

The Contribution of SMEs to the Process of Transforming a Centrally Planned Into a Market Economy: The Case of Estonia

David Smallbone

Centre For Enterprise And Economic Development Research
Middlesex University, UK

Urve Venesaar**

Estonian Institute of Economics
Tallinn, Estonia

Phone: +372-2-44-45-70 Fax: +372-6-30-88-51 e-mail: mail@sekr.tami.ee

Abstract

After a discussion of the structural adjustment that has been occurring since 1991, the paper assesses the contribution of manufacturing SMEs to economic development in Estonia based on an in-depth survey of SME managers. It shows that SMEs are already making an important contribution to restructuring, employment generation and the development of foreign markets. At the same time, the need for technological modernisation combined with financial constraints, the tax burden and the lack of a developed business infrastructure make active policy support a necessity if the development of the SME sector in Estonia is to be sustained.

Introduction

One of the central issues facing all transition economies in Central and East European countries (CEEC) is the need to develop a small and medium sized enterprise (SME) sector. The potential roles for SMEs in the transformation process include: contributing to economic restructuring, using privatised property for production, generating employment, and contributing to the development of an entrepreneurial class as part of the wider process of social transformation. Moreover, it can be argued that manufacturing SMEs have a particular role to play because of their potential for generating external income through foreign sales combined with the effects of their more extensive input-output linkages on the multiplier benefits of any given export-led expansion. Whether or not SMEs are able to fulfil these potential roles depends on a variety of factors including the ability of government to create the conditions in which they are able to survive and grow.

In this context, the paper will consider the contribution of manufacturing SMEs to the process of transformation in Estonia, using empirical evidence drawn from a survey of 100 SME managers undertaken in the summer of 1995. The survey data will be used to demonstrate some of the ways in which SMEs are already making an important contribution to the current development of an economy that between 1939-91 was an integral part of the former Soviet Union. At the same time the survey data will also be used to identify some of the ways in which this contribution might be enhanced with appropriate policy support.

The survey of Estonian SMEs was part of a larger study of the factors influencing the survival and growth of manufacturing SMEs in Poland and the Baltic States. To be included in the study all firms had to be at least 50% private and 50% indigenously owned; independent (ie not part of a larger organisation); employ not more than 100 employees; and operating in one of four manufacturing sectors¹ (which generated at least 50% of sales turnover). A stratified random sampling design was employed which aimed to include a similar number of firms in each of the four sectors and also in four size groups (1-5; 6-20; 21-50; 51-100). A total of 600 face to face interviews were completed in 1995 including 100 in Estonia, Latvia and Lithuania.

The following section of the paper summarises the structural changes that have occurred in Estonia since 1991 together with some of the characteristics of the SME sector that has developed since then. This is followed by the main part of the paper which uses our survey evidence to assess the contribution of manufacturing SMEs to economic restructuring, employment generation, the development of foreign market sales, and also as a source of innovation. The paper concludes with a summary of the main implications for policy.

Structural Change in the Estonian Economy During the Transition Period and the Growth of the SME Sector

The contribution of manufacturing SMEs to the transformation of the Estonian economy needs to be considered in the context of the scale of the structural adjustment facing the country in 1991 together with the macroeconomic conditions that have pertained during the transformation period. The problem for the manufacturing sector in Estonia (and in the other Baltic States) is to adjust from a highly concentrated structure based on mass production methods and relatively inflexible production processes, to a more flexible production system. During the socialist period, manufacturing was integrated into a technological chain and locked into markets in the former Soviet Union which involved a high level of military orientated production at the expense of consumer goods. As a consequence, there is now a need to radically restructure the manufacturing base in order to develop a more flexible production system which is responsive to changes in consumer demands and the forces of market competition. Clearly within such a context, the potential role of SMEs is considerable because of their inherent flexibility, although to fulfil such a role in practice requires SME managers overcoming considerable constraints.

Although the number of private enterprises in Estonia has increased dramatically since 1991, the external environment has presented many threats as well as opportunities for enterprise development. By 1995, GDP (at constant prices) represented just 67.5% of its 1990 level and similar figures for industrial and agricultural output are 38.9% and 55.5% respectively. Nevertheless, after reaching the highest rate of GDP decline in 1991/2 (-14.2%), the annual rate of decrease fell annually until it began to rise in 1994/5 (by 3.2%). The growth that has occurred recently has been largely export-led although increasing foreign investment has also contributed to some growth in domestic demand. A positive factor has undoubtedly been a slowing down of the rate of inflation to 29% by the end of 1995 in the case of consumer prices; and to 22% in the case of producer prices (Opman M, 1996). After declining in the early part of the transition period, domestic income levels started to rise again in 1995 so that by the third quarter of 1996 average real wages reached US\$ 250 per month, compared with US\$ 160 in the same quarter of 1994.

Nevertheless, low average incomes combined with a small domestic population (1.5m) make the development of export markets a priority for many SMEs

The decline in GDP that Estonia experienced between 1991-95 was accompanied by rapid structural change. The share of GDP represented by manufacturing declined from 21% in 1992 to 14% in 1995 whilst its share of total employment decreased from 31% to 24%. Although the orientation towards manufacturing under the centrally planned system means that a relative shift towards services is to be expected as transformation to a market system progresses, it is clear that in some sectors (such as textiles; leather and footwear; wood products and furniture), a decline in output has occurred since 1991 which reflects a decline in competitiveness as well as the effects of losing ties with the former Soviet Union. Nevertheless, there is evidence that the decline in manufacturing output has been halted, since an increase (of 1.5% at constant prices) was recorded in 1995 for the first time since 1991. However, manufacturing employment has continued to decline and expert opinion² suggests that despite some improvement, manufacturing still has major weaknesses stemming from a lack of attention to new product development and technological modernisation, both of which are affected by major resource constraints.

In terms of the SME sector, the 1990s has seen a rapid increase in the number of firms in Estonia although, as in other transition economies, there are difficulties in estimating the precise number because of data deficiencies. Unlike Poland, where some private enterprises were allowed to operate during the socialist period, the development of private enterprise in the Baltic States is almost entirely a post 1990 phenomenon. The peak in the rate of new firm registration (ie 12-14,000 per annum) was reached in 1993-94 although this has since fallen to about 10,000 per annum by 1995. Nevertheless, in July 1996 approximately 62,500 businesses were listed in the Enterprise Register of which about 87% were private indigenously owned. However, not all registered businesses are actively trading and it has been estimated that only about half of those registered are active enterprises (Liuhto, 1996). On the basis of business registrations, the number of SMEs (1-99 employees) accounted for 98% of the total number of enterprises in 1995, 53% of total employment, 59% of total sales, and 44% of total investment. By contrast in the EU in 1990, firms employing less than 100 represented 99.5% of the total number of enterprises, accounting for 56.7% of total employment and 49.2% of total output by value (EIM, 1994). This means that although the SME sector has grown rapidly, Estonia still has some way to go before the share of SMEs is similar to that in mature market economies in the EU.

As in many western countries, there are marked regional imbalances in the distribution of SMEs in Estonia which reflect spatial variations in the rates of new firm formation. In Estonia, a disproportionate share of SMEs is located in Tallinn and surrounding counties, which in July 1996 accounted for 54% of all registered businesses but only 29% of the total population. Similarly, in February 1996 when there were about 43 registered enterprises per 1000 inhabitants nationally, spatial variations ranged from 18 per 1000 inhabitants in Ida-Viru to 78 per 1000 inhabitants in Tallinn. As a consequence, the impact of the development of SMEs is higher in Tallinn and in the North and West of Estonia and lower in the southern counties of Estonia and in Ida-Virumaa where the economy is still highly dependent on public sector employment (Eesti Bank Bulletin, 1996).

Although in some respects the pattern of SME development in Estonia shows some similar features to that in western economies, in other ways the conditions experienced in the early stages

of transformation in particular, make it quite distinctive. Many small firms do not have a single or clear product focus and entrepreneurs are often engaged in several different activities, some of which may be based on individual trade deals (Segal, Quince and Wicksteed & Ecofin, 1995). Such a pattern can be explained by the uncertainties that existed in the external environment in the early stages of transition and the need to generate a quick return on capital employed. Multiple ownership is another feature of the development of small private enterprises in Estonia. For example, 57% of firms in our survey had 3 or more owners compared with only 20% in our parallel Polish sample where a longer tradition of private enterprise exists.

An additional distinctive feature of Estonian SMEs is the high proportion of joint stock and limited liability companies reflecting the very low minimum capital requirements that have existed hitherto for these types of business. However, this situation is being changed as a result of the adoption of a new Commercial Code in 1995 which involves higher minimum capital requirements. As a consequence, the share of sole proprietorships is likely to increase in the future because higher minimum capital requirements are likely to make joint stock and limited liability companies less attractive options for entrepreneurs. Another difference in comparison with mature market economies is the role of privatisation in the process of business formation although this aspect will be discussed in the following section of the paper.

The Contribution of Manufacturing SMEs to Economic Restructuring in Estonia

Despite the fact that industrial production in Estonia declined considerably between 1990-94, the number of manufacturing enterprises multiplied during the same period to reach 8700 by July 1996, compared with just several hundreds in 1987. Most of this increase is accounted for by an increase in the number of SMEs. On the basis of data extracted from the Estonian Enterprise Register, SMEs (up to 100 employees) accounted for 95% of all manufacturing enterprises in 1995, employing 40% of total manufacturing employment and producing 36% of total manufacturing sales. As a consequence, in the face of a decline in manufacturing output and employment, the rapid increase in the number of manufacturing SMEs may be considered as a dynamic factor in the Estonian economy. Their increasing contribution is partly a reflection of privatisation which has involved a redistribution of industrial production from large to smaller enterprises. As a result, during a period when production in large state-owned enterprises declined continuously, production in private sector firms increased to reach an estimated 65% of GDP in 1995 compared with 60% in Latvia and 55% in Lithuania (Estonia People & Welfare, 1996).

The role of SMEs with respect to privatisation has been influenced by the methods used which often involved a decentralisation of management and a denationalisation of former state-owned enterprises into new legal forms before their actual privatisation. At this stage, most of the large state owned enterprises were divided into smaller units which was one of the factors creating the basis for the subsequent development of SMEs. There is evidence to suggest that where privatisation has involved SME development, the pace of transformation has been quicker than in the case of privatisations which have involved large private firms being established (Terk & Pihlak, 1996). At the same time, our survey evidence also suggests that SMEs set up as a result of privatisation often face particular difficulties with respect to the level of production technology and

the shortage of external finance for new equipment. Their higher propensity to own the premises in which they are operating (42% compared with 16% of other SMEs in our survey) means that a large part of finances of the privatised firms have often been spent on purchasing premises. Nevertheless, by contributing to bringing privatised property into productive use, these SMEs are making a contribution to the process of social and economic restructuring in Estonia.

In a situation where an economy has been in steep decline, the existence of a group of enterprises whose owners have the desire to grow their businesses, and who can also demonstrate an ability to achieve growth, are potentially significant for the economy, as well as for the entrepreneurs themselves. In this respect, almost all of the Estonian SMEs surveyed (88%) were seeking to grow in 1994; in fact, 63% reported a strong growth objective. Although the answers given by managers to such questions may be sensitive to the macroeconomic conditions during the time period to which they relate, such a result does appear high by western standards. For example, in a survey of 139 manufacturing SMEs in London in 1994, only 55% had been aiming to grow during the 1991-94 period; just 37% reported a strong growth objective (CEEDR, 1994). Nevertheless, the relatively hostile external environment for manufacturing industry in Estonia is reflected in the fact that only 55% of surveyed firms were actually able to achieve real sales growth in 1994; in 31% it declined; and in a further 13% it remained stable³. Despite this however, most surveyed firms in Estonia reported they were profitable in 1994. The performance of Estonian SMEs in terms of sales growth was above that of their Latvian and Lithuanian counterparts although below that of similar Polish firms during the same period (Smallbone et al, 1996a). Moreover, when compared with the trend in manufacturing output in Estonia during the survey period, the performance of these SMEs appears relatively strong. Although part of the explanation may be a result of the fact that we are only able to survey surviving businesses, it may also reflect the fact that SMEs are quicker to respond to new market opportunities than either state owned, or large former state owned firms that have been privatised, which take longer to adjust. One factor is the effect of the delay that is common between the time when an intended privatisation is announced and the time when it actually takes place. During this period, the activity of enterprises is typically constrained because of difficulties in obtaining loans and establishing contracts with suppliers and customers. As a result, not only the performance indicators of these enterprises are affected as Terk and Pihlak (1996) found, but the level of growth orientation of the sector and thus of the economy overall is also affected. By contrast, the development of the SME sector during the transition period has been a positive force in contributing a source of dynamism to the process of restructuring.

The Contribution of Manufacturing SMEs to Employment Generation

Ever since the publication of the Birch Report it is the contribution of SMEs to employment generation that has been the main focus of attention of policy makers in western countries. Although current levels of unemployment in Estonia appear modest in comparison with some other transition economies (5% in 1995 compared with 15% in Poland for example), this is partly a result of the ability of the private sector to create jobs to absorb the reduction of employment in the former state owned enterprises. At the same time, it must be recognised that the actual unemployment rate is almost certainly higher than the official rate. This is because the low

level of unemployment benefit does not encourage unemployed persons to register as unemployed. As a consequence in sectors such as construction, agriculture, trade and services particularly, a considerable part of labour resources are employed in the shadow economy which in 1994 was estimated to represent 13% of Estonian GDP. It is also the case that as in many mature market economies, there are considerable regional variations in unemployment rates which are highest in South and East Estonia because of the combined effects of the liquidation of large state owned enterprises and the low level of new job creation.

TABLE 1: NET EMPLOYMENT CHANGE DECEMBER 1993-JUNE 1995

	Estonia	Latvia	Lithuania	Total
	Dec. 93/ July 95	Dec. 93/ July 95	Dec. 93/ July 95	Dec. 93/ July 95
Net absolute change	+475	-130	-153	+192
% change	+20.9%	-4.9%	-6.0%	+2.6%
Mean change per firm	+6	-1.5	-2	+1
Median change per firm	+3	0	0	0
Min change per firm	-24	-200	-84	-200
Max change per firm	+60	96	80	96
Total employment	2749	2544	2399	7692
No of firms	87	87	73	247

Note: This table excludes those firms that started trading after December 1993

Our survey evidence shows that in the period between December 1993 and June 1995, Estonian manufacturing SMEs were creating jobs at a rate that was significantly above that of similar firms in Latvia and Lithuania during this period (Table 1), although lower than those surveyed in Poland (Smallbone et al, 1996a). However, we must stress that the cross-sectional nature of our data means that we can only refer to the jobs created in firms that have survived; we are not able to identify any jobs lost through non-survival. More detailed analysis shows that job creation is not confined to a handful of fast growing companies. In fact, a majority of Estonian firms (62%) increased employment during this period, which is a higher proportion than in either Lithuania (51%) or Latvia (38%) (see Table 2). Although Table 1 only refers to firms that were already trading in December 1993, among firms founded after this date Estonian SMEs also showed a higher employment growth rate than those in Latvia or Lithuania. By June 1995 the median size of Estonian firms founded since December 1993 was 16.0 jobs compared with 11.0 in Lithuania and 9.0 in Latvia.

TABLE 2: EMPLOYMENT CHANGE (DEC 1993-JUNE 1995) AT THE INDIVIDUAL FIRM LEVEL

Employment Dec.1993	ESTONIA		LATVIA		LITHUANIA		BALTIC STATES	
	Firms	Jobs	Firms	Jobs	Firms	Jobs	Firms	Jobs
TOTAL								
incr. employment	54	633	33	432	36	382	123	1447
stable employment	12		16		16		44	
decr. employment	21	-158	38	-562	21	-535	80	-1255
Total	87	475	87	-130	73	-153	247	192

Note: This table excludes those firms that started trading after December 1993

Although firms employing fewer than 20 employees show the highest average rates of employment increase in all four countries, it is firms in the 21-50 size band which make the largest

proportional contribution to job creation: 43% of the net increase in employment in Estonia from 21% of the total number of firms, which is partly explained by the fact that firms in this size group have a lower propensity to shed labour than larger firms. However, a key finding of the research from a policy standpoint is that the firms making the biggest contribution to net employment generation in 1994 were those that were able to grow in the real value of sales turnover. For example, 82% of the additional jobs created in 1994 in existing firms, were generated by those 55% of firms that increased real turnover. This is significant when considered in the context of the decline in manufacturing output and employment that occurred in Estonia until 1994. The results suggest that SME in the manufacturing sector are beginning to grow and increase employment.

However, our survey results also show that manufacturing SMEs in Estonia that seek to increase employment face certain constraints that result from labour market characteristics. When managers were asked about any barriers they face when seeking to recruit additional labour, 71% identified at least one such barrier. The most commonly reported constraints were 'shortages of skilled labour' (56% of all firms) and 'levels of social taxation' (20% of firms). Skills shortages are associated with the restructuring of the economy that results in a decline of employment in some sectors and an increase in others which has implications for the demand for labour, particularly for different types of labour skill. As in the other three countries surveyed, high levels of social taxation affect the willingness of firms to increase employment in the formal sector of the economy, encouraging them instead to tap into informal labour markets. In 1995, employers in Estonia were required to pay 33% of salary costs in social taxation whereas employees made no contribution. This is in addition to enterprise income tax which firms are also liable to pay. The growth of the informal sector is one of the most consistent features of transition economies and although the phenomenon has many aspects to it, the use of illegal employees is encouraged partly by the high non-wage costs of employing workers legally and by the high overall tax burden which fall disproportionately on smaller enterprises. The challenge for policy makers is to re-assess the current burden of taxation with a view to channelling more of the activity (and the associated employment) into the formal economy.

The Contribution Of Manufacturing SMEs To External Income Generation Through Foreign Market Sales

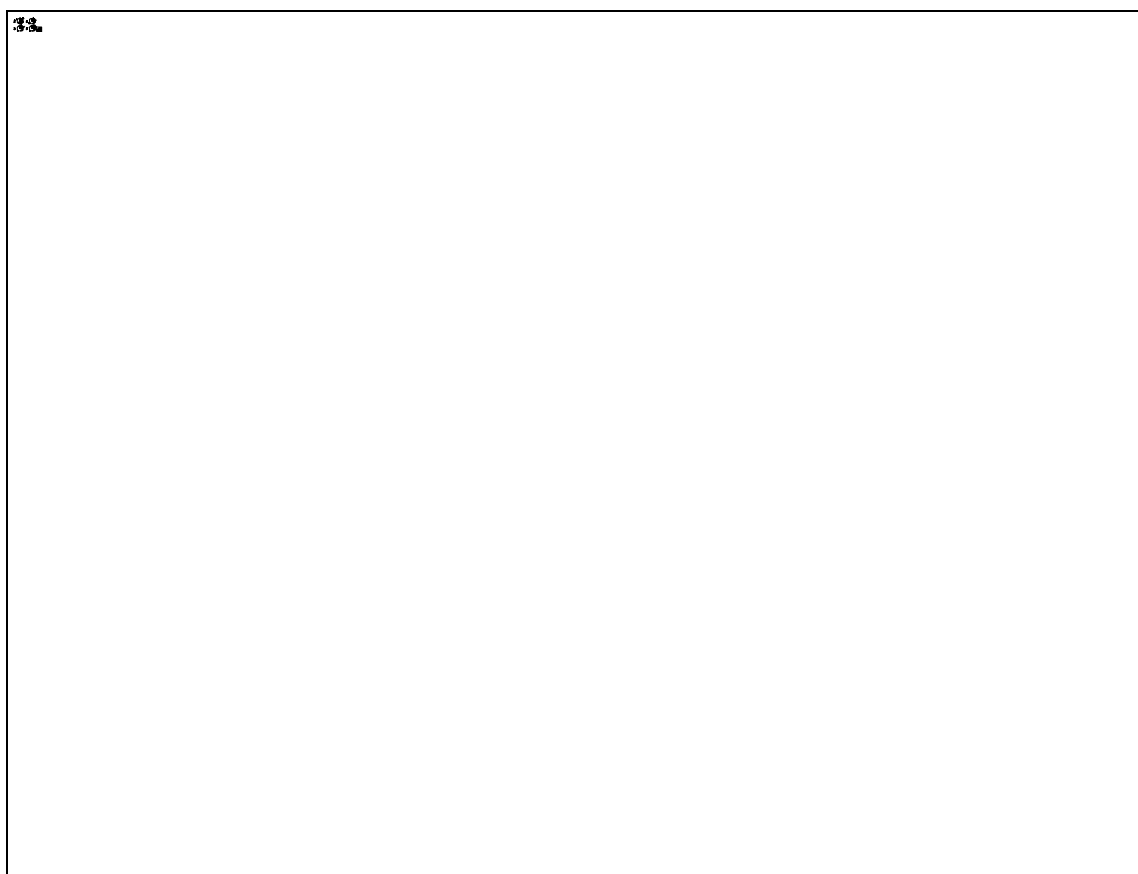
One of the most important factors influencing the long term growth prospects of any economy is the ability of its firms to develop sales in foreign markets, since this represents an important mechanism for generating external income which allows the economy to grow. In the case of Estonia this is particularly important because of the limited size and scope of the domestic market and also because of the need to replace traditional markets in the former USSR.

Our survey evidence shows that Estonian manufacturing SMEs have responded quickly to the opportunities presented by western markets although the study also reveals certain potential weaknesses which stem from the methods used to service foreign markets, in some cases, as well as the size related barriers which SMEs face when seeking to develop or increase export sales. National statistics show that before 1991 approximately 90% of export sales were generated from markets in the East whereas by 1995, 75% were coming from western markets. The contribution of SMEs is demonstrated by the fact that small manufacturing firms (0-99 employees) accounted for about 45% of total export sales of manufacturing goods in 1995 (Estonian Statistical Office, 1995).

In fact, among our surveyed firms one of the key factors influencing the ability of Estonian SMEs to achieve growth in 1994 was the extent to which they were able to exploit foreign markets. Figure 1 shows that the proportion of Estonian SMEs that were exporting in 1994 was significantly higher than in the other three countries, although the proportion of total sales generated from overseas markets varied considerably between firms: from 3% to 100%. The higher level of export orientation among Estonian SMEs is also associated with a higher level of penetration of western markets than in Latvia or Lithuania where firms are still more dependent on markets in the CIS than in Estonia. A significant minority of Estonian firms appear highly export orientated. For example, in 34% of Estonian firms exports account for at least half their total sales (mainly in the clothing, metal goods/engineering and wood products/furniture sectors) and firms employing more than 20 were significantly more likely to be exporting than those employing less than 20. The more rapid re-orientation of Estonian SMEs to new foreign market opportunities is influenced by the more liberal trade policies in Estonian than in Latvia or Lithuania. Low domestic demand combined with the absence of customs duties on imported goods has resulted in strong competition for limited domestic sales thus forcing firms to seek market opportunities elsewhere. In addition, macroeconomic conditions have stabilised more rapidly in Estonia than in her Baltic neighbours.

However, one of the most consistent characteristics of exporting firms was their tendency to depend on subcontracting (or a similar form of collaborative agreement with customers) for a high proportion of total sales: 67% of Estonian exporters in our survey were involved in such linkages which typically accounted for 62% (median) of their total sales. The significance of the phenomenon is demonstrated by national statistics which show that one sixth of total foreign trade in 1995 (by value) was made up of outward processing of goods in Estonia. To become an exporter through developing subcontracting (or similar forms of collaborative relationships with customers) is an attractive strategy for SMEs seeking to enter foreign markets, as our survey evidence indicates. When the managers of exporting firms engaged in such collaboration were asked about its advantages, they stressed the "greater continuity of sales"; "less need for marketing"; and in some cases the "transfer of knowledge". At the same time, managers also recognised potential disadvantages which included: "dependence on 1 or 2 major customers" and "lower profit margins". The challenge for SME managers is to manage these relationships with foreign customers in the longer term with a view to moving along the value chain and to sell products and services rather than just labour as subcontractors. The challenge for policy makers is to develop an appropriate framework within which such an evolution is encouraged.

Figure 1: % Sales Generated from Overseas Markets 1994



It is widely recognised in western countries that smaller firms face certain size related disadvantages in identifying and exploiting foreign market opportunities. Moreover, because of the potential contribution of export sales to economic development there is strong case for policy makers to prioritise policy support for SMEs in this respect. The main barriers that surveyed managers in Estonia perceived to increasing export sales were the strength of competition in foreign markets and the lack of information about these markets. However, more detailed analysis reveals the limited marketing experience and capability of surveyed firms which is a particular constraint when firms attempt to develop or increase export sales. This is demonstrated by the fact that few exporting firms had engaged in active research about foreign markets. Instead, the main sources of foreign market knowledge were existing customers, informal contacts with other businesses, trade fairs and exhibitions, and the media. Business support agencies had only been used by a small minority of firms (11%) as a source of information about foreign markets. One of the main policy priorities in Estonia is to develop a high quality business support infrastructure that will enable SMEs to sustain and deepen their involvement in foreign markets as well as providing a means of support for firms seeking to enter such markets for the first time.

Manufacturing SMEs as a Source of Product and Process Innovation

Innovation is important to local, regional and national economies since it represents an opportunity to gain a competitive advantage which is potentially more sustainable than that based simply on price (Porter, 1990). In this respect, SMEs are often said to be a source of innovation, being more flexible, dynamic and sensitive to shifts in demand than larger firms. Clearly, these are precisely the type of attributes that economies which are in the process of transforming from a planned to a market based system need to acquire.

Our survey evidence reveals that whilst manufacturing SMEs in Estonia are active in developing new products, financial constraints limit their ability to modernise and upgrade production technology. For example, whereas 72% had introduced at least one new product in the two years prior to the interviews which suggests that product innovation was almost a necessary condition for survival, only a third of firms had acquired new process technology during this period (although these were significantly more likely to be firms that achieved real turnover growth in 1994). However, in both cases the constraints facing firms seeking to innovate were considerable. For example, although 82% of firms expressed a strong interest in developing new products, the main barriers to achieving this were said to be a lack of finance (65%), suitable production equipment (46%), and market information (26%) together with the high level of uncertainty in external environment (23%)⁴. Where firms had been able to develop new products, this was typically achieved either by relying entirely on their own resources (63% of cases) or by collaborating with partners (21% of cases). Only 9% of firms had used consultants or other external advisers to assist with new product development.

The importance of the need to modernise production technology is demonstrated by the fact it was the most frequently mentioned priority for improving business performance by surveyed managers (56%). The problem is that the majority of firms are using ageing equipment with little more than half (53%) using computers in any capacity, and then almost entirely in administration and office related activities rather than in production. Not surprisingly, when managers were asked about the most important barriers to improving the level of production technology within their firms, it was finance that was the most frequently mentioned (by 83% of managers); in fact, no other barrier was mentioned by more than 18% of firms.

Our conclusion is that whilst manufacturing SMEs are attempting to "innovate" in the sense of introducing products that are new to them, resource constraints limit their ability to introduce new production processes which has implications for the nature and extent of product innovation. In fact, the level of bank involvement in financing surveyed firms was particularly low. Only about 1 in 6 firms had used a bank loan as part of their initial start-up capital and only 22% had used a bank as one of the sources of funds for investment in 1993-94. Increasing the supply of external finance to SMEs is a high priority if such firms are to fulfil their potential as a source of innovation in the Estonian economy.

Conclusions And Implications For Policy

Our conclusion is that Estonian manufacturing SMEs are already demonstrating their potential contribution to economic transformation, particularly in terms of economic restructuring, employment generation and the development of foreign market sales. In comparison with Lithuanian and Latvian firms, Estonian SMEs appear to have adjusted more quickly to the opportunities and threats in their external environment. Whilst these results are encouraging, it is important to keep in mind the scale of the task to be accomplished which is reflected in the decline in GDP that occurred in Estonia until 1995, the negative trade balance that still exists, an inflation rate that is still almost 30% per annum, and the very low average incomes of the population by western standards.

It is also clear that Estonian SMEs face many constraints which hitherto the government has not viewed as a priority for action. A number of bills aimed at supporting SMEs have been over-ruled by the Estonian Parliament and those support measures that have been introduced, have often not operated in the way they were intended to. For example, the Foundation for Crediting SMEs which was set up in September 1993 has offered loans at market rates although it had been previously agreed that SMEs would benefit from subsidised loans. In fact, in Estonia at the present time only the reformulated Small Business Credit Fund and the State Export Credit Fund are targeted at SMEs and from our survey evidence, neither appear to have significantly penetrated the manufacturing SME sector. In addition, whilst foreign aid projects (such as the business centres established under the EU Phare programme, the Swedish NUTEK centres and those sponsored by the Nordic Council of Ministers) aim to promote entrepreneurship and SME development, the absence of a co-ordinated strategic policy framework for SME development limits their impact.

It is accepted in many western countries that SMEs face certain size related disadvantages compared with larger firms that may be used to justify policy intervention. It can be argued that there is a role for policy to assist SMEs overcoming such disadvantages in order that they may increase their contribution to economic development in the longer term. In the case of Estonia, such a view does not appear to have been recognised by government despite the fact that there are a number of areas that would appear to justify priority attention. The first is the limited availability of external finance which is forcing Estonian SMEs to look for joint ventures or collaborative deals with foreign partners as an alternative to banks or other sources. Another priority is to review the tax burden on business with a view to encouraging more employment growth in the formal sector of the economy. The total tax burden (including social taxation) looks high by western standards although the difficulties involved in dealing with the problem should not be underestimated because of the need to generate revenues to pay for social policies. Improving the business support infrastructure in Estonia is also a priority if the contribution of SMEs to the future development of the economy is to be fulfilled and assistance in identifying and exploiting foreign markets is a particular priority in this respect.

The government has an interest in the development of appropriate support systems because of the various ways in which SMEs contribute to economic development. On the basis of the evidence presented in this paper, SMEs are already contributing significantly to the development of a market economy in Estonia although their ability to sustain this is threatened by a number of constraining forces which government is in a position to address. However, in a situation of scarce

resources, a degree of selective targeting will almost certainly be required. Our survey evidence suggests that SMEs with a strong desire to grow and a demonstrated track record of being able to achieve it are those which are the most likely to be employment generators, and firms that are seeking to develop or increase foreign market sales would seem to warrant particular attention. Since technological modernisation is fundamental to the ability of firms to compete in the market in the longer term, there is a case for a targeted policy initiative that seeks to improve access to finance, technological know-how and to foreign markets on the basis of competitive advantages that are potentially sustainable. However, perhaps the most important single step that government could take would be to develop a strategic framework in which the contribution of SMEs to the development of the Estonian economy is recognised together with the need for appropriate policy support if this contribution is to be maximised. Such a strategy could then be used to guide the future development of support programmes whether funded by internal or external sources and whether delivered by public or private sector institutions.

References

- CEEDR (1994) **Researching the Support Needs of Small Manufacturing Firms in South London**, Centre for Enterprise and Economic Development Research, Middlesex University
- Opman M (1996) **Eesti Vabariigi majandusseisundist 1995, aastal** (On economic situation in Estonia in 1995)/ **Eesti Välismajanduse** Teataja 5/1996, pp 1-22;
Eesti Bank Bulletin 2/1996, p.11;
- EIM (1994) **The European Observatory for SMEs: Second Annual Report**
Confederation of Estonian Industry and Employers (1996) **Estonian Industry 1996**, Tallinn, 230p.
- Estonian National Report for Habitat II (1996) **Estonia: People and Welfare**, Tallinn, 1996;
- Estonian Statistical Office (1995) **Ettevõtete finantsnäitajad** (Financial statistics of Enterprises), 1-4/1995, Tallinn, 1995-1996;
- Liuhto K (1996) 'The Transformation of the Enterprise Sector in Estonia-A Historical Approach to a Contemporary Transition', **Journal of Enterprising Culture** 4, 3, 317-329
- Porter M (1990) **The Competitive Advantage of Nations**, Macmillan
- Smallbone D, Piasecki B, Venesaar U, Rumpis L & Budreikate D (1996a) **The Survival, Growth & Support Needs of Manufacturing SMEs in Poland and the Baltic States**, Final report of ACE funded project, contract no: 94 07443R, pp143
- Segal, Quince and Wicksteed & Ecofin (1995) **Small and Medium Enterprise in Lithuania: the results of a business survey**, Ecofin Baltic Consulting Ltd, Vilnius, July 1995
- Terk E & Pihlak Ü (1996) 'Privatised Enterprises: What has become of them?' **The Baltic Review**, Summer 1996, Tallinn, p23-24

NOTES

- ¹. The sectors were food processing (NACE 15); clothing (NACE 17/18); metal products/engineering (NACE 28/29); and wood products/furniture (NACE 2010/50; 3611/15).
- ². Based on an interview with experts at the Estonian Ministry of Economic Affairs by Dr Venesaar
- ³. Managers estimates of the percentage change in sales turnover between December 1993-December 1994 in current prices was deflated using producer prices indices for the appropriate sector.
- ⁴. Each manager was able to identify up to 3 constraints.