies. Where SMEs are using external advice, this is more commonly sourced informally than formally and is typically assistance to help a business to operate and meet its statutory obligations rather than to support business development. Although a structure of business associations and a Chamber of Commerce are emerging in Estonia, very few SMEs appear to turn to these as a source of information and/or business advice. In addition, the private sector consultancy is in its infancy, as far as SMEs are concerned.

In this context, there is a priority need for public policy to contribute to addressing the existing deficiencies in this market and to help build market capacity, such as through the use of a subsidised consultancy scheme. The creation of Enterprise Estonia and Kredex are positive institutional developments, as is the attempt to upgrade the quality of the local business support centres, reported elsewhere (Smallbone, 2003), although to do this effectively requires the development of an effective monitoring system to ensure quality control. At the same time, the survey evidence suggests there is still some way to go, illustrated by the significant

minority of SMEs using local business centres as a source of information, advice and/or consultancy, who are dissatisfied. The survey also reveals a need to more actively disseminate information about those support programmes that are available, which currently have very low penetration levels, based on low levels of awareness both of the programmes themselves and of who to approach to access them.

Beyond this, the key policy priorities emerging from the survey analysis are: firstly, a need for the government to work closely with the financial institutions to improve access to finance for new business start-ups; secondly, a need to continue to improve the efficiency of registration procedures and practices for start-ups; thirdly, to develop effective regulatory impact assessment procedures for new legislation affecting businesses, as well as to monitor the total regulatory burden on established SMEs; and fourthly, to improve the dialogue and penetration of the micro-enterprise sector, which accounts for the bulk of the Estonian business sector, but which is systematically under-represented in current support programmes and initiatives and relatively disadvantaged on most indicators.

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