

Entrepreneurial Activity in Estonia and Implications for SME Policy¹

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Abstract

Entrepreneurship in new member states has been assessed as a driving force of decentralisation, economic restructuring and movement in the direction of market economy. As countries vary markedly in a way they regulate and provide an environment for enterprises, Estonia is an interesting case with its notably open small economy, extremely liberal economic policy and the ability to stay on the economic growth trend during the last 10 years.

The issues of the activity of firm formation in regions and entrepreneurship policy have attracted attention in Estonia because of considerable regional differences in the number of enterprises and labour market situation (e.g. job creation, unemployment) and because regional economic development has been strongly polarised to the territory around Tallinn and other larger towns. The aim of the paper is to assess regional firm formation, focusing on differences compared with the average firm formation rates in the country, and to understand why such variations exist. The paper is based on empirical evidence drawn from the database of the National Tax Board and two large-scale telephone surveys undertaken in 2002 and 2005, supplemented by a review of secondary data from other studies conducted in Estonia.

Entrepreneurial activity across regions indicates differences in entrepreneurship environment and possibilities. Counties with larger centres have developed faster than others, and a number of peripheral regions are lagging behind all the others. The analysis showed spatial variations in the firm formation rates, which can be explained by differences in economic structure, size of enterprises and other factors. Also we can distinguish factors that hinder development of start-up enterprises compared with those faced by older enterprises. For eliminating these constraints it would be needful to find appropriate policy measures to support the development of entrepreneurship in the country.

JEL classification: L53, M13, R12

Keywords: entrepreneurial activity, new firm formation rate, regions, entrepreneurship policy

1. Introduction

New firms formation is an important indicator of entrepreneurial activity and key component of economic development and growth. There is a number of empirical studies to show that new firms have a significant role to play in employment generation (e.g. Baptista et al, 2005), innovation (e.g. Fritsch & Mueller, 2005), economic growth and reduction of unemployment. Consequently, resulting from different impacts of these roles, several surveys have indicated spatial variations in business formation rates across countries as well as within countries (Reynolds, 2002; Johnson, 2004). It is therefore important for every region (e.g. county) to understand more thoroughly the reasons of spatial variations, which may have important

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implications for entrepreneurship policy. In policy interests it is needful to know how to increase the activity of firm formation rates in regions (counties).

In Estonia, the impact of firm formation activity and development of enterprise sector has been assessed in general as a positive factor in economic development since the early years of transition, based on the fast growth of enterprises and the role of SMEs in generation of employment (Smallbone et al, 1999; Venesaar, 1999; Estonia country..., 2002; Smallbone & Venesaar, 2004). As a result, the share of employment in SMEs achieved nearly 80% of total employment in business sector in 2004. However, the growth of job creation led to a growth of overall employment only from 2001 (Labour Force, 2002), because the period of transition brought along a considerable decline in the participation rate of working-age population in the labour market and caused a growth of unemployment and inactivity. But the improvement of business environment and continuous rejuvenation process of the stock of enterprises together have improved the performance of enterprise sector as a whole and also the labour market situation.

Entrepreneurial activity across regions in Estonia indicates differences in entrepreneurship environment and possibilities, especially between the capital Tallinn and other counties, as regional economic development has been strongly polarised to the territory around the capital city. Tallinn is the business centre of Estonia. With its close to 400,000 population (29% of the Estonian population) the capital city is the heart of the national economy – over half of the Estonian enterprises which produce all together ca 50-60% of the gross domestic product and nearly 3/4 of enterprises' profits are located there. One-third (33%) of employed population of Estonia are living and 38% of employed population are working in Tallinn. Being attractive with its good infrastructure, institutional development and favourable external business environment, more than half of the foreign capital-based Estonian enterprises are also located in Tallinn, owing to what the export turnover per enterprise is the biggest in Tallinn. All these circumstances are supporting the growth of the number of operating enterprises in Tallinn, which in recent years has been constantly slightly higher than the Estonian average, or 6.3-6.7% per year. The tertiary sector has grown rapidly in Tallinn's economic structure. Therefore, the share of Tallinn and the surrounding Harju county in the total number of operating enterprises has been gradually rising. A survey on entrepreneurial initiative of Estonian people (Eesti..., 2005) also indicated differences in entrepreneurial initiative across different regions in Estonia. This survey showed that the initiative to set up own enterprise is the biggest in Tallinn and Harju county. It also suggested that every second potential entrepreneur comes from this region.

A number of studies have been carried out in Estonia about regional development of small enterprises, which have evaluated differences in socio-economic development across regions, sources of regional problems, analysed possible policy strategy choices, use of support from foreign donors (Regional..., 1996; Estonia Country..., 2002; Raagmaa, 1996; Kudela & Venesaar, 1999). In those studies, a kind of success from establishing a support system and participation of foreign assistance in this has been mentioned. The studies about manufacturing SMEs in transition countries and the influence of internationalisation have helped to find out the contribution of SMEs to economic development, characteristics in firms' behaviour and their support needs for future development (Smallbone et al., 1996, 1999). In recent years, some studies

have been made to assess the results of measures implemented as entrepreneurship support policies and to identify more precisely entrepreneurs' demands in the country as a whole as well as in different regions (e.g. Jürgenson et al, 2003; Eesti..., 2005). But the firm formation rates across counties have been studied less thoroughly, which will be a contribution of the current article into regional studies in Estonia.

Big differences can be found in the economic structure across counties. One of the reasons for this is definitely the legacy of planned economy but also different paths of development in the transition period and the firm formation rate across sectors and regions. The aim of the current article is to examine the regional firm formation activity, focusing on differences compared with the average firm formation rates in the country, and to understand why such variations exist. The firm formation analysis across counties and sectors has been conducted so as to explain the regional differences. Taking into account several other structural differences (e.g. size of enterprises, labour market indicators), the article makes references to the previous studies defining also directions of job flows in different groups of enterprises (on the basis of ownership, size, age and other factors). Relying on the results of analysis, the research tries to find implications for entrepreneurship promotion policies.

The paper is based on empirical evidence drawn from the database of the National Tax Board and two large-scale telephone surveys undertaken in 2002 and 2005, supplemented by a review of secondary data from other studies undertaken in Estonia.

The structure of the article is as follows. The next section describes the data and methodology of analysis. The third section presents the results of regional analysis on firm formation, and the differences in the flows of jobs in enterprises with various characteristics (e.g. ownership, market orientation, enterprise's size). The fourth section analyses the impact of entrepreneurship promotion policies and a need for policy support in regions. The final section concludes the study.

2. Data and methodology

The current research is based on the database of the National Tax Board for the period of 1999-2004, where the registered number of enterprises is used as the number of births and the number of enterprises at the end of the year as the stock of enterprises. As the database contains only enterprises, then some inaccuracies are connected with under-representation of self-employed. Nevertheless, the database is the best basis for assessing business formation rates in regions.

The firm formation rates are calculated and used in the analysis in two ways. First of all, the firm formation rate is defined as the average annual number of registrations per 1000 of the adult population (B1). This indicator is measuring the activity of population in setting up new businesses. Age group 18-64, which reflects more real activity of citizens in new firm formation, has been used for calculating the indicator. Secondly, the firm formation rate is calculated as the ratio of new firm registrations to the registered stock of businesses at the end of the year (B2). This indicator shows the extent to which the business sector has been rejuvenated.

The subject of the research includes 15 counties of Estonia and their activity in firm formation. As Tallinn exceeds several times other counties by the number of firms and the formation activity per 1000 inhabitants, the in order to explain differences in entrepreneurship activity across counties more clearly, Tallinn has been excluded from the calculation of average figures. The average figure of counties has been used in the analysis, whereas the contrast of Tallinn from the counties average has been brought out.

Based on the firm formation rates per 1000 adult population, the counties have been divided into two groups: those where activity of firm formation in the period of 1999-2003 was above the average (excluding Tallinn) and the others where the respective figure was below the average. Differences in economic structures of counties and firm formation by fields of activity in counties have been looked upon as significant factors for firm formation activity. In this case the firm formation rate has been calculated as a percentage from the stock of enterprises.

The main policy implications are drawn about the impact of SME promotion policy and support needs of SMEs with the aim of achieving their increasing contribution to regional economic development of the country.

3. Analysis of firm formation rates across regions and sectors.

In the period of 1999-2003 over 35 thousand firms were formed in Estonia, 59% of those in Tallinn. The firm formation activity has constantly increased its relevance in Tallinn's entrepreneurship sector. There was a difference of more than five times between Ida-Virumaa, the county with the lowest figure, and Tallinn. Based on the county's average firm formation rate (excluding Tallinn), the counties can be divided into two groups: firm formation activity in 1999-2003 was above the country's average in Tallinn, Harju, Hiiu, Pärnu, Saare and Tartu counties. Rapla and Lääne-Viru counties, where the firm formation rate was relatively close to the country's average, can also be included in this group (Table 1). The second group of counties with below the average firm formation rate includes the remaining eight counties (Ida-Viru, Jõgeva, Järva, Lääne, Põlva, Valga, Viljandi and Võru counties). The grouping is also supported by the increase/decrease of the number of employees, whereas the number of employees increased in counties with higher firm formation rate and decreased in counties where it was below the average. This rule does not imply to Valga and Võru counties where the firm formation activity is below the average, but where the number of employees has increased on account of bigger firms.

The second indicator (B2) for characterising the firm formation rate expressing the extent of rejuvenation of the stock of enterprises, is different but in correlation with the first indicator (B1). Some exemptions of this indicator are obvious in the counties with a smaller than average number of enterprises, for example, in Ida-Viru and Viljandi counties where the firm formation rates per 1000 of adult population in general are among the lowest and the firm formation activity is also low, but the number of enterprises formed in the period of analysis reached the average level of the country (Ida-Viru 52%) or even exceeded it (Viljandi 54.1%). Such rejuvenation of enterprises allows supposing that the business activity in these counties will increase.

The analysis suggested that the counties with lower firm formation rates have more frequently lower employment and higher unemployment rates, but some exceptions indicate the impact of other external influences, which needs to be studied in the future.

Next we look the factors that influence the firm formation activity in counties. The differences in economic structure of the counties and in firm formation activity across sectors in the above-mentioned groups of counties are considered as substantial factors influencing the employment generation and development of regions. It is convenient to use the firm formation indicator as a ratio of firms to overall number of firms in the sector, which shows the share of firms being renewed in the investigated period.

Table 1: Business activity and employment change in enterprises in 1999-2004.

| County | Firm formation 1999-2004 | | | Change in the number of employees in enterprises ± | Firm formation 1999-2003 (B2) | |
|-----------------|--------------------------|--------------------------------|--------------------------|--|------------------------------------|--------------------------|
| | Total | B1 (Per 1000 inhabitant 18-64) | Variation from average ± | | % From total number of enterprises | Variation from average ± |
| Tallinn | 20597 | 78.4 | 53.7 | 6437 | 64.7 | 12.6 |
| Harju | 2632 | 32.6 | 8.0 | 4130 | 56.2 | 4.1 |
| Hiiu | 165 | 26.6 | 1.9 | -21 | 45.5 | -6.7 |
| Ida-Viru | 1605 | 14.5 | -10.2 | -8426 | 52.0 | -0.1 |
| Jõgeva | 414 | 18.5 | -6.2 | -1299 | 51.8 | -0.4 |
| Järva | 403 | 17.3 | -7.4 | -1532 | 45.7 | -6.4 |
| Lääne | 307 | 17.9 | -6.7 | -187 | 37.9 | -14.2 |
| Lääne-Viru | 957 | 23.8 | -0.9 | 438 | 51.3 | -0.8 |
| Põlva | 327 | 17.5 | -7.2 | -711 | 41.8 | 10.3 |
| Pärnu | 1808 | 33.2 | 8.5 | -1244 | 54.6 | 2.5 |
| Rapla | 536 | 23.7 | -1.0 | -314 | 52.4 | 0.3 |
| Saare | 624 | 29.4 | 4.8 | 178 | 47.7 | -4.4 |
| Tartu | 3283 | 35.0 | 10.3 | 1326 | 55.3 | 3.2 |
| Valga | 378 | 18.5 | -6.2 | 145 | 46.6 | -5.5 |
| Viljandi | 683 | 20.2 | -4.5 | -1 | 54.1 | 2.0 |
| Võru | 393 | 17.2 | -7.4 | 445 | 42.4 | -9.7 |
| Total | 35112 | 41.2 | 16.6 | -636 | 58.8 | 6.7 |
| Without Tallinn | 14515 | 24.7 | 0.0 | -7073 | 52.1 | 0.0 |

Source: National Tax Board; Statistical Office, author's calculations

The firm formation has been more active in retail and wholesale trade, service and agriculture. In the group of counties where the firm formation rates per 1000 of adult population are over the average, the firm formation rates by sectors are also higher than in other groups of counties. The biggest differences are in retail and wholesale trade, service and agriculture (Table 2).

When analysing the formation rate of firms by sectors in greater detail we can see that in addition to the more active firm formation rate in four above-listed sectors, firms in the first group are formed more actively also in manufacturing (Tallinn and other big cities), construction (Tallinn, Tartu) and other sectors. In the counties with the general firm formation rate below the average in some sectors, the rate exceeds the average of the republic. But in both groups there are counties where the firm formation rate in some sectors is very low. The present analysis enables to identify those sectors where the implementation of entrepreneurial policy measures could contribute to increasing firm formation rate and mitigate regional contrasts.

Table 2: Firm formation rates by groups and economic activity in 1999-2003, %, (B2).

| Economic activity | Firm formation rate, % | | Variation ± |
|--------------------------|------------------------|--------|----------------|
| | Group 1 | Group2 | |
| Mining, electricity etc | 4.2 | 3.3 | 0.9 |
| Manufacturing | 6.5 | 5.7 | 0.8 |
| Construction | 7.2 | 6.8 | 0.4 |
| Wholesale | 19.7 | 15.7 | 4.0 |
| Retail trade | 9.2 | 6.3 | 2.9 |
| Transport, communication | 8.3 | 7.8 | 0.5 |
| Services | 12.4 | 10.6 | 1.8 |
| Education, health | 8.4 | 9.0 | -0.6 |
| Agriculture, forestry | 11.1 | 7.9 | 3.2 |
| Total | 12.6 | 9.7 | 2.9 |

Source: Source: National Tax Board; Statistical Office, authors' calculations

Note: 1) Some discrepancy in the table is connected with 8% of unknown enterprises by sectors

2) Group 1 includes counties with firm formation rates above the average (Tallinn, Harju, Hiiu, Pärnu, Saare, Tartu, Rapla, Lääne-Viru); Group 2 includes counties with firm formation rates below the average (Ida-Viru, Jõgeva, Järva, Lääne, Põlva, Valga, Viljandi, Võru).

Business activity of the counties can also be influenced by the size structure of enterprises and several other factors (ownership, market orientation, etc). For example, a previous analysis of job flows across groups of enterprises suggested enterprise groups with different job creation potentials. On the basis of ownership, the job creation rate of foreign-owned enterprises was higher than that of Estonian-owned enterprises (Venesaar, 2003). Better growing capacity of foreign-owned enterprises is due to the higher number of their employees and turnover in the sample studied, as well as their location in a region with better infrastructure (in Tallinn). By orientation

to markets, restructuring has been faster in exporting enterprises, which is expressed by high rates of job creation.

By size of enterprises, as a rule, the job creation rates are expected to be higher in micro-enterprises, although few of them are able to survive in the market. The findings of previous research indicated that the average job creation rate was higher in small enterprises (with 10-49 employees) than in micro-enterprises, followed by medium-sized enterprises (Venesaar, 2003). Although both labour policy and entrepreneurship policy in Estonia have promoted creation of new enterprises, the entrepreneurship environment has not favoured, if to regard labour market flows, job creation in micro-enterprises.

In conclusion, the firm formation and job creation rates vary considerably across counties and enterprise groups classified on the basis of various characteristics, and there are a number of enterprise groups which could be the subject of entrepreneurship policies with the aim of bringing more new jobs to the market.

4. Managers' opinions about the constraints of newly established firms

The overall opinion is that indirect support to business development prevailed through macroeconomic stabilisation and improvement of legal external environment during a first decade of private sector development in Estonia (Venesaar, 1999; Estonia Country..., 2002). Since 2000, the aim of SME policy has become increasingly linked to improving the competitiveness of firms in domestic and foreign markets and by today a working support system has been developed, based on the entrepreneurship support principles used in the European Union. This support system has worked almost five years and some studies have been made to ask entrepreneurs' opinions about the impact of entrepreneurship services on setting up new enterprises and entrepreneurship development (Jürgenson et al, 2003; Eesti ..., 2005).

The following analysis is dedicated to the opinions of managers of newly established firms (young firms operating up to 2 years) on the basis of two surveys (2002 and 2005). We try to identify differences in the opinions of start-up enterprises' about which problems and difficulties they seem to encounter more frequently than old enterprises. Not surprisingly, the results of the analysis showed that finding financial resources and markets were more frequently mentioned as factors constraining the development of enterprises by the managers of newly established firms than by managers of older enterprises. The need to improve financing opportunities for SMEs is one of the priorities identified in the SME policy document. The surveys revealed that only a minority of Estonian SMEs received external finance at start-up. This means that the vast majority of business start-ups in Estonia are still reliant on self-financing, in the context where the scope of accumulated or inherited wealth is smaller than in most of the developed countries.

When respondents were asked about the type of information they need to overcome difficulties, then the managers of newly established enterprises mentioned more frequently (in both surveys) the information about markets, regulations and standards in foreign markets, and about foreign partners. As for the reasons for not using consultancy, they explained that consultancy has not been necessary (92% in 2002

and 83% in 2005) or they did not find appropriate consultancy (more in 2005). The need for consultancy was assessed as needful twice more frequently by managers of newly established firms than by older ones (Table 11). Among the concrete types of consultancy they mentioned more often a need for consultancy about accounting, taxation, sales and marketing, business planning and financial sources. It is noticeable, that a need for consultancy has arisen much in 2005 compared with the previous survey, which may indicate increasing competitiveness in the markets as well as awareness of managers about the availability of consultancy.

Table 3. What do you think, does your enterprise need advice or consultancy from outside?

| Does your enterprise need advice? | Age of firms (2005) | | | (2002) |
|-----------------------------------|---------------------|-----------|---------------|---------------|
| | Over 5 years | 3-5 years | Up to 2 years | Up to 2 years |
| Definitely yes | 7,7 | 7,6 | 14,8 | 13,0 |
| Probably yes | 19,5 | 20,5 | 15,8 | 18,8 |
| Probably not | 39,8 | 39,7 | 36,8 | 40,4 |
| Definitely not | 26,6 | 26,6 | 25,2 | 23,9 |
| Don't know | 6,3 | 5,5 | 7,4 | 3,9 |
| What kind of advice is needful? | | | | |
| Accounting | 21,8 | 26,6 | 25,3 | 16,9 |
| Taxation | 26,0 | 24,8 | 32,7 | 9,3 |
| Sales and marketing | 38,5 | 40,8 | 50,6 | 9,2 |
| ICT technology | 14,7 | 15,2 | 7,2 | 2,1 |
| Exporting | 8,6 | 13,3 | 5,2 | 4,5 |
| Legal advice | 43,3 | 42,2 | 23,0 | 14,9 |
| Business planning | 36,4 | 36,3 | 54,7 | 5,0 |
| Financial sources | 22,6 | 23,7 | 24,1 | 7,4 |
| Quality requirements | 20,9 | 18,1 | 18,6 | 9,7 |
| Other | 10,8 | 10,1 | 6,8 | 1,2 |
| Don't know | 2,5 | 0,6 | 4,0 | 10,8 |

Source: (Eesti väikese..., 2005); authors calculations.

In addition on the growth of awareness of entrepreneurs, the activity of using the offered services by starting companies has also grown. For example the starting subsidy has been used by ca 5% and training subsidy by 7% of respondents, that is still quite a low level. This implies to a necessity to increase the impact of entrepreneurship policy, especially to support the regions and fields where the level of establishing new companies is low.

A new Entrepreneurship Policy Programme document has been worked out based on the results of various studies conducted during 2004-2005 and compared with the current policy document (2004-2006) it is a step forward in the development of entrepreneurship and entrepreneurial initiative through a favourable entrepreneurship environment and appropriate support schemes. Entrepreneurship policy has established four purposes to achieve: strong enterprise culture; legal environment favourable to entrepreneurship; SMEs' access to finance; capability for SME growth and exports (Eesti ettevõtluspoliitika..., 2005). A lot of measures on that document are directed towards solving the abovementioned problems and increasing the activeness of establishing

new companies. The results of the research brought out in the article can be of use in composing and specifying entrepreneurship policy action plans.

Conclusion

Development of entrepreneurship has been a dynamic process in Estonia influenced considerably by changes in domestic business environment as well as the external influences, which is typical for a small country with open economy. Development of entrepreneurship through SME development and regional firm formation has supported economic development in Estonia, the growth in employment and decrease in unemployment. However, based on the firm formation rates per 1000 adult population, the counties vary considerably, which allows suggesting differences in entrepreneurship environment and possibilities. Differences in economic structures and firm formation as a percentage of the stock of enterprises by sectors in counties have been looked upon as a significant factor for firm formation activity. The low firm formation rate in a number of counties and groups of enterprises (e.g. manufacturing, construction) allows assuming that the regulation influencing the establishment and activity of enterprises, other policy measures or external influences during the period under study have not encouraged formation of firms.

In the development of entrepreneurship policy in Estonia we should take into consideration differences between regional and sectoral firm formation rates. First of all, the counties with below the average firm formation rates can be suggested for policy support to facilitate SME development and employment generation. It is still useful to study more thoroughly these groups of counties where firm formation rates were lower than average, which may help to discover deeper problems in different enterprise groups that need to be solved to make the entrepreneurship environment more acceptable.

The results of the analysis showed that finding financial resources and markets for newly established forms were more frequently mentioned as factors constraining the development of these enterprises. The managers of newly established enterprises mentioned more frequently about the difficulties in finding information about markets, regulations and standards in foreign markets, and about foreign partners. The need for consultancy was assessed as needful twice more frequently by managers of newly established firms than by managers of older ones. Although considerable progress has been made in institutionalisation of entrepreneurship policy, there is a need to offer more actively services which can better consider the needs of newly established firms and entrepreneurs in regions with the aim to strengthen the role of entrepreneurship in economic development in Estonia

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