Estonian SMEs in a fragile environment 1991–2000

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Introduction

The transformation process in Eastern European countries in transition has been usually analysed by three different but intervolved issues: politics, economy and society. In contrast to often rapid and even revolutionary political transformations, economic and social transformations are rather seem to emerge as much slower evolutionary processes, taking possibly decades (Mugler 2000). For example, from this complexity view, privatisation (already practically completed in Estonia as a political and economic reform) is but one element of the transition.

On the other hand, traditional approaches and theories do not seem to fit particularly well in the landscape of transition economies, but have rather a tendency to misguide the researcher (i.e. Peng, Heath 1996, Liuhto, Michailova 1999). Some scholars have even challenged the widely used term "transition". For example, according to Lagerspetz (2000), the term "transition", so often used in comments on post-socialistic change, is dismissed and depicts the process as predictable and the "transition" problems as having an automatic solution. However, there is no widely accepted evidence on routine or standardised procedures for structuring the transition from the planned economy to the market economy (Staudt 1994). Thus, the term may have app-lied too instrumentally in legitimising the political decisions, which have led to the emergence of new societal problems.

One reason making the investigation more difficult is that before the start of major transformations in the turn of 1980/1990s, it was very different to conduct research on socialistic economies and organisations. Until the end of 1980s, it focused mostly on pure system descriptions rather than any in-depth analysis. Furthermore, before the 1990s the small business sector and private entrepreneurship were formally (officially) almost non-existing. When the world political map started to undergo a process of reterritorialisation, as some of the boundaries disappeared and some emerged, major changes appeared in economic life of great many countries, too. These changes seemed to happen at the price of internal resistance (Berg 2002), although no stronger political resistance appeared in most cases.

The most important accomplishment of Estonia's recent development is inevitably the consolidation of political democracy. The fast westward turn of foreign trade and the restructuring of economy have been less easy, although Estonia is no doubt within the first candidates to enter the EU. The economic growth that has taken since mid-1990s has been able to raise Estonian GNP back to pre-independence level. During the whole period after its new independence Estonia has followed a liberal and open economy policy. However, it has also created growing inequality between regions, occupations and genders. Poverty, marginalisation and health problems result from the neglect of social policy. For the time being, public discussion on tasks of economic and social policies seems rather difficult to initiate. Some radical recent changes such as abolishing company income tax (in 1999; after a short period of negative economic growth) and progressive income tax already earlier have certainly stimulated economic growth and some foreign direct investments, but this extreme open and liberal policy has a more dark side as well: it calls for one's own initiative and will to be responsible for one's own future – requirements that are certainly too much to many people who used just to receive and follow orders from the government and authorities. In their study on demographics, poverty and poverty relief in Estonia, Wilder and Viies conclude that considering social life, many Estonians are in bad condition. This was particularly true when they examined the condition of those less likely to be successful in adapting the changing economy – that is – the very old and very young, and the less educated or unskilled (Wilder, Viies 2001).

Thus, a characteristic of societal life in Estonia is a kind of unspecifity in terms of goals. Own national identity is in progress and at the same time the pressure to define country's internal position, especially relations to the EU and NATO is increasing. The image of the EU in Estonia is multidimensional: general public sees there both positive and negative sides.

Varieties of Estonian environment in transition

Running businesses under 'environmental tyranny' may be exaggerating, but there are pressures and demands from the environment calling for adaptive capacity. Some of the pressures operate in a short notice, others in a long run. A good number of them are objective, but many perceived. The environment has been traditionally seen as resource controller affecting enterprises through the process of making available or withholding resources, providing information sources etc. Political stability and ideological legitimacy tend to reduce environmental uncertainty and thus encourage future-oriented behaviour, giving entrepreneurs the confidence to establish new firms. Nation-states try to facilitate and protect enterprises both directly and indirectly. Whether these efforts ultimately increase or decrease enterprise stock and company growth may vary and is not yet known in a longer run in a transition economy such as Estonia.

One of the forthcoming challenges comes from demographic area. The population of Estonia has namely been constantly decreasing since 1990. Considering the small population number in Estonia (1.45 million) and the decreasing trend of it, it is not an exaggeration to talk about a demographic crisis, which will be not easy to overcome (Antler, Ylöstalo 1999). Improving socio-economic stability, general progress in well-being and effects family policy (which is actually still missing today to a large extent) may have a certain impact on demographic processes; however, as it is well known, a tendency towards the worsening of the demographic situation is an uneasy trend.

Estonian SMEs face this trend in the labour market. The Estonian labour market has undergone major changes during the last decade. The number of employed persons has been continuously decreasing already since the second half of the 1980s. At the turn of the new millennium the number of employed persons in Estonia in the year 2000 was 608 thousand, that is more than 200 thousand less than in 1989. Over the same period the labour force participation rate fell from 77% to 58%. The most drastic changes occurred in 1993–95, when unemployment was actually born and reached its current relatively high level of 10% and has stabilised at that level.

From year to year the distribution of employment by fields of activity is drawing closer to the employment structure of developed countries. The proportion of industry and agriculture is falling while that of services is increasing, respectively. The greatest changes have occurred in the primary sector , where the share of agricultural workers in the total employment has fallen from 18% to 8%. At the same time the proportion of the services sector has increased from 43% to 57%. Of all employed some 90% are employees and 10% entrepreneurs. Side by side with unemployment Estonia has a notable shortage of qualified labour (Antila, Ylöstalo 2000).

There is shortage of both highly qualified white collar and blue collar workers. State owned vocational schools do not provide training employers could be satisfied with. This might due to type of training dating still back to the shortcomings in the system of vocational training as a heritage from the Soviet time. Another uneasy phenomenon is that each year a considerable proportion of youngsters 'disappears' after basic or high school without any further training in vocational schools or institutes of higher education.

Institutional changes constitute an important and necessary area in the route from transition to convergence in Estonia. The transition process in the 1990s laid the foundation for a sounder market economy including the strengthened institutions and laws for the support of private enterprise. The process of movement toward other market economies has been termed "harmonisation" (Ennuste, Wilder 2001). This next stage gives a new priority: the need to develop laws, institutions and economic and social environments consistent with those of common trading partners, capable of enduring an international setting. Anyway, there is a number of institutional reforms needed. This is important, because there is evidence that the impact of institutional development on economic growth is inevitable. Furthermore, economic growth depends also on the quality of institutions; public sector and institutional framework are sometimes treated as the unpaid factor of production.

In spite of its reputation as a liberal country with rather low level of corruption, there are still problems related to efficiency of the institutional framework and enactment of the rule of law. For example, the European Comission's Enlargement Strategy Paper (2000) drew attention to the need to improve market supervision, especially adequate enforcement of industrial and property rights, to fight against pirated and counterfeited goods. Equal treatment of all market participants and fighting tax evasion are also crucial to promote fair competition. Additional recent problems mentioned lately are the concern that corporate interests have had too great impact on the political decision-making as a capacity of firms to shape and affect the basic rules of the game and the emergence of clientelistic networks that evolved around political parties (Ennuste, Wilder 2001).

Rajasalu (2001) has given a list of anticipated reforms including their content and impact on nominal convergence criteria. A bulk of these reforms tend to raise budgetary expenditures, they may hamper compliance with the government financial sustainability criterion. Therefore, right timing of reforms and careful and responsible accounting become to play an important role to avoid unmanageable budget deficits. The 'top ten' in Rajasalu's list are as follows: pension reform, employment policy and unemployment insurance, health care reform, public management reform, agricultural reform, environmental reform, reform in education and R&D funding, raising defence expenditure to 2% of GDP, increasing the staff of the Estonian missions in the EU and the personnel of EU related projects in Estonia, and minor adjustments in the tax system.

There is a recent interesting comparative study about the government agencies behaviour and operation conducted by Pôlajeva and Vensel (2001). In this study, the same interview-based questionnaire was administrated in Estonia, Russia, Finland and Sweden. The results showed that the development of legal and institutional infrastructure is not in accordance with radical changes in the society and success in economic development in Estonia. The authors emphasise that entrepreneurs and managers have to cope quite frequently with unexpected changes in laws and government economic policies which could seriously affect their business decisions. Sometimes entrepreneurs and managers are not informed clearly about new laws and plans to change existing laws and policies; possibilities to voice their concerns indirectly or directly are quite small. The government announcements' credibility was evaluated by respondents as a sometimes happening phenomenon.

According to the same study, law enforcement mechanism (especially the court system) was found to operate weakly; entrepreneurs and managers do not trust the objectivity of courts and judges. Furthermore, money power over the court decision played an important role in the court cases and knowing the judge personally could influence the court procedures and outcomes also quite frequently. The degree of civil servants' wilfulness and power was evaluated to be quite high: there were signs of "helping-hand" and "grabbing-hand" model characteristics in Estonian legal and regulatory environment. However, uncertainties in dealing with government agencies, uncertainties in law-making rules, and uncertainties in law enforcement mechanisms had not improved over the last five years and mostly these uncertainties had remained on about the same level.

As to the comparative part of the study, the conclusions from comparisons of the same characteristics of government agencies' behaviour, law making procedures, and operating of the enforcement mechanisms in Russia, in Finland and in Sweden, there were large and significant differences between Russia and two Nordic countries in terms of legal and institutional environment in favour of Finland and Sweden. The legal and institutional environment in Russia was significantly less developed, the influence of bureaucrats' behaviour was high, law making procedures were unclear and the enforcement mechanism was not well-working. It was not expected that Estonian legal and institutional environment was in general closer to the Russian one, but there was still a remarkable degree of instability and uncertainty, and administrative capacity of the state governance was weak in Estonia. According to this study, uncertainties in dealing with government agencies, in law making procedures and in operation of the law enforcement mechanism had been decreased during the last five years significantly in Finland and Sweden, they had increased in Russia, and remained in general the same in Estonia.

Thus, the situation tends still to be aggravated by unclear principles of public and corporate governance in Estonia. More transparent and efficient institutional framework could improve the rule of law and supervision of markets and thus promote economic growth and facilitate catching-up. A well functioning institutional framework is a prerequisite for further development.

Estonian SMEs in a transition context

As in all mature market economies, the great majority of Estonian enterprises are micro-firms employing less than ten persons. According to the statistics supplied by the National Tax Board, 74.7% of the active firms in 2000 were micro-enterprises, 19.5% small and 3.6% medium-sized enterprises:

Number of	1994	1995	1996	1997	1998	1999	2000
0–9	66.6	70.7	71.3	72.2	72.3	69.5	74.7
10–49	25.6	23.1	23.1	22.6	22.7	21.0	19.5
50–249	6.5	5.4	4.9	4.6	4.4	4.1	3.6
250+	1.3	0.8	0.7	0.7	0.6	0.6	0.6
Unknown	0.0	0.0	0.0	0.0	0.0	4.7	1.6
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

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

Table 1: Size of enterprises in 1994–2000, in %

The table above actually understates the role of micro-businesses by excluding a large number of sole traders. The total population of enterprises consisting of micro and small firms has increased during the 1990s. As an outcome, a mean size of active enterprises (sole traders excluded) has decreased from 22 employees in 1994 to 13 employees in 2000 (Ettevõtteregister). Approximately two thirds (64%) of the registered entrepreneurs (including firms and sole traders) at the beginning of 2001 were in services, 15% in manufacturing and 21% in primary sectors (mainly in agriculture) (Justiitsiministeeriumi Registrikeskus 2001). The concentration in services partly indicates the low entry thresholds compared with manufacturing and partly the pattern of demand for services that were very poorly developed during the old Soviet regime. New businesses that were first registered in 2000 were actually even more concentrated in services: 69% of all new ventures started in service industry.

The contribution of SMEs to total employment can be best evaluated on the basis of data from the National Tax Board. These data indicate that employment in SMEs accounted for about 75% (18.7% in micro-, 29.8% in small-, 26.2% in medium-sized firms) of the total Estonian labour force of 608000 persons in the year 2000, as table 2 shows:

Number of	1994	1995	1996	1997	1998	1999	2000
0–9	10.7	14.1	14.9	15.9	16.5	17.4	18.7
10–49	25.1	27.2	28.6	29.4	30.5	29.7	29.8
50–249	30.1	30.3	28.9	28.1	27.7	26.9	26.2
250+	34.1	28.4	27.6	26.6	25.4	26.0	25.4
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: National Tax Board.

Table 2: Employment in enterprises by enterprise size group, in %

It can be further noticed that the proportion of total employment in SMEs has increased clearly, while employment in large and medium-sized companies has declined. This might be partly resulting from the fact that a good number of large state-owned companies were privatised in the 1990s and that the number of employees in Estonia has been constantly decreasing since the mid 1980s, as mentioned earlier.

The other contribution of SMEs into Estonia's economic development is indicated in their share of value added, which accounted (without sole traders) for about 50% of GNP in the turn of the millennium. Nearly one third of value added (31%) was created by large firms, another third (33%) in medium-sized enterprises and a bit more than a third (36%) in micro-enterprises, which is rather small proportion in comparison with their share of the total number of enterprises. A closer look at these data gives an explanation: the distribution of vale added between employment size groups is related to the distribution of enterprises across economic activities, because large and medium-size companies have been traditionally more represented in manufacturing, where a good quarter (24%) of total value added of Estonian economy is created. Smaller firms tend to operate in more labour intensive sectors.

From a more subjective perspective, given the critical rope of entrepreneurs and small business managers as shapers of business decisions, actions, and, consequently performance, investigation of variations in business owners' and managers' perceptions of the environment and its changes adds the general understanding of decision processes, firm actions, and enterprise outcomes in a transition economy. The debate on the hostility and controllability of the perceived economic environment is much investigated and largely reported in the literature (i.e. Sutcliffe et al. 1998) and there is also an increasing body of knowledge relating to this issue in economies in transition as well.

In order to assess the factors that affect the ability of Estonian SME sector to grow and survive, the attitudes, opinions and motivation of small business managers and owners of small firms have been studied in several surveys over the past few years (e.g. Smallbone et al. 1998, European Comission, Phare 1999, Miettinen et al. 2000, 2002, Venesaar et al. 2002). These surveys suggest that the main obstacles to the development of small enterprises are related in the first place to market conditions (strengthening domestic and external competition, limited domestic purchasing power, weak domestic demand etc.), financial shortcomings (availability of financing, shortage of funds and support) and government policy (regulations, infrastructure, laws). In addition, there have been problems relating to production (availability of machinery and equipment), labour force problems (shortage of managerial and skilled labour). The order of importance has changed in last ten years, but the factors mentioned above have remained among the main obstacles to SME development or even worsened over the past decade.

Privatisation issues are once again up through a couple of current cases, such as Estonian railways and oil-shale industry in Eastern Estonia. It is pointed out in the ongoing debate that when the marketplace takes over from the government, the already poor may lose further. This does not mean, however, that the change may not benefit to society but that there are distributional issues which should, at least, be considered. According to the official policy, privatisation is seen in the first place as an instrument for improving efficiency and productivity and, therefore, a means for promoting economic growth. If it works, then over time, more jobs should be created in a longer run, providing more and better employment opportunities for individuals, and government revenues should be increased, allowing government to increase assistance to those permanently disadvantaged by reform.

On the other hand, government revenues should not be the primary motive for privatisation, because when a government becomes dependent on privatisation as a source of revenue, it not only puts itself in a vulnerable position (there is only a finite number of enterprises to be sold), but the goal of maximising government revenue can start a conflict with the original goal of improving efficiency and productivity. It may also come into conflict with citizen participation in privatisation (Vensel et al. 2001). It is also understandable that some persons are badly hit by privatisation operations through losing their jobs. Oftentimes they are the very same persons who have great difficulties to find a new job. A risk of becoming obsolete creates resistance to change, particularly in the cases where a privatised company (or its subsidiaries) is located in regionally outside growth centres.

Conclusions

At the new independence in 1991, there was an almost unanimous consensus that it was imperative to rid of the vestiges of the Soviet Union. Having regained its independence, Estonia was unwilling to risk losing it again by clinging Soviet type institutions and practices. More than this, Estonia has pursued to rid itself of any reminders of its occupation. This created an environment that not only encouraged, but rather demanded, both political and economic change on a major scale. It also led Estonia to look to the West for its future and required change in order to make it to qualify to the West.

The reform programme that emerged, while not without a number of hesitations and mistakes, has been, generally speaking, a successful one. The economic and political reforms which were instituted were, for the most part, and demonstrated by the outcomes, the ‘musts’, things that needed to be done. The crucial role played by the macrostabilisation and liberalisation programmes which were started early in the process have been leading themes in the transition process, not to forget the role of a stable, sound currency and that of a stable banking system within a larger, sound financial market (Lesser 2000). This step to introduce and maintain a sound currency, which began in Estonia in 1992, was absolutely essential to the halt in the post-independence recession Estonia encountered and the fall in the rate of inflation which can be observed by 1993–1994. Although the banking crisis is over now, it seems evident that i.e. small start-up businesses experience more problems to finance their operations now than a decade earlier (Miettinen, Lehtomaa 2002).

As a free market system was introduced, there has been, over the first decade, a recognition that government had a role to play in modifying market behaviour to prevent the abuse of market power. 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 (Venesaar, Smallbone 2002). At the same time, the social costs of the rapid liberalisation of the economy became evident: economic reform has not treated all individuals the same. Furthermore, the reform, particularly on the scale that has been witnessed in Estonia in the last 10 years, requires major labour market adjustments. This not only means dislocation of workers, at least in the short term, but a rise, perhaps a permanent rise, in the unemployment rate and increased pressure on the social assistance or social security system. At the same time, other demands on social assistance, especially from elderly pensioners, are increasing the pressures, while government's ability to respond is limited by the overall climate of fiscal restraint which is still in place.

To conclude, the Estonian economy is still characterised by low productivity and income level as well as by relatively low prices. Its GDP per capita (at purchasing power parity basis) reached only 36% (that is equal to Poland) of the EU average in 2001. The situation can not be changed radically within a few years: it has been estimated that although Estonia has the best starting point in the Baltic states, and assume that the living standard in Estonia will increase 5% a year in the next decades, and that at the same time the population growth per annum will be zero (which is an optimistic forecast), the Estonian GDP per capita will reach a figure of US dollars 8800 in year 2010. This figure is still far below that reached in Greece in 1995. With the same growth rate continued, the equivalent figure in the year 2025 will be US dollars 18200, which corresponds to the living standard reached in neighbouring Sweden and Finland (in EU-average) in the mid-1995. According to these assumptions, it can be projected that Estonia will reach the lowest level of the EU welfare pyramid (the Greek level) in year 2030 and that in about fifty years time, in year 2050, Estonia will be approximately on the same level with Finland (Tiusanen, Talvitie 1998).

Thus, although the Estonian economic policy and economic environment seem to be quite promising from many aspects and the progress since the early 1990s has been remarkable, there is a long way to go in the convergence context. Rather reliable and favourable business environment has attracted a good amount of foreign direct investments that support technological development, but even more would be welcomed, although a risk of becoming too independent on foreign investors is already there.

Nevertheless, there are still further opportunities to make economic environment more favourable. In education, a reorientation to technical and technological specialities is needed (for the time being, there is a boom of selecting business studies with a declining share of engineering students). Estonia has also to overcome its backwardness in research and development: Estonia's annual allocation of 0.62% of its GDP to research and development is one of the lagging ones of the new EU candidate countries (Purju 2001) and far below the EU–15 average of 1.86, not to talk about 3.77 in neighbouring Sweden and 3.50 in Finland. The problem should be partly solved by raising public funding of R&D; however, the motivation for raising business sector investments in R&D is also to be encouraged.

There are also shortcomings in the institutional framework as mentioned earlier. Although business legislation is more or less appropriate, the rule of law is not as strong as it might be. There are still problems related to industrial and intellectual property rights. The cases of tax evasion and unfair competition are not rare. Solving business disputes in courts is costly and time-consuming. 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 on the development of central-local, public-private partnerships that are essential development tool within the EU. As Venesaar and Smallbone (2002) have stated, the key policy priorities in this context 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 upcoming EU membership. Nevertheless, eventual catching-up is very time consuming and will take several decades.

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