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The Entrepreneurial Circumstances for Small Medium Enterprises within Estonia

A Legal Perspective

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	Julkaisun nimike Liiketoiminnan säännöstö pienille ja keskisuurille yrityksille Virossa - Oikeudellinen näkökulma	
<p>Tämä tutkimus käsittelee liiketoiminnan säännöstöä pienille ja keskisuurille yrityksille (pk-yritykset) Virossa neljän eri tilanteen kannalta: yrityksen perustaminen, maakaupat, verotus ja rikollisuus. Näitä liike-elämän tilanteen tärkeitä lainsäädännöllisiä osioita tarkastellaan sekä akateemisesti että käytännöllisesti. Tutkimus sisältää sekä olennaisten Euroopan Unionin (EU) lakien että liiketoiminnan sääntöjen, taloudellisen kasvun ja pk-yritysten välisen riippuvuuden tarkastelua. Aihe on ajankohtainen, sillä tämä riippuvuus on herättänyt kiinnostusta globaalin rahoituskriisin vuoksi. Tutkimuksessa tarkastellaan miten säännöstö on kirjoitettu ja toimiiko se eri tavalla käytännössä (ml. epäviralliset kustannukset).</p> <p>Empiirinen osuus toteutettiin kvalitatiivisena tutkimuksena ja se sisälsi haastatteluja, joita käytettiin yhdessä sekundäärisen kvantitatiivisen aineiston kanssa. Sekundääristä tutkimusaineistoa käytettiin ja arvioitiin liittyen neljään yritys-elämän tilanteeseen Latviassa ja Liettuassa. Tämän tarkoituksena oli saada kokonaiskuva pk-yrityksiin liittyvästä säännöstöstä Baltian maissa ja suhteessa Viroon.</p> <p>Tulokset osoittavat, että neljän tilanteen kirjoitettu säännöstö on Virossa muutamaa poikkeusta lukuun ottamatta pääasiassa selvä ja yksityiskohtainen. Säännöstöä myös noudatetaan ja se menee monissa tapauksissa syvemmälle kuin EU-laki. Epäviralliset kustannukset säännöstön mukaisten menettelytapojen kohdalla ovat hyvin pienet, eikä niitä itse asiassa joissain tilanteissa ole ollenkaan (esim. verotus), vaikka ne ovatkin tavallisempia alueilla, joilla ”venäläistämistä” on tapahtunut. Viro on tarkastelluista maista vähiten korruptoitunut, sillä on halvimmat täytäntöönpanokustannukset ja sillä on Baltian maiden pk-yrityksiin verrattuna paras säännöstö.</p> <p>Kaiken kaikkiaan nämä tulokset tarjoavat uutta empiiristä aineistoa liike-elämän tilanteisiin liittyen, kuten myös arviointia entisen neuvostotasavallan velvoitteiden sanamuodoista ja yhdenmukaisuudesta EU-lakien kanssa.</p>		
Asiasanat Viro, liiketoiminnan säännöstö, pk-yritykset, Euroopan Unionin laki, yrittäjyys		

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<p>This thesis focuses on the business regulation for Small and Medium Enterprises (SMEs) in Estonia in relation to four identified entrepreneurial circumstances: company formation, land acquisition, taxation and criminality. Important identified legal parts of each entrepreneurial circumstance are assessed both academically and practically. The study includes an assessment of relevant European Union (EU) Law as well as the overall connection between business regulation, economic growth and SMEs. The topic is current as this connection has attracted increasing attention since the global financial crisis. The primary interest of the research is connected to the question as to how the regulation is written and as to whether it operates differently in practice including any unofficial costs.</p> <p>A qualitative empirical approach was taken involving interviews and which was used together with secondary quantitative data. Additionally secondary research data was used and assessed in relation to the four entrepreneurial circumstances for both Latvia and Lithuania. The findings indicate that the wording of the written regulation for all four circumstances is generally clear and detailed (with one or two minor exceptions) in Estonia. It also complies and in many cases goes further than the EU Law. Unofficial costs within the regulatory procedures is very low and in fact non-existent in some circumstances (e.g taxation) although more common in regions where "Russification" has taken place. Estonia is the least corrupt, has the cheapest cost compliance procedure and is the best regulated for SMEs of the Baltic States countries.</p> <p>Overall these results offer new empirical evidence on the reality of the entrepreneurial circumstances, as well as an assessment of the wording and conformity to EU law obligations by an ex-Soviet state.</p>		
Keywords Estonia, Business Regulation, SMEs, European Law, Entrepreneurship		

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1 INTRODUCTION

1.1 The aim and scope of the study

The aim of this doctoral dissertation is to assess the business law reality of 4 identified circumstances for Small and Medium Enterprises (SMEs) operating in Estonia. The bulk of the research work comes in the form of published journal articles which are numbered 1-4 and referred to as thesis articles in this dissertation.

The study assesses how the law is worded and then also in practice how the law operates (if it is different as to how it is written). To completely see the reality of the law within the 4 circumstances there has to be an assessment as to whether the written law is different in practice. That is to say how much corruption is there and how does it affect in practice the 4 circumstances of the research and therefore affect the reality of the law for SME's.

Corruption means unofficial costs (bribes) which have an effect on those entrepreneurial circumstances for SME's. As (Goorha,2000)says the importance of preventing corruption is that it is costly to society, discouraging private sector investment and deterring economic growth. Consequently, as part of the reality the level of corruption the unofficial costs and its effect is considered within each circumstance.

This business law reality includes the relevant Estonian law as well as an assessment with conformity to European Union (EU) legislation. This is because the framework for this dissertation has been affected by the entry of Estonia into the EU, which took place in May 2004. Consequently there needs to be an assessment of the Treaty of Accession of May 2004, (the legally binding membership agreement for the expansion of the EU from 15 to 25 members, which included Estonia). This is the legal document, governing Estonia's membership and the specific conditions of accession, including exemptions. These have to be assessed to appreciate how it affects the specific four SME circumstances, in particular their important parts.

Estonia has obtained exemptions from EU law affecting these 4 circumstances (like some other new EU States from a Soviet background such as Latvia and Lithuania) and these need to be assessed as part of the written law. The written law of both the EU as well as the Estonian has to be found, stated and assessed and this includes relevant Directives and Regulations which Estonia should comply with.

Within the limits of the dissertation 4 circumstances have been identified as important for SME activity: company formation, land acquisition, taxation and criminality. These 4 circumstances have been selected because they cover different areas which affect SME's in different ways and yet have been assessed as important individually for SME development. It is also important to identify the important parts of those circumstances which have most effect on SME's as this will influence SME activity the most.

Private company formation has been chosen because company formation is the most often used form of business organisation and for SMEs the most significant. Private companies account for over 55% of registered businesses and much output (World Bank Report, *Doing Business 2004* pp17-19). Further as the study is specifically related to SMEs, it will be private companies not public. That is those whose shares are not offered to the general public for sale and whose minimum capital requirements are not generally large. This is because it is this type of company that the SME would be most interested in.

Land acquisition has been chosen because of the long-term connection between land acquisition and SME development within an economy. Land acquisition affects "green-field site development" that is developing a completely new enterprise and acquiring the land to do so.

This helps to establish more long term development of SMEs within a country (World Bank Report, 2005 chapter 4) (Tyson, 1994). Taxation has been chosen because the tax system can encourage or discourage the development of SMEs.

Taxation affects the incentives for SME activity by weakening the link between effort and reward. "The way governments regulate and tax firms and transactions both within and at their borders plays a big role in shaping the investment climate, sound regulation addresses market failures that inhibit productive investment....sound taxation generates the revenues to finance public services that improve the investment climate" (World Bank Report, 2005 chapter 5 p1). Criminality has been chosen because it affects the environment SMEs work in and discourages activity. (Goorha, 2000) indicates that criminality is costly to society it discourages private sector investment, and deters economic activity.

Although the legal aspect is strong within the dissertation other subjects, including business, economics, politics, history and culture are discussed where relevant to help with the assessment of the reality.

The following research questions are to be answered within the dissertation.

Why are SMEs important?

What are the important parts of the 4 circumstances for SMEs from a legal perspective?

What is the written law in relation to those important parts in Estonia? How is it worded and how is it affected by EU law?

Is the written law different in practice through corruption?

1.2 Structure of the study

Part 1 is an introductory chapter. Part 1.1 looks at the purpose and aims of the study including the research questions. Part 1.2 describes the structure of the study. Part 1.3 looks at the background and importance of the study including the EU and its Northern Dimension. Part 1.4 covers the academic positioning of the thesis articles. Part 1.5 the definition of important terms used within this thesis such as SMEs and entrepreneurship. The 4 circumstances are also defined as to their use in the study. Part 2 describes the theoretical framework. Part 2.1 covers the importance of SMEs and their connection to the business law environment. The importance of SMEs for Estonia a former Socialist economy is discussed and assessed. Then the link between SMEs and the business law environment is considered. Part 2.2 describes and assesses the effect of legal origin on the 4 circumstances and their important parts from a legal perspective. This includes the Soviet legal influence as well as the German legal connection and tradition. Part 2.3 describes and assesses the importance of the 4 circumstances for SMEs which is reviewed academically including finding out the important parts of each circumstance, from a legal perspective. For example why private limited company formation is important for SMEs and what are important parts which affect SMEs.

Part 3 is a description of national law and EU law relevant to each thesis article. Part 3.1 gives a general description as to how the European Treaty of Accession 2004 (the legal binding EU membership agreement expanding it legally from 15 to 25 members including Estonia), has an overall effect on Estonia and the 4 circumstances of this study. Part 3.2 then goes through each thesis article and the relevant permanent or temporary provisions and exemptions of the Treaty of Accession which apply. The EU law is described and assessed and how the Estonian law complies with the EU law through its own written law. For example, Article 20 of the Treaty is a permanent provision which has an effect on the company

formation circumstance of this study. Its wording is reviewed and assessed together with the Estonian written law as to whether Estonia has complied with the EU law.

Part 4 describes and comments on the research design and methodology used within this study. Part 4.1 assess the qualitative case study design and application and as to why it was decided upon for this study. Part 4.2 describes and explains the research process involved with this study including the case selection and the reasons for them as well as the data collection. The selection process for the people interviewed and the type of interview with their advantages and disadvantages is also described and reviewed. Part 4.3 then assesses the quality and validity of the research of this study, which includes evaluating how credible and transferable the data is.

Part 5 is a summary describing and assessing each of the thesis articles and also includes a summary of the other 2 Baltic States countries Latvia and Lithuania and their regulatory position in relation to the same entrepreneurial circumstances. Part 5.1 describes article 1 (company formation), article 2 (land acquisition), article 3 (taxation), article 4 (criminality). Part 5.2 compares Latvia, Lithuania and Estonia with the regulation procedures and costs for each of the 4 circumstances. This is from the same secondary data used for Estonia in the thesis and there is also an assessment of compliance with the same EU law, although there is no empirical qualitative data for Latvia and Lithuania.

Part 5.3 gives a short overall comparison of the 3 countries regulation relating to the 4 circumstances of the study, which includes comment on the most favourable country for SMEs.

Part 6 is a conclusion on the main implications of the study. Part 6.1 is a description and assessment of cross-article themes which are present within all 4 articles of the study. Part 6.2 answers the research questions of the study. Part 6.3 covers the limitations of the study together with suggestions for further future research. This is followed by the original published articles referred to in the study.

1.3 Background and importance of the study

Since the fall of the Berlin wall in 1989 Eastern and Central Europe has been through changes particularly political and economic, which have had an important global effect. One area of Europe undergoing such change whose significance is underestimated and overlooked is the North East area of the Baltic Sea. This is an area covering the subject country of the dissertation, Estonia. The importance of

Estonia has been increased in recent years due to the European Union's (EU) "Northern Dimension".

This was strengthened with the accession of Finland and Sweden in 1995 to the EU. It has been further helped by the enlargement process and the increased EU co-operation. The idea behind it is to ensure that EU activities continue to deal with issues facing Northern Europe, and that the Baltic Sea co-operation can create a functional frame work for the "Northern Dimension" policy. It was created for the countries of Europe's northern regions to increase prosperity and combat cross-border crime. There is strong evidence linking increased SME entrepreneurial activity, economic growth and prosperity for a country or a region. Consequently any entrepreneurial significance and the SME circumstances within Estonia must be taken within a regional context, for its development and influence. Regional and cross-border co-operation is one of the ten priority sectors of the EU action plan for the "Northern Dimension".

According to the action plan *"Further enhancing regional and cross-border co-operation is an essential element of the Northern Dimension concept to ensure peace, stability and sustainable development"* (EU, 2000). Estonia is an important part of this policy, as well as a new member of the EU. Although small in area, size and population, the process of transition from a planned to a market economy for Estonia is significant.

Estonia is also located next to the vast size and mineral wealth of Russia the established EU economies of Sweden and Finland, and the largest and newest member Poland. Estonia is situated in the Baltic Sea measuring 45,000 square kilometres with a population of 1.3 million people. It enjoys many natural and social advantages that make it an attractive prospect for foreign investment and it serves as a gateway to the rapidly growing markets of the Baltic Region. SMEs are a significant part of a market economy essential to long term growth of a country. For a country like Estonia which in many ways is a model for other former Eastern European countries from a communist background the significance is even greater. The time period which has elapsed from the fall of the communist system (over 20 years) and admission to the EU club should not diminish the enduring necessity of such SME development.

It appears that there are good reasons for SME entrepreneurial activity in the Baltic Sea region and particularly, Estonia. However, considering the speed of the changes it is important that any management decision to invest or engage in business activity within Estonia is carefully assessed in order that it is strategically right. Any manager making such a decision must look closely at the business reality in order to obtain the most rewards.

Assessing the reality of business law for SMEs in Estonia will give valuable information which can be used to help with the development of the business regulation environment. It will give more complete information that the regulatory authorities will be able to consider and assess and then make changes to that regulation.

By choosing 4 different circumstances it adds further value to the significance of the study because of the different areas covered which is helpful for business regulation and subsequent SME development. Although there needed to be a limit on the number of the circumstances assessed because of time and the depth of assessment needed. Also, due to regional development and the EU “Northern Dimension” policy referred to, the maintenance of similar development and cooperation is important. Estonia’s progress with its legal environment for SMEs can be looked at by other countries within the region and compared.

It is also the right time for an assessment of the reality of the business law environment for SMEs. Estonia has been in the EU for a few years which provides some stability and also it has been part of the Soviet Union in its recent past. The total reality will show its development more clearly. The overall importance of the dissertation is that it will firstly enhance entrepreneurial investment decision making in the sense that firms (e.g. Finnish SMEs) will be able to assess the reality of the entrepreneurial circumstances mentioned within Estonia. Secondly the legislative authorities will be able to take into account the findings and thirdly, for other ex-Soviet countries the reality of the entrepreneurial circumstances may be able to be used as a model for progression or adaption.

1.4 Positioning and academic contribution and importance of the thesis articles

Each thesis article of the dissertation contributes to the reality of the entrepreneurial circumstances in the following way. Thesis article 1 examines company formation and assesses the regulation which an SME has to go through in order to form a company. It assesses and adds more detail partly validating previous quantitative research (which is used in the article) in that area, including unofficial costs. The primary Estonian company law regulation is evaluated as to its wording, including meaning and compliance with EU law, something which has been overlooked in previous research. The reality of the existence of the separate legal entity principle of company formation is tested through empirical evidence. This concept is vital for business development and through this assessment of Estonia

it is examining something established in the older EU countries and the reality of its operation in a new EU Member State.

Thesis article 2 looks at land acquisition and the regulation compliance procedure for an SME in Estonia. It particularly focuses on foreign SMEs and the reality of regulation validating the virtual non- existence of unofficial costs shown from previous secondary quantitative research (used in the article). It also academically breaks new ground by assessing in reality if that regulation is more difficult to comply with for a foreign SME through an assessment of the procedures involved together with new empirical research. Additionally, the EU exemption obtained by Estonia restricting land ownership by foreigners is assessed. Although this exemption has now lapsed (2011) it is still an assessment of the operation of an EU law exemption within a new EU Member State. This thesis article also provides a different aspect to the other 3 thesis articles in the sense that it looks at a long term more permanent commitment for an SME which is of academic value.

Thesis article 3 emphasises the importance of the regulatory tax environment building on previous academic work. The tax procedures and costs are looked at validating previous quantitative work in the area and the existence of unofficial costs. It academically reaches new areas by gaining more information on that reality through empirical research from 2 very different relevant sources. The first source assesses and interprets the regulation and the other source is an SME operating in Estonia. The compliance of relevant EU laws by Estonia is also assessed through a primary source and the actual wording commented on, which is new.

Thesis article 4 highlights the importance of the criminal law environment for SMEs through new empirical research it obtains detail as to the reality of criminal statistics and crime rate and more information on organised crime activity. Both domestic and global secondary quantitative research is used and partly validated and extended through the depth of this research. The extent of security costs for an SME validates previous research and adds more depth. New sensitive information is obtained an addition to previous academic work providing more extensive indicators for countries from similar Soviet backgrounds. Also EU criminal law conformity by Estonia is assessed through the wording of laws using a primary source of the actual relevant Estonian legislation.

All 4 thesis articles look at the reality of the implementation of specific EU laws in Estonia within each entrepreneurial circumstance, as a relatively new Member State. The actual wording of primary Estonian law within each of the 4 entrepreneurial circumstances is assessed and its conformity with EU law. This is an academic contribution on the conformity and implementation of such laws by an ex-Soviet country.

1.5. Explanation and definition of important terms used within the dissertation

By this I mean defining the core terms of this research, only their meaning and usage within the study, together with a brief justification for their inclusion.

SMEs

The term SMEs needs defining because it is the subject of the study. Three important matters in the definition were considered significant, labour force size, sectors, and formality of enterprise. In relation to size of employees, the definition used by Tyson, in relation to the so called “Socialist black hole” missing from socialist economies was felt appropriate, that is less than 200 employees. Further, following conventional definitions and recent research by the World Bank (Beck, and Demirguc-Kunt, et al 2002), formal enterprises and not informal, this would include registered private limited companies (not public), partnerships and sole traders. It would also cover the service, manufacturing and trading sectors. Consequently, when examining the entrepreneurial circumstances or when discussing the entrepreneurial environment, it is that definition of SMEs that is used within the dissertation. Furthermore, entrepreneurial activity and SME development are used when referring to either within the dissertation, and certainly they are often used as such when academics are discussing the small business environment. It would be possible for a large firm to be engaged in entrepreneurial activity, however for the purposes of this study that kind of entrepreneurial activity is not looked at.

Entrepreneurship (entrepreneurial)

The term entrepreneurship (entrepreneurial) needs defining as both terms are frequently used within the dissertation in relation to the specific SME circumstances of the study. (Tyson, Petrin, et al 1994) give a brief, but clear review of the literature on definitions of the term. They then provide a definition, which they consider the most appropriate for the East European economies in transition.

Traditional definitions have put entrepreneurship into four types: (i) entrepreneurship as innovation, (ii) entrepreneurship as risk-taking (iii) entrepreneurship as a stabilising force moving markets toward equilibrium (iv) entrepreneurship as founding or owning and operating a business. Tyson, loc cit felt that the fourth category was the most appropriate particularly because of the “Socialist black hole” and the absence of small firms from Socialist economies. In particular, the significance of entrepreneurial development within the former communist economies of the Soviet Union is greater because of the “So-

cialist black hole”. This is the phenomenon he referred to and the comparison with mature market economies in particular, the significant absence, from the Socialist industrial structure of small firms in the range of fewer than two hundred employees. However, it is now over twenty years from that situation with Estonia having become a member of the EU, and she has progressed economically.

Consequently the definition from the (GEM,1999,p3) was felt to be the most appropriate. Therefore, for the purposes of the dissertation, entrepreneurship or entrepreneurial circumstances is within that definition. Therefore, the entrepreneurial circumstances for SME’s would mean the circumstances (specifically relating to company formation, land acquisition, tax and criminality) for the following: any attempt at new business, or new venture creation such as self-employment, a new business organisation or the expansion of an existing business. This could be by an individual, team of individuals or an established business. It is consequently wider (for example, as it includes an attempt) than the fourth definition preferred by Tyson, although it takes the developments mentioned into account.

Also the 4 specific SME circumstances of the dissertation need to be defined.

(a) Company formation

This relates specifically to a private company, not a sole trader, a partnership, or a co-operative. The reason for the limitation, is because limited liability companies are the most prevalent and for SME’s the most significant. SME activity is increased, when the potential losses are limited to their capital participation. Furthermore historical evidence from certain developed countries (Ireland, USA, and the UK) suggests that the introduction of limited liability dramatically increased the number of companies seeking registration.

Added to which limited liability companies account for over 55% of registered businesses and much of the output (World Bank Report, Doing Business 2004 pp17-19).Further as the study is specifically related to SMEs, it will be private limited companies not public. That is those whose shares are not offered to the general public for sale and whose minimum capital requirements are not generally large. Although as the specific entrepreneurial circumstance is company formation, if permits and licences are required as part of the process, they are included within the study.

(b) Land acquisition

For the purposes of this study it relates to real property i.e. land. That does not mean in any way to lessen the significance of property rights generally, it simply

is that land acquisition affects “green-field site development”. That is developing a completely new enterprise and acquiring the land to do so, which embeds entrepreneurial development within the given country. The other aspect is the access to the acquisition of the land and any limitations which consequently affect the SME development. Are there for example restrictions relating to foreign purchase of land within Estonia and how has the Treaty of Accession affected this issue.

(c) Taxation

Relates to tax policy and how it can encourage or deter the development of SMEs. It includes the tax rate and the compliance cost for an SME, as well as exemptions and allowances for both indirect and direct taxes, and how they operate within Estonia from a legal perspective. Clearly, from a historical perspective new types and systems of taxation had to be devised. The former Soviet system relied largely on the taxation of profits of enterprises and new forms of taxation.

For example, Value Added Tax (VAT), needed to be established or expanded. In Soviet times taxation was dominated by the principle of equalisation (Elliott, 1997p4). Under this procedure profit inequalities were reduced by imposing heavier taxes on more profitable firms, and lighter taxes on (or subsidies for) less profitable firms. As (Litwack, 1991 p114) indicates, managers within firms never knew what they could expect their taxes to be as tax rates were continually set and changed by superiors in the hierarchy. The effect of this practice was that it stimulated massive tax evasion, corruption, and shifts from legal to non-legal activities.

(d) Criminality

Relates to activity that is not legal and the effect it has on SMEs. What kind of criminal behaviour is present, and at what level within the entrepreneurial environment of Estonia. For example, the crime levels of theft, and robbery, and the extent of organized crime and how that may affect the cost of entry for an SME. As (Goorha, 2000) states “Corruption is costly to society it discourages private sector investment, it deters economic activity, causes perverse allocations of talent in an economy, and overall hurts economic growth”. (Sakwa, 2002) whilst commentating on the situation in Russia in the 1990s states “The prevailing criminalisation has squeezed out honest entrepreneurs”.

2 THEORETICAL FRAMEWORK

The theoretical framework of the study is based around three areas and how they affect the 4 circumstances of the study. The theory and academic literature shows why SMEs are important and how there is a connection with the business regulation environment. Then the effect of legal origin is looked at and how it may have had an effect on the 4 entrepreneurial circumstances. The theoretical background of the important legal parts of each of the 4 circumstances is then described and assessed.

2.1 The importance of SMEs and the connection with business law

All the transition economies from the former Soviet Union and Central and Eastern Europe to China, and Vietnam were similar in one important respect. This was that their planned economies had been dominated by large firms and SMEs were almost non-existent, although they are a large part of any market economy. The imbalances inherited from these planned economies, created enormous profits opportunities for entrepreneurs.

Entrepreneurs started enterprises at a rapid, though varying rate in each of the transitional countries as stated by (McMillan and Woodruff, 2002 p154). The importance of entrepreneurial activity and SMEs was commented on by authors like (McMillan and Woodruff *loc cit*). “In this paper we focus on the emergence of East European entrepreneurship. We do so because of the central importance of entrepreneurial activity in the processes of economic growth and development”

A global study on entrepreneurship (GEM,1999 p43), supports the comments of these authors that entrepreneurship is critical to economic growth. Probably, the most critical, innovative aspect of the survey (1999) was identifying which was the most important factor enhancing entrepreneurial activity in a given country. It was found that it was a set of social and cultural values, along with appropriate institutions legitimising and encouraging its pursuit. On further evaluation it is logical and reasonable to conclude, that the best way of legitimising entrepreneurship would be by legalising it, for a person to be able to pursue such activity in an open legal form.

It is clear that the business law environment is important for SME entrepreneurial activity which is important for a country’s economic growth. SMEs are also very important for Eastern European countries coming from the ex-Soviet system be-

cause there weren't any in existence during that time period within those countries when they were members of the Soviet Union.

SMEs are considered the engines of growth in both developed countries and developing countries. They provide low cost employment since the unit cost of persons employed is lower for SMEs than for large size units. SMEs help achieve fair and equitable distribution of wealth and regional dispersion of economic activities and contribute significantly to export revenues because of their low-cost labour intensive nature. SMEs have a positive effect on the trade balance since SME's generally use indigenous raw materials. They assist in creating an entrepreneurial culture by bringing together skills and capital through various lending and skill enhancement schemes. They give the resilience to withstand economic upheavals, maintaining a reasonable growth rate since being indigenous is the key to sustainability and self-sufficiency (SME Bank, 2005).

The significance and importance of the role of SMEs is further illustrated by (Welford, 1996 p412) who comments on the fact that a significant small scale business sector carries an immense potential of making an economy not only prosperous, but also distributes that prosperity to a greater section of a country's population. Although, a recently published paper was not so positive (Beck, Demirguc et al 2002). Here, the authors explored the relationship between the relative size of the SME sector, economic growth and poverty. Using a sample of 76 countries they found a strong association between the importance of SMEs and gross domestic product per capita growth. However while a large SME sector is a characteristic of successful economies, the data failed to support the hypothesis that SMEs exert a causal impact on growth, and there was no evidence that SMEs reduce poverty. The literature review within the paper looked at what the overall picture was in relation to whether SMEs reduce poverty and boost growth.

(Birch, 1979), argued that small firms are particularly important in job creation, he reported that over the 1970s firms with fewer than 100 employees generated eight out of ten new jobs in America. However (Davis, Haltiwanger and Schuh, 1996) show that while gross rates of job creation and destruction are higher in small firms, there is no systematic relationship between net job creation and firm size. Furthermore in Sub-Saharan Africa, (Biggs and Shah, 1998) found that large firms were the dominant source of net job creation in the manufacturing sector. Also some empirical evidence suggests that many small firms are more capital intensive than larger firms within the same industry (Little, Mazumdar and Page, 1987). This, suggests according to Beck *loc cit*, that SMEs are not necessarily more suitable to the labour abundant and capital shortage characteristics of developing countries. Furthermore, he comments that although the positive SME view

argues that small firms are more innovative, the microeconomic evidence is inconclusive. On examining United States firms (Acs and Audretsch, 1987) found that small firms have higher innovation rates in “high technology” skill-intensive industries, and larger firms have the innovative edge in “lower technology” capital intensive industries.

There is some evidence to suggest, in developing countries, that large exporting firms are typically the primary mechanism through which technologies are adapted from abroad to local circumstances (Biggs et al, 1996). This survey shows that some of the evidence does not state that SMEs are the best way for improving innovation and productivity. When looking at the significance of SME development therefore, and the correlation to the business law environment, and the reality of the 4 SME circumstances of the dissertation, this would lessen their importance.

However, because of the special circumstances of the former Soviet countries and the “Socialist black-hole”, the economic correlation is greater and more obvious. Because there is a lack of small firms altogether within these former state run economies, as indicated by (Tyson, 1994) and authors like (Koves, 1992). The latter, quotes Stanley Fischer of the Massachusetts Institute of Technology and former president of the World Bank “The key to the long-run transformation of the former Socialist economies may be less in the privatisation of the very large industrial firms ..than in the development of new firms and the growth of existing smaller firms.” This, together with the fact that even authors like Beck et al, who are not so positive altogether about the economic influence of SME’s still acknowledge the fact that a large SME sector is a characteristic of a successful economy. Which suggests quite strongly, the significance of SMEs and their connection to entrepreneurial economic growth is accurate, particularly within the former Socialist economies of Eastern Europe, like Estonia.

It could be suggested that it is just over twenty years since the collapse of the Soviet Union and therefore the need for SME development in Estonia is not as great now. However, the development of SME activity needs to be on-going even if the country is at an advanced stage of transition. Also because of the history of countries like Estonia (from Soviet backgrounds with the Socialist black hole in relation to small business) it is important to maintain SME development. This is because they have no historical SME background to fall back on. (Kirkby and Watson, 2003 p193) reaffirm the need for SME’s in both developed and transition economies as the engines of growth. For countries that approach an advanced stage of transition to a market economy, (such as Estonia), there is also the need for internationalisation. They comment on the importance of European SMEs

becoming more efficient and providing further economic growth. Additionally, (Winięcki et al, 2004 pp 94-95) state that the size structure in the EU is dominated by small firms, yet there still remains a gap to be filled by future expansion in SMEs. The jump start of SMEs in East-Central Europe was one of the most important developments in post-communist transition. However the development of SMEs has not yet reached other high growth countries.

The connection with the business law environment as a crucial factor in sustaining and developing the SME sector mentioned by Koves loq cit was recently acknowledged at the 31st International Small Business Conference (September 2004) in Warsaw, Poland, by Mirosław Marek, chief executive officer of the Polish agency for enterprise development. "A series of factors influence the competitiveness of small and medium-sized enterprises, amongst which one of the most important is the legal environment of business operations, and not only in the sense of creating favourable conditions for economic activity but also of ensuring the stability of valid regulations".

A business law environment which is favourable for SMEs and has stable regulations will encourage the development of SME activity which is important for economic growth. (Jesselyn, 2004 p16) states that as little as possible regulation within a stable operating environment for SMEs, is important for SME development as this means a certain and reliable environment. She states further that the legal and regulatory frameworks establish the "rules of the game" and govern the way in which the government and business interact with each other. These rules influence investment decisions, the opportunities and rewards available to entrepreneurs and consequently it is important that they are stable and certain. (Stevenson, 2010 p190) also comments on the importance of the business law environment for SME growth stating that the quality of the rules in the legal and regulatory system has an effect on the level and distribution of entrepreneurial activity.

Within a stable business law environment regulation which helps SME development includes: regulation which is transparent, efficient and implemented in a simple way, it then becomes easier for entrepreneurs to compete, innovate and grow (Doing Business, 2013 p18). During the 1990s governments began to realize and recognize the importance of an enabling business law environment for SMEs.

Perhaps this was because of the events that took place from 1989 and the collapse of the Soviet Union which led to many countries having to establish market economies and encourage economic growth.

(Stevenson and Lundstrom, 2002) indicate that, since then, governments have been reforming the business law environment with SMEs in mind and the impact on existing ones and new entrants. They comment further, that in particular this has meant: simple tax systems, and entry procedures for starting an SME which helps entrepreneurial activity. This is supported by (Djankov et al 2002) who also comments that simplified business entry regulations and less costly procedures lead to more new firms being established. However, care must also be taken that the business law environment for SMEs is at a realistic level. (Bannock et al,2002) state that when business regulation is at a level that's too high that is too many regulations to comply with and not properly enforced, the effect is that business regulation divides SME activity into formal and informal sectors. If that happens then the effect on economic growth by SMEs is not as great.

(OECD,2004 p50) also makes comments on the importance of having a business law environment which is helpful for SMEs. It gives examples of areas within the business law environment which encourage SMEs to start and develop including: where property rights are clearly recognized, and transaction costs involved in setting up and doing business for an SME are as low as possible, through fair and simple taxation, registration and judicial systems and procedures, and consistency in the rule of law. Also, (Audretsch et al, 2007 p112) writes about the need to establish a business law environment which encourages new SMEs to start-up, by reducing regulation to business entry. They link economic growth to increasing the number of small start-up firms within an economy and the business regulation environment can have an effect on that number of start-ups by SMEs. How easy to start is it for a new SME is the question they ask. They comment that the big regulatory issues affecting entrepreneurial activity are to do with the time and cost of starting a business. The number of days it takes to obtain approvals, the number of required procedures, the number of regulations that have to be satisfied and the cost of business registration and regulation compliance.

The connection between the business law environment and SMEs is clearly acknowledged by both academics and practitioners. The best environment for SMEs would be one which is stable but has few business regulations, which are clearly enforced by the rule of law. That type of business law environment will encourage the start and development of SME activity which is important for economic growth.

2.2 Impact of legal origin theory

The Estonians were Christianised by German crusaders at the start of the 13th century, these brought officials of the Catholic Church and German landowners. In the early 13th century invaders from Denmark occupied Northern Estonia where they founded the city of Tallinn. At the same time the German land owners (who had taken over Estonian farms) in Southern Estonia, joined together with the Teutonic knights. This alliance along with the Danes selling their Estonian land to the Germans, led to the Germans ruling all of Estonia and Northern Latvia (a territory the Germans called Livonia) until the 16th century. In the middle of that century all of Livonia went to the Russians after a war except for part of Southern Livonia, which went to Poland.

However, the Russian occupation of Estonia only lasted a few years, as they were then removed by the Swedes. Estonia was left under Swedish rule and in real terms all ethnic Estonians were left as landless peasants, having to farm for German nobility who maintained ownership of land even after the Swedish occupation. In the early 1700 century Russia occupied Estonia imposing their language and cultural values on the country. Although, German rule of estates within Estonia never changed and native Estonians still worked on German farms. However, during the 18th century more freedom was given by Russian law for native Estonians, including having access to education and professions as commented by (Rodgers,1992).Russia accepted and recognised Estonia's independence, in 1920. However this independence was short lived as Russia re-took Estonia in 1940 although, this rule was interrupted by the German occupation during the Second World War. Estonia reclaimed its independence in 1991 and joined the EU in April 2004.

Estonia's legal history has undoubtedly been influenced by its occupations. Through Russian legal tradition (Estonia was under the Soviet legal influence), there has also been a strong German legal connection and tradition.(Topornin,2000 p14)comments "Already during the Russian Empire, before the World War 1,there was a very strong German tradition in Russian law. From the time of Peter the Great, German experts have exerted influence on the formation of Russian law and its concepts and the way of thinking of law in general. This feature did not vanish during the Soviet period, quite on the contrary, the German conceptual thinking continued to live in new circumstances. One has to remember that the socialist doctrine prevalent in the Soviet Union was originally German. To combine Marxist thinking with German legal concepts was not so difficult, because Marx and Engels themselves expressed their legal ideas through German notions."

Consequently, through Soviet rule and German colonisation, Estonia has always had a strong German influence within her legal historical development¹.

This German influence historically within Estonia has had a direct effect on their choice of legal models. As (Munday, 2003 p 474) indicates when commenting on new legal models highlighted by Gianmaria Ajani. "For importation to be successful there must be an adaption to the conditions of the recipient countries... a civil code is regarded as a symbolic document...Estonia for its part has elected a new text largely borrowed from Germanic models."

This was further highlighted by (Ayani,1998 p5) in an article on the adoption of new codifications by the ex-Soviet countries. Where he indicates that even though there is much similarity between European civil codes, property rights and obligations reflect, for example, the needs of an individual society. Consequently he emphasises. "The importation of civil codes from abroad always presents the problem of their unsuitability to the society which they have been transplanted". He goes on to comment, that when considering the status of the process of re-codification one can say that the successful importation of German codes has resulted in adaption to the countries which have imported it and that Estonia chose the German model.

Consequently, when assessing Estonia and its new Civil Code the German historical influence is an important feature. (Munday, op cit p274) comments on the Property Law Act. "It shows in both its basic conceptions and in detail strong resemblance to its German big brother. It has a strong Germanic type land register system run by the courts. The property law determined the conception of the whole future Estonian civil law". If this is the case, then it may provide a background which is helpful for SMEs and the 4 circumstances of the study.

Estonian law has developed features of flexibility and detail in its laws from the German historical influence².

¹ (Terterov, 2003 p49-52 has always been very important to the development of Estonian legal thought and that is obvious up to the present day...The legal system has absorbed many foreign influences but the German legal system remains the most influential. Civil law has a tendency towards detailed codification of most legal issues, minimising the influence of judicial discretion. In spite of this there is a tendency to look to precedent in resolving controversial legal matters which has been considered practical in the environment of rapid change since restoration of independence".

² The comparative literature on the adaptability channel indicates that German legal history is very different from say France's. German courts published comprehensive statements that illustrated how courts decided between conflicting statutes, resolved ambiguities and tackled new situations. See (Dawson, 1968). Law faculties at universities

By, allowing detail and flexibility within its legal regulation, Estonia would, for example not have too much vague regulation (which is an important legal part of the taxation circumstance). Additionally the regulation would be able to change easily to meet new circumstances within which the 4 entrepreneurial circumstances of the study operate.

However the Soviet legal background of Estonia should also be remembered as important, and the extent and degree of Russification in a legal sense may show itself within the study. Russification is the idea of making something Russian in character or quality. In Estonia, after 1881 there was a policy of Russification that lasted until 1905 and it extended to education as well as to the legal and administrative systems. The accession of Alexander III marked the beginning of a period of more rigid Russification. The Russian municipal constitution was introduced in 1882. Russian criminal and civil codes replaced the old Baltic ones. In 1887 Russian was made the language of instruction, instead of German and Estonian, (*Britannica Encyclopaedia*)

One of the features of Russian law is its declaratory nature that means it is merely stating something, but it may be different in practice. This may be something which shows itself within this study, (Dickinson, 2004 p21)³. The discussions over the different conceptions of the development of the Estonian civil law and its outcome were important. It showed that the Estonian legislators were willing to make a fresh start with a legal culture governed by Western standards. This together with its historical legal links with German law and the choice of a German legal model by Estonia on transition should have helped its legal development. Estonia's ability to respond to new or changing circumstances is very important. Cultural features of Estonians, include suspicion of officials, a natural cynicism (reinforced in Soviet times) good manners, non-tactile, reserved, with a northern European attitude to punctuality.

worked directly with courts to decide cases and then worked to rationalize reality. This was through active debate and interchange between scholars and practitioners. Germany developed dynamic legal ideas that formed the basis for codification in the 19th century. Germany rejected the approach adopted by the French, and the German civil code encouraged jurisprudence creating a responsive, flexible legal system.

³ "During the Soviet period law was marginalised, used to serve the political needs of the communist party, based around a central theme of a planned economy....consequently what developed was a deeply rooted distrust almost enmity towards law from ordinary Russian people, and certainly that legal proceedings could not be used to advance or protect their own interests. Added to which Soviet law was often inconsistent and declaratory, with dubious judicial independence".

Estonians are very individualistic, and status is gained in Estonia by achievement, decisiveness and energy. They have had no former aristocracy, only foreign occupiers. Silence can be positive as well as negative in Estonia, and they have in recent years used Finland as a role model⁴. Examining the historical and cultural influences a country like a person is affected by their historical background. Estonian conflicts with Russia and Germany have influenced Estonian culture, and pieces of each invading country's culture have been adopted by native Estonians. Although the most significant cultural effect, as a consequence of these occupations, has been the fear that Estonian independence will be threatened by outside forces⁵.

The effect on the important parts of the four SME circumstances is probably the greatest on the land acquisition circumstance. After years of land ownership by foreign powers, there is still a sensitivity to land acquisition by foreign SMEs. This is illustrated by the exemption for agricultural land that Estonia was granted within Part 3 the EU Accession Treaty of April 2004. The consequence for a foreign SME could be greater compliance cost with registration procedures. Additionally, their perception of land security could be less than an Estonian SME. Although understandable, such sensitivity could lead to less SME land acquisition in the future by foreigners in Estonia. This is important because land acquisition by SMEs is part of a long-term strategy and embeds their activity within a country.

2.3 The significance of the 4 entrepreneurial circumstances of the dissertation and their important legal parts

(a) Company formation.

The formation of private companies is beneficial for entrepreneurial activity for several reasons. Resources can be pulled together as shareholders join together in establishing the company's capital. There is perpetual succession of a registered private limited company, despite the death of the founder, and most significant the entrepreneurial risk is reduced with formation. This is because registration provides a "birth certificate" for the entrepreneur, who becomes a separate legal entity. Whereby, the assets of the company are separate from any personal assets

⁴ See (Lewis, 2005).

⁵ See (Rodgers, 1992 p2).

belonging to the members, and cannot be taken to satisfy any company debts. Limited liability gives freedom for innovation and experimentation, making a business venture from an SME less risky, increasing its longevity and likelihood of success. This separate legal entity principle is an important part but there are also other parts of company formation, which are important in helping SME entrepreneurial development.

The (World Bank Report, 2004 chapter 2), indicates three are significant. The necessary procedures and the time involved together with the cost, and the minimum capital requirements in the registration process. The number of procedures describes the steps the potential entrepreneur has to deal with. At each procedure the entrepreneur may be stopped and in some countries this may involve a government official. He may have to be bribed in order for the process to continue. The number of days and the official costs associated with each procedure are also relevant.

The more difficult and costly the registration process, then the less likely the entrepreneur will want to register and form the company. The minimum capital requirement is the amount of capital that the entrepreneur needs to place into a bank account before registration starts. The account is frozen during business entry, and in many countries remains so until the dissolution of the separate legal entity. Difficult entry registration is associated with less private investment, higher consumer prices, greater administrative corruption, and a larger informal economy (World Bank Report, 2004 *loc cit*).

SME activity is increased when the potential losses are limited to their capital participation by the establishing of the separate legal entity principle, by private limited company formation. Governments can go a long way with simple reforms including adopting better information, and communications technology to inform possible entrepreneurs, and to make one place a shop for SME company formation and registration.

(b) Land acquisition.

The importance of the correlation between land acquisition and SME development within an economy is that by developing a new enterprise through a green-field site and acquiring the land to do so embeds SME entrepreneurial activity within a country. As land was generally owned by the state in the former Soviet economies, like Estonia, this increases the importance of its acquisition by SMEs.

(Tyson, 1994 pp165-184) comments on the things that policymakers and governments from countries coming from a Soviet background should think about in

their attempts to have long term SME development. She suggests a stable system of well-defined property rights. She makes the very significant point, that if potential entrepreneurs are uncertain about the state's commitment to respecting property rights, they may invest only in projects involving short term horizons. This requires little fixed capital, which implies an economy based on exchange rather than production which doesn't provide sustained economic growth.

(Tyson, *loc cit*) also indicates strongly and succinctly the central features of property rights. In particular protection of SME entrepreneurs allowing them to invest without fear of later claims by former property owners, a legal framework for resolving disputes among property holders (including between them and the state), and circumscribing the state's right of eminent domain. (Topornin, 2000 pp 27-65) adds further weight to Tyson's argument. When discussing Russia as a transitional economy they comment on the fact that the development of entrepreneurship requires paying special attention to the legal provision of the right to private property.

Although, Estonia is a more advanced transitional economy it comes from a Soviet background and it still needs continuous attention to private property legal provision. A proper system of property rights is required, that is clarified and defined because without this individuals will not exercise their rights in a way enhancing production. The perception of how secure land acquisition is, can be a significant factor for entrepreneurial activity. (McMillan and Woodruff, 2002), made a survey of entrepreneurs who had formed small manufacturing firms within 5 European transition countries (Poland, Romania, Slovakia, Ukraine, and Russia). The findings were that the entrepreneurs reinvested less of their retained earnings when they perceived their property rights to be insecure. This was irrespective of whether they owned the collateral that is generally needed to obtain credit. This effect is significant, because those entrepreneurs in the sample with the least secure property rights invested nearly 40% less of their profits than those with the most secure property rights.

Providing secure land acquisition rights reduces the risks of fraud and mistakes within transactions. This gives buyers, renters, and lenders wanting to acquire an interest in land for entrepreneurial activity, the confidence that they will get what they bargained for. A secure right to land encourages SME entrepreneurial activity because of the benefits that registered titling of land provides. For example, it can improve access to credit for an SME from a lending institution such as a bank. Land ownership is an important indicator of credit worthiness, and a registered title allows lenders to easily prove ownership. Titled land is also accepted more easily as security. The reason for this is that lenders can determine whether

others have an interest in the property (third parties other than the SME for example). Consequently, an assessment of the ability to take the land, if the borrower refuses or cannot pay the debt can be more easily made (World Development Report, 2005 p81).

For an SME it is important to acquire titled land. This is because lending with assessment security, and borrowing on better terms when in entrepreneurial activity can take place, as they do not have the financial reserves of large businesses. In Peru, residents of urban areas in Lima that received title to their land have used the titled land as collateral to buy minibuses, build small factories, and start other types of small businesses (World Development Report, 2005 loq cit).

The more secure title to land there is within a country then the less difficult it is for SME entrepreneurial activity, because it is easier for their business operations to be financed. Securing titled land rights benefits both SME landholders through investment incentives, credit access and the community at large through its impact on growth and employment opportunities. However, while the price governments charge for titling land should be realistic taking into account the benefits. It should not be inflated because of "red tape" or demand for unofficial payments by registry staff. Maintaining monopolies over surveyors, notaries and other professionals who prepare the necessary documentation can also increase costs. This can deter SMEs entrepreneurial activity. In Russia, surveyor fees equal to 2 years of the minimum wage keep many from registering their property (World Development Report, 2005 p82).

Governments can also improve the security of land title (and consequently encourage land acquisition) by maintaining an efficient land registry and this is becoming easier with advances in computer technology. Firstly, the cost of issuing initial titles can be significant, particularly where a large percentage of land is untitled, as is the case in many developing countries. Conflicting claims may need to be resolved, boundaries determined and accurate maps drawn. Secondly, it is typically much easier to provide title to land where ownership rights are recognised in the community, than where titling may involve the claims of others. Thirdly even where there are no rival claimants land titling reforms can run into resistance. Land registry personnel can oppose modernization, either because of lack of interest or the loss of opportunities to obtain side-payments from registrants. In Russia and other former Socialist countries opposition to rural land titling has come from the managers of collective farms (World Development Report 2005 p83). This is because titling involves breaking up these farms into individual parts, threatening managers jobs, income and weakening their power over farmers.

The other important part for an SME is the time and cost of registration (McMillan and Woodruff, 2002) (World Development Report, 2005 part 2 chapter4).

(c) Taxation.

The way governments regulate and tax firms and transactions both within and at their borders plays a big role in shaping the investment climate, good, clear regulation helps to encourage business and taxation generates the revenues to finance public services that improve the investment climate, as stated by the (World Bank Report, 2005 chapter 5 p1). For SMEs the significance of taxation regulation is that it encourages or discourages entrepreneurial activity across borders, within a country or group of countries, such as the Baltic States of which Estonia is a part.

Strategically, taxes affect the incentives for SME activity and investment by weakening the link between effort and reward. Also, by increasing the cost of inputs used in the production process. Tax rates and compliance costs are both important, when collected or if applied unevenly, as they can deter and distort competition. Firstly, the interpretation and application of tax regulations can be unpredictable bringing uncertainty, and risk for firms and inviting corruption. Secondly, tax regulations also create monopolies or cartels for favoured groups, imposing costs on consumers and firms and it can stop incentives for an SME to innovate and boost their productivity. Thirdly the tax rate itself will affect whether SME's will engage in business activity. An analysis of twenty five studies that looked at the effect of tax rates on Foreign Direct Investment concluded that a 1% increase in tax rates reduces Foreign Direct Investment by about 3.3% (Baldwin and Krugman, 2004). As a consequence SME's often reduce their tax burden through informality and evasion.

Tax systems have these problems often historically embedded as indicated earlier in the dissertation, in part 3(c) by (Elliot, 1997) and (Litwack, 1991). In the Soviet Union, taxation was dominated by a lack of equality in taxation of firms, and continual changes. The effect of this was that it stimulated massive tax evasion and corruption. Taxation regulations can increase the burden SMEs face when the regulations change frequently, are vaguely drafted or are enforced or interpreted inconsistently. It all leads to uncertainty and deters entrepreneurial activity (World Bank Report, 2005). Further, tax administration can increase compliance costs and increase corruption. When compliance costs are the same for firms of different sizes they have a greater effect on smaller firms. When red tape and corruption are within a tax administration an SME has less incentive to comply.

(d) Criminality.

Criminal activity, is illegal activity in breach of the criminal law and has an influence on SME development, (Goorha,P 2000) (Sakwa,P 2002). They all indicate that criminality deters entrepreneurial activity, for SMEs by raising transaction costs for SMEs through bribes and protection money and discouraging entrepreneurial and economic activity.

The higher the level of criminal activity the greater the discouraging effect on SME activity.

(The World Development Report 2005 p89), assessed the effect of criminality on SMEs and entrepreneurial activity and commented "Robbery, fraud and other crimes against property and against the person undermine the investment climate. Rampant crime discourages firms from investing and increases the costs of business, whether through the direct loss of goods or the costs of taking precautions such as hiring security guards, building fences, or installing alarm systems. In the extreme, foreign firms will decline to invest, and domestic ones will flee the country for a peaceful locale."

The crime rate for robbery, fraud, crimes against property and the person, and the transaction costs (bribes, protection money) are the key aspects for SMEs.

The deterrent effect of the criminal justice system is something which the government of a country has influence over. The penalties for theft, robbery and other property crimes can influence, and alter a thief's cost-benefit decision making. Connected to this are the penalties that are applied consistently, and how effective the overall system is at preventing and deterring crime. Criminal law is only as effective as those that enforce it and the police play an important role.

The government can help to reduce the effect of organised crime on SMEs, by taking some of the profits out of organised crime by reducing the regulation that SMEs have to comply with. As the regulation increases SMEs are less able to comply with the rules, and less likely to ask the government to protect them from criminality. As a consequence organised criminals then meet that demand. This is indicated by the (World Bank Development Report, 2005 pp90-92).

Historically, the "nomenklatura" is connected to the deterrent part of criminality and SMEs entrepreneurial activity. Within the former Soviet Union system, (which Estonia was part of for a long time), the ruling Communist party consisted of traditional hierarchies. This central alliance had the authority to appoint managerial positions, in all industries and even in the ministries that were over them.

Appointments to these well paid and rewarded jobs were based on loyalty, and the nominees were called “apparatchiks”. They would recommend their friends and families for their jobs (Winieki, 1990). With the transition to a market economy the system of “nomenklatura” collapsed. The controlling authority no longer had control over the “apparatchiks” and the managers able to increase their bribes. However, this legacy has a negative effect because it is part of the criminality circumstance (bribes for example) that deters SME entrepreneurial activity. It increases transaction costs and SMEs have not got the same extra money to use, as larger businesses.

(Johnson, McMillan and Woodruff, 2002), carried out a survey of managers of start-up manufacturing firms and they were asked whether “extra-legal” payments were needed in order to receive government services or a business licence. Over 90% of Russian managers said they had to make “extra-legal payments” compared to about 20% of Polish managers. Those firms in the sample that were the most concerned about corruption invested nearly 40% less than those least concerned. Organised crime was found to be a further deterrent to entrepreneurship. When asked whether payments to private agencies were necessary for protection of their activities, more than 90% of Russian managers, and 8% of Polish managers said they were.

3 A DESCRIPTION AND ANALYSIS OF RELEVANT EU AND NATIONAL LAW (REFERRED TO WITHIN THE THESIS ARTICLES)

3.1 General description and application

What follows within this chapter is a description and assessment within the context of the 4 thesis articles of this EU and Estonian law. The European Union Treaty of Accession 2004 is the official legal document that confirms the membership of a country within the EU. As such the Treaty also gives the conditions of membership for each country, as negotiated. The English version is referred to⁶ and the Treaty can be viewed in full within the appendices of this dissertation.

Only articles and exemptions relevant to the 4 entrepreneurial circumstances are commented on and referred to within the specific thesis articles. Estonia, as part of the new group of Member States, signed the Treaty of Accession (The Treaty) in April 2004 which is indicated by Part 1 Article 1 of the Treaty⁷. Additionally, Part 1 Article 2 of the Treaty has relevance also as Estonia would have to comply with the Treaty of Rome 1957 and the amendments to the Treaty of Rome laid down in the Maastricht Treaty of 1993 and subsequent directives and regulations⁸. Part 3 deals with the relevant permanent provisions and Part 4 with the temporary provisions which are assessed within the thesis articles, 1, 2, 3, and 4 respectively.

This then has an impact on the 4 entrepreneurial circumstances and is referred to in each of the four thesis articles, in the sense that both permanent and temporary provisions of the Treaty of Accession apply as well as relevant directives and regulations from the other Treaties.

⁶ (Official Journal of the European Union, 2003).

⁷ *“The Republic of Estonia hereby becomes a member of the European Union and Parties to the Treaties on which the Union is founded as amended or supplemented.*

⁸ *“From the date of Accession the provisions of the original Treaties and the acts adopted by the institutions and the European Central Bank before accession shall be binding on the new Member States and shall apply in those States under the conditions laid down in those Treaties and in this Act”.*

3.2 Description and assessment of EU and Estonian law within each specific thesis article

Thesis article 1 company formation: Article 20 of the Treaty of Accession Part 3 is particularly relevant to the company formation circumstance and is a permanent provision this permanent provision is described and assessed within thesis article 1 in the sense of the EU law and how the Estonian law complies.⁹ There is the Co-ordination of Safeguards Directive 68/151/EEC for private limited companies. The Safeguards Directive is about similar safeguards of liability for a company throughout the EU. This is important for SME activity particularly because of the limited legal liability concept.

This EU safeguards provision is clearly within the company formation entrepreneurial circumstance and its coverage and compliance by Estonian law is assessed and commented on within thesis article 1. This EU Safeguards Directive is about similar safeguards of liability for a company throughout the EU and it is fair to say that Estonia has complied overall with its EU company formation law obligations.

It is important to remember that as indicated, a directive is a guideline only for Member States as long as the required result is obtained. Thesis article 1 shows clearly that Estonia has complied with the separate legal entity principle for company formation through the Estonian law, as it is clearly referred to within the Estonian Commercial Code (ECC). There is also clear compliance within the EEC with the other directive articles.

Thesis article 1 shows that directive articles 2-10 are also clearly covered by the wording including: measures to ensure compulsory disclosure of the instruments of constitution (directive article 2). A file for the limited company within the Commercial Register is clearly indicated and the public can see the companies details (directive article 3). Liability and company details in letters and order forms (directive article 4) and an indication of who is responsible for the disclosure of the company's commercial documents (directive article 5) is also covered.

⁹ “Annexe 4 A. Company law 1.31968 L 0151 First Council Directive 68/151/EEC of 9th of March 1968 on co-ordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, with a view to making such safeguards equivalent throughout the community(o)L as amended by:31989 L 0667 Twelfth Council Company Law Directive 89/667/EEC of December 1989 on single-member private limited liability companies (O) L 395 30.12.1989,p.40”.

Additionally (directive article 6) penalties for omissions in publication details as well as company responsibility for any appointment irregularity (directive article 8). Finally within thesis article 1, judicial preventative control of the company formation process is also written clearly within the Estonian law.

The other directive which is important for SMEs is the 12th Council Company Law Directive 89/667/EEC of Dec 1989 on the possibility of a single member private limited liability company being allowed through Estonia's law. Within thesis article 1 it is assessed and commented on that In Estonia the ECC refers to this indicating that the management board of a company may have one director, so the essentials of that part of the directive has also been covered.

The entrepreneurial effect is that it is easier for limited liability companies to be formed. This should increase the number of such companies because it now takes only one person who would then have the security of its limited liability protection. This is one of the important parts of that circumstance in relation to SMEs. It could bring increased registration of private limited companies and subsequent business output through SME activity, as shown by historical evidence (referred to at part 2.3(a) of this dissertation).

Consequently it is fair to say that Estonia has complied overall with its EU company formation law obligations. It is important to remember that a directive is a guideline only for Member States as long as the required result is obtained and Estonia has done just that in relation to company formation and its EU obligations.

Thesis article 2 land acquisition

There was a temporary provision which was an exemption from the EU Treaty of freedom of movement of capital obtained by Estonia on its accession to the EU.¹⁰ It is clearly within the land acquisition entrepreneurial circumstance and its coverage and the wording within Estonian law is assessed and commented on within thesis article 2. However, it was a temporary provision and as such lapsed in May 2011.

¹⁰ Part 4 Temporary provisions and transitional measures stated in Article 24(3). Free movement of capital. *"Notwithstanding the obligations under the Treaties on which the EU is founded. Estonia may maintain for a period of seven years from the date of accession the rules laid down in its legislation existing at the time of signature of this act. Regarding the acquisition of agricultural land and forests by nationals of the Member States and by companies formed in accordance with the laws of another Member State and being neither established nor registered nor having a local branch or agency in Estonia.*

This article 2 still however shows the application of this exemption through the Estonian law which applied to foreign SMEs making such agricultural or forest land acquisitions, and who were not established in Estonia or who did not have any representative office. The relevant Estonian law was the Restrictions on Transfer of Immovable Property Ownership 2003 (RTIPO). What s2 (4) of the 2003 Act said is that the restrictions in Estonia applied to agricultural land and woodland with the size of 10 hectares or more. In such cases foreign individuals and companies (including other EU member state nationals) are allowed to acquire land only with the permission of the county governor. That is if you don't come within the requirements of the exception¹¹.

Only with the permission of the county governor could the land acquisition take place. The land acquisition could take up to sixty days, and included an opinion of the local government council on the location of the land. S4 (3) and 4(4) then became important as to how it worked. The wording was a little confusing, and inconsistent and gave a wide discretion to the county governor which could have led to corruption and greater compliance cost for an SME. The wording could have been clearer so that the process could have taken place more quickly and simply. S4(3) of the Estonian law stated that an action plan and the finances of the person wanting to acquire the land as well as their professional and economic experience had to be taken into account, in making the decision. S 4(4) was the authorisation section, which stated that authority for the land acquisition shall be granted if at least one of the requirements set out in s2 (2) or (3) is partially met¹². The language used was not that clear and it gave a wide discretion to a county governor with language such as, partially or sufficiently met being used.

However on assessment of this EU exemption thesis article 2 indicates that given the history of foreign ownership that sensitivity to land ownership in Estonia was understandable. The Estonian agricultural area is 1.450 hectares which represents one third of the country and 45% of the country is covered by forests. It also cites (Gunter, 2003) who gives further reality to the reasons, stating that political and

¹¹ The exception was stated in subsections (2) and (3) as a resident farming or forest business. Which, required proof by a notary (expense and cost to the SME). It also said, amongst other things, required within this exception. For example under s2 (2) a statement from the environmental authority was required, and another act referred to (the Forestry act) for permission to be given. Consequently, it was not easy for an SME, to come within the exception.

¹² It says that residence duration in Estonia or agricultural or forestry production management experience does not. Also, in the opinion of the issuer of the permission, the additional criteria in s 4(3) are 'sufficiently met'. That is an activity plan, means of disposal, applicant's economic or professional experience.

farming interests were the main reasons for the restrictions for foreign arable land acquisitions over 10 hectares.

Thesis article 3 taxation

Academics, (Schenk, and Oldman, 1991 p5) divide taxes into 2 types, direct taxes and indirect taxes. A direct tax is a tax which is assessed and collected from a person or business who suffers a reduction in his income, an example would be income tax. An indirect tax is a tax that is collected from someone or some business that does not have the burden of paying it. It is assessed on a product or service to be sold before the product or service reaches the consumer. The consumer pays the tax as part of the market price of the product or service, but the tax is collected from the businesses who sell the product or service. An example would be Value Added Tax (VAT). The relevant EU law in thesis article 3 is mainly about the indirect tax VAT.

EU countries have been allowed to give exemptions for VAT up to a certain amount of turnover. This is to help small businesses and means that up to a certain amount of money a country is allowed to legally state that a business does not have to register its transactions for VAT.

Within thesis article 3 there is a description and assessment of a permanent VAT exemption granted to Estonia through the Treaty of Accession 2004¹³. The amount a country grants as an exemption is important because the wording is “may grant up to”. So there is no legal obligation for Estonia to grant the maximum amount of 16000 euros as the wording in the EU Directive is “may” and not “has to”. Estonia grants the maximum allowed under the EU Directive. This is an incentive for small business and is clearly identified by the wording in the Estonian VAT regulation where it is clearly written in¹⁴. It gives an exemption from registering as

¹³ Annex 9 Taxation.

“3.31977 L 0388 Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes common system of Value Added Tax uniform basis of assessment as amended by: In implementing Article 24(2) to (6) the following Member States may grant an exemption from Value Added Tax to taxable persons whose annual turnover is less than the equivalent in national currency of: Estonia: EUR16000”.

¹⁴ VAT 204 19(1) If the taxable supply of the transactions specified in clauses of this Act, except the transfer of fixed assets and distance selling to a person of Estonia, carried out by a person, except a foreign taxable person with no permanent establishment in Estonia, exceeds 250 000 kroons as calculated from the beginning of a calendar year, an obligation to register as a taxable person (hereinafter registration obligation) shall arise for the person as of the date on which the supply reaches that amount.

taxable transactions if turnover is less than 250,000 kroons (approximately 16000 euros).

Other EU VAT directives described within thesis article 3, which are important are connected to the harmonization of a common VAT system within the EU. The main EU legislation relates to the harmonisation of EU law, through a common system of VAT within the Member States¹⁵. As with all EU directives it lays down the guidelines but the applicable Estonian tax regulation is both detailed and readable. It covers the objects of the directive including the aspect of “goods or services supplied and imported” as well as referring adequately to other sections for exemptions making it easy to find. The “taxable person” is also covered within the Estonian tax regulation and thesis article 3 comments on the detail, compliance and it being easy to read.¹⁶

Thesis article 3 also discusses the compliance of Estonia’s tax regulation with a directive in 2001, which took into account the modern electrical changes that had occurred and to assist the EU Single Market to function more effectively within the VAT area¹⁷. Simplifying and harmonising were the goals of the directive. On reading the legal wording of the Estonian regulation, it allows simple but significant details that the EU directive lays down as well as electronic invoicing if agreed by the parties¹⁸.

¹⁵ Sixth Council Directive 77/388/EEC of 17 May 1977 VAT Article 1 Member States shall modify their present value added tax systems in accordance with the following Articles. They shall adopt the necessary laws, regulations and administrative provisions so that the systems as modified enter into force at the earliest opportunity and by 1 January 1978 at the latest. Article 2 The following shall be subject to value added tax: 1. the supply of goods or services effected for consideration within the territory of the country by a taxable person acting as such; Article 4 “Taxable person” shall mean any person who independently carries out in any place any economic activity

¹⁶ Value Added Tax Act 2004 (VAT) Chapter 1 General Provisions S1. Object of taxation (1) The following shall be subject to VAT 1) supply created in Estonia, except supply which is exempt from tax; 2) import of goods into Estonia (s6), except imports exempt from tax (s 17); 3) provision of services the place of supply of which is not Estonia (subsection 10 (5)), except supply exempt from tax; 4) supply of goods or services specified in subsection 16 (3) of this Act if the taxable person has added value added tax to the taxable value of such goods or services; 5) intra-community acquisitions of goods (s8), except intra-Community acquisitions of good which are exempt from tax (s18). (2) VAT is applied as tax on added value, with the exception of special cases arising from this Act.

¹⁷ Council Directive 2001/115/EC with a view to simplifying, modernising and harmonising the conditions laid down for invoicing in respect of value added tax

¹⁸ The Estonian VAT Act 2005(6) An invoice may be issued on paper or, subject to acceptance by the acquirer of goods or the recipient of services, by electronic means.

In addition to the EU directives there is also a recommendation from the EU which is discussed within thesis article 3. A recommendation is not legally binding like a directive or regulation, but is how the EU sees a certain issue and how it wants that issue to progress within the Member States. The general recommendation was connected to direct taxes and that the form of ownership not being subject to different tax rates. By providing a flat tax rate Estonia is supporting this. A flat rate tax system means that everyone is taxed at just one rate which means everyone pays the same percentage tax on any earned income above the tax threshold.

The EU Commission recommendation of 1994 was seen as an important future development in relation to taxation of SMEs, further by article 2 of that recommendation the EU wanted Member States to eliminate tax obstacles to changes in the legal ownership forms (for example the incorporation of partnerships or sole traders when becoming limited companies)¹⁹. As thesis article 3 indicates by having the same rate of tax Estonia provides such an environment making it easy for an SME manager to make such an ownership change. Overall, Estonia's regulation complies with EU law through its wording very clearly and in fact goes further by providing a user friendly regulatory playing field supporting the future development of the EU.

Thesis article 4 criminality

Part 1 Article 2 of the Treaty of Accession is relevant (as referred to in 3.1 of this dissertation) and means that Estonia as a member of the EU has to comply with previous EU Treaties and their relevant directives and regulations. Estonia would have to comply with the Treaty of Rome 1957 and the amendments to the Treaty of Rome laid down in the Maastricht Treaty of 1993 and subsequent directives and regulations.

The main EU laws identified within thesis article 4 relate to mutual cooperation by the EU Member States within the field of crime and organised crime. This means that each EU Member State has a duty to help and support each other, for example by providing relevant information on crime and organised crime to each Member State who needs such information.

¹⁹ Recommendation 1994 Article 2 Member States are invited to adopt or extend those measures necessary to eliminate the tax obstacle to changes in the legal form of enterprises, in particular the incorporation of sole proprietorships or partnerships.

Within thesis article 4, firstly, there is the directive relating to victim compensation, which allows a crime victim resident in one member state to claim from another member state of the EU some compensation if the crime took place in that other Member State which they were not a resident of. For example, a German national resident in Germany would be able to claim compensation if he was a victim of crime whilst in Estonia²⁰.

The Estonian Legislation has 2 acts within its laws to comply with the EU Victim Compensation Directive. In Estonian law the State Compensation Victims of Crime Act 2004 covers crimes of violence against a person and that the person injured by such violence is entitled to receive state compensation for their injuries. This Estonian law is wider than the coverage of the EU Compensation to Crime Victims Directive because it covers temporary residence of aliens, and is wider in coverage than the “habitually resident” referred to within the EU directive. Also the intentional aspect of the EU directive wording is also specifically stated and is detailed within the Estonian law within the State Compensation Victims of Crime Act.²¹

The Victim Support Act²² identifies the body responsible and administrative procedures for applications and the legal wording of the directive has been complied with.

²⁰ Council Directive 2004/80/EC Relating to Compensation to Crime Victims.

Article 1 Right to submit an application in the Member State of residence Member States shall ensure that where a violent intentional crime has been committed in a Member State other than the Member State where the applicant for compensation is habitually resident, the applicant shall have the right to submit the application to an authority or any other body in the latter Member State.

Article 2 Responsibility for paying compensation. Compensation shall be paid by the competent authority of the Member State on whose territory the crime was committed.

²¹ State Compensation of Victims of Crime Act 2004 Crime of violence s2(1) For the purposes of this Act, ‘crime of violence’ means an intentional act committed against the life or health of a person which is punishable pursuant to criminal procedure and as a result of which the injured person: 1) dies; 2) sustains serious damage to his or her health; 3) sustains an impairment of health for at least six months. (2) An act which causes the consequence specified in subsection (1) of this section under the following circumstances is also considered to be a crime of violence: 1) a criminal offence committed directly against the life and health of the injured person due to negligence if the offender is mistaken in the circumstances precluding unlawfulness of the act; 2) action taken by the injured person or a third person to prevent a criminal offence, apprehend a criminal offender or assist a victim of crime. section 3. Recipient of compensation (1) Estonian citizens, aliens residing in the Republic of Estonia on the basis of a permanent or temporary residence permit and refugees staying in Estonia who have suffered injuries specified in subsection 2 (1) of this Act as a result of a crime of violence (hereinafter victims) are entitled to compensation.

²² Victim Support Act 2003.1. Scope of application of Act (1) This Act regulates the state organisation of victim support and the procedure for payment of state compensation (hereinafter com-

Secondly, this article 4 identifies the EU measures relating to the enforcement of the principles of mutual recognition of decisions in criminal issues. This is the idea that every EU Member State has to recognise every other EU Member States criminal decisions within its criminal law system and processes. The Treaty of Amsterdam 1998 suggested that a process of mutual recognition of criminal matters between Member States should happen within 2 years and the Treaty of Lisbon made further suggestions²³. However, the EU has not made much progress and the use of the wording “endeavour to ensure” in the Lisbon Treaty does not impose on Estonia any legal obligation but just cooperation. The need for directives by the EU on mutual recognition of criminal matters is commented on within this article 4.

The third criminal area referred to in this article 4 is that there have been measures from the EU against organised crime, which affect Estonia. Organised crime has an effect on the transaction costs of an SME in Estonia by increasing those costs. There is a pact against organised crime between the Member States of the EU²⁴. The pact against organised crime is an agreement of inter-government activity by the EU member governments to fight organised crime.

The pact consists of principles of co-operation and sharing of information related to organized crime activities, and included, a determination to cooperate fully in fighting all kinds of organised crime, co-operation in the development and effective operation of central law enforcement against organised crime, as well as the prevention of money laundering. It was written in the first part of the pact that all the EU countries who signed expressed a commitment and determination to work closely together to fight organised crime.

pensation) to victims of crime.(2)This Act prescribes the persons who are entitled to victim support services and state compensation and the conditions of and procedure for applying for,granting and paying the compensation.

²³ Article 61 Treaty of Lisbon 2007.”The Union shall endeavour to ensure a high level of security through measures to prevent and combat crime, racism and xenophobia, and through measures for coordination and cooperation between police and judicial authorities and other competent authorities, as well as through the mutual recognition of judgments in criminal matters and, if necessary, through the approximation of criminal law”.

²⁴ Pre-Accession Pact on organised crime Between the Member States of the European Union and the applicant countries of Central and Eastern Europe and Cyprus(the Pre-Accession Pact)ojc 220,15.7.1998

Thesis article 4 comments that although Estonia has signed the pact against organised crime it does not have the same obligation for Estonia as a directive does. Consequently Estonia is under no legal obligation to comply as the pact consists only of recommendations that EU countries should try to implement.

However, one of the principles of the pact against organised crime related to fighting money laundering. The EU had made 2 directives against money laundering which become binding on Estonia as an EU Member State and consequently they are described and assessed within thesis article 4.²⁵ This EU directive relating to money laundering has been complied with by Estonia through its wording in a very clear and detailed way in particular providing penalties for breaches by any relevant organisations²⁶. This act also refers to the Estonian Penal Code for a further criminal penalty against such money laundering²⁷.

Overall, Estonia has completely complied with its EU criminal law directive obligations. It is important to remember that a directive is a guideline only for Member States as long as the required result is obtained and Estonia has done just that in relation to the criminal law through its legal wording. In fact the relevant Estonian law is wider with greater coverage than the minimum laid down by the EU directive. Additionally, thesis article 4 makes it clear that Estonia has tried to ensure some approximation of criminal law and co-operation against organised crime by trying to implement the principles including co-operation and exchange of information.

²⁵ Directive of 10 June 1991 on Prevention of the Use of the Financial System for the Purpose of Money Laundering (91/308/EEC). Article 2 Member States shall ensure that money laundering as defined in this Directive is prohibited. Article 11 Member States shall ensure that credit and financial institutions: 1. establish adequate procedures of internal control and communication in order to forestall and prevent operations related to money laundering.

²⁶ See Money Laundering and Terrorist Financing Prevention Act 2004. This Act regulates the activities of credit institutions, financial institutions, the Financial Intelligence Unit and other agencies and persons in the prevention of money laundering and terrorist financing. S 2 Money laundering is the acquisition, possession, use, conversion or transfer of, or the performance of transactions or operations with, property acquired as a result of a criminal offence or in return for participation in such an offence, the purpose or consequence of which is the concealment of the actual owner and the illicit origin of the property. S26¹. Violation of requirement to register and preserve data (1) Violation of the requirement to register and preserve data provided for in the Money Laundering Prevention Act is punishable by a fine of up to 100 fine units.

²⁷ The Criminal Code 2002.s 148 Money laundering (1) Money laundering is punishable by a fine or detention or up to four years' imprisonment. (3) Money laundering (1) on a large-scale basis, or 2) by a criminal organisation, is punishable by three to ten years' imprisonment.

4 METHODOLOGY

In this chapter firstly the selection of an appropriate research design is described and justified. Secondly, the research process with case selection is described and considered and thirdly the data collection and validity is discussed.

4.1 Research design and application of the case study approach

Authors such as (Yin, 2003, p44) indicate that the research should be designed in such a way so that there is a clear connection between the research questions and the research design. In this particular study the research questions were identified logically and precisely before the most suitable research design was chosen. It was decided that qualitative research could fill some gaps of previous quantitative research both domestic and global and provide more in-depth analysis. In the early part of the research process it was felt that these gaps could be filled by such a design which is considered suitable for exploratory business research (Ghauri and Gronhaug, 2005)

Qualitative studies can bring a more complete picture and understanding of the overall factors at play in a small number of SMEs and consequently there can then be more of a holistic approach taken to dealing with the circumstances (Cresswell, 2003). Additionally qualitative methods are flexible and are used to explain and give in-depth answers to various aspects of a problem, consequently they were considered the most suitable here (Rowley, 2002 p18).

In case studies the data collection and analysis are closely interconnected and there is no definite phase of analysis (Cresswell, 2003). The interweaving of the data collection and evaluation right at the start is acknowledged as the best way forward and the most productive for assessment (Miles and Huberman, 1994). This was the situation with this study.

Within the research design a case study approach is used for all 4 thesis articles and consequently is a significant part of it. The aim being to assess from different case perspectives the reality of the business environment in the 4 identified entrepreneurial circumstances. Generally case studies are the better strategy when “how” and “why” research questions are posed (Rowley, 2002 p16) and are well suited to research areas that not much is known about (Ghauri and Gronhaug, 2005 p15). It was felt that this was the situation with this research and

the subject of unofficial costs and whether the regulation was in practice as it was written within the former Soviet countries, like Estonia.

There are different classifications of case study research although on assessment while often under different names they are of a very similar character. (Yin,2003) distinguishes between a single case study and a multiple case study, whereas (Stoecker,1991) discusses the difference between intensive and extensive case study research. A single or intensive case study looks at a unique, deep, broad detailed description. A multiple or extensive case study looks at testing theoretical propositions in more than one case, (Eriksson and Kovalainen, 2008).

The specific empirical part of this research consisted of multiple case studies or a single case study within the particular entrepreneurial circumstance. The thesis articles 3 and 4 are based around multiple or extensive case studies, with the number of cases being 2. Whereas thesis articles 1 and 2 are based around a single case study.

4.2 Research process

4.2.1 Case Selection

The first part of the research was to carry out a thorough academic literature review of SMEs and their importance, the connection to the business law environment as well as the identified important legal parts of each entrepreneurial circumstance. The study is an exploratory one with the research problem being acknowledged clearly. The main objective was to consider the problem under investigation, identify the important and relevant concepts and facts (Ghauri and Gronhaug, 2005 p49).

A case has been described as an event an organization or a management situation (Rowley, 2002, p19) the focus here is related to organisations, particularly as the subject matter is SMEs and the reality of the entrepreneurial circumstances present in Estonia.

The multiple case study strategy is preferable to a single case study as it brings a wider perspective and greater understanding of the issues involved although there is no specific rule as to the number of cases that have to be included (Rowley, 2002,p21). However, the researcher must justify the selection of each case and how they help with the objectives of the study,(Ghauri and Gronhaug,2005 p179). In multiple or extensive case studies the choice of cases becomes a rele-

vant point to think about and (Yin, 2003) comments on the fact that replicating and logic should be used. That is to corroborate or reject propositions that have been put forward. With this qualitative research in order to see the reality as widely and exactly as possible, different case studies involving persons with different backgrounds from different organisations were chosen, depending on the specific entrepreneurial circumstance.

One problem was the sensitivity of the subject area (corruption) and the difficulty in finding appropriate and relevant contacts meant that the same case study was used in more than one entrepreneurial circumstance. The practical reality of selecting and deciding on particular cases for research is often governed particularly by time and financial restraints, (Rowley, 2002, p19). This was the situation in this research as it involved a country not where the researcher resided. Additionally, the sensitivity of the research, in particular the question of unofficial costs within each of the entrepreneurial circumstances meant that the researcher realised it would take some time and effort in finding suitable and willing case studies. In fact the time involved with the different case study participants was between 2007 and 2012. It is agreed by authors such as (Ghauri and Gronhaug, 2005 p176) and (Rowley, 2002, p19) that cases should offer an efficient means of getting answers to research problems, and it was this that drove the selection together with the above mentioned practical constraints.

The sensitivity of the subject area meant that the researcher had to be careful and patient in order to obtain relevant and willing cases. Because the focus of the research was Estonia, one of the important criteria justifying selection was that the case selected was connected to the reality of the business regulation in a practical sense in Estonia. The selection was then dependent on the relevance to the entrepreneurial circumstance (company formation, land acquisition, taxation and criminality). An SME was selected as well as two law firms present in Estonia and involved in the relevant business regulation and an ex-police inspector from Narva Police.

The 4 selected cases were: (1) Marcon Holdings, a small textile manufacturing company in Tallinn, Estonia, (2) Sorainen, a Pan-Baltic business law firm, based in Tallinn Estonia, (3) Borenius a specialized taxation law firm, based in Helsinki (with an operating branch in Tallinn), (4) Narva Police, Estonia.

The first case (1) Marcon Holdings was chosen because it was an SME operating as a business in Estonia and it was a typical type of manufacturing SME and had operated there for a few years. It was small (employing 5 workers) its manufacturing activities and premises were based in the capital city and it was owned by a foreigner. The researcher thought that by selecting case (1) it would mean that

answers to the research questions would reflect similar small business firms operating in Tallinn and because case (1) had been operating there for a few years it would be more useful. This was because the case selected would be able to comment on the effect of any changes to the regulation and procedures within the entrepreneurial circumstances of the dissertation. Tallinn as the capital city would be the most likely place an SME would operate a business and it would then bring more useful research results, which would be helpful for other SMEs thinking of doing business in Estonia.

Also only having a foreign owner would help in giving answers to the research questions by bringing less bias (as the person was not Estonian) and more depth to the reality as a foreigner when dealing practically with the regulation and processes within the entrepreneurial circumstances. The qualitative research questions of how and why, which are acknowledged as the best strategy for case studies would be answered in a practical way with good depth and it would be typical of how other small SMEs in Tallinn found the situation. For example the answers to the level of the existence of unofficial costs, one of the important research questions of the dissertation would be answered by an actual SME going through the processes.

After reviewing the academic literature and relevant quantitative material such as business surveys, it became apparent to the researcher that there was a potential difference in level of unofficial costs (a key research question) between the entrepreneurial circumstances. In that the taxation and the criminality circumstances were more open to the potential of having unofficial costs, at that time (2007) which the secondary quantitative research indicated. Additionally, case (1) became available to the researcher at a later stage in 2011 and consequently was used within the taxation and criminality entrepreneurial circumstances. This was also because the other 2 circumstances company formation and land acquisition had already been the subject of a research assessment by the researcher.

There were 2 law firms which were chosen cases (2) and (3) because they dealt with the regulation areas within the research objectives from a legal perspective and could give answers as to how the wording was interpreted and were specialized within those specific areas. Both cases (2) and (3) would be able to answer “how” the Estonian law was written and “why” it was written that way because for example of EU law obligations. Consequently, the researcher thought that both cases selected because they were specialized in the field of the specific entrepreneurial circumstance would provide in-depth answers as to how the law read, was interpreted and operated in practice. This would bring a wider more specialized view than for example asking an SME operating in Estonia because

each of the law firms would have dealt with many SMEs and would be specialized in Estonian law within the entrepreneurial circumstance.

Case (2) Sorainen was a specialist business law firm which had operated in Estonia for some years and would be able to answer in more depth the reality of the written law on land acquisition and company formation. This was because the firm dealt with SMEs acquiring land and forming companies and went through the process dealing with the regulation and interpreting it. Also case (2) because it was law firm would be able to give a legal view on the “key” legal parts of the company formation circumstance and the land acquisition circumstance. How secure was the separate legal entity principle of a company in Estonia and how secure was the title to land? Case (3) Borenius was a specialist taxation law firm with a branch operating in Tallinn, consequently the case study would help with the “key” legal parts of the taxation circumstance relating to how the tax regulation was written, interpreted and applied in practice to SMEs.

Both cases (2) and (3) had been operating in Tallinn for a few years and therefore would also be able to give their opinion on any changes to the regulation and procedures for SMEs within the relevant entrepreneurial circumstance. Also, because two of the case studies were law firms who both dealt with different but relevant regulation meant that close cross case comparison was possible.

Narva Police were chosen as a case study (4) because of the needs of the specific criminality circumstance. One of the “key” legal parts of the circumstance was the crime rate for specific crimes such as robbery and crimes against property. Case (4) would give a practical specialist opinion on the crime rate and would be more knowledgeable than an SME view. Also, the researcher thought that the Police would be able to answer whether the crime rate was higher in practice than the secondary quantitative data showed and “why”. This would provide valuable qualitative data.

Also, the other “key” legal part of the criminality circumstance was transaction costs (bribes and protection money), and the police would provide a specialist opinion on the extent of bribery as well as to the extent of the involvement of organized crime. It would provide more qualitative data because it was specialized and be wider covering than one SME opinion. The extent of, how organised crime operated and was involved with the protection costs of SMEs would be more extensively answered.

Narva Police was chosen because the subject of the case study and the contact of the researcher had worked in that police force. Also the researcher thought that Narva was an appropriate case because of its high Russian population, and may

provide information as to whether “Russification” had any effect on the criminality circumstance. The researcher found it very difficult to find an organization or person to be a case for the criminality circumstance, because of the sensitive nature of the area including organized crime, and the question of criminality itself. He was turned down several times after initial willingness once the reality of the research objectives was fully indicated. However the researcher had expected this and was not deterred eventually finding a suitable case study in 2011.

An important selection issue for all the cases of was the question of the person within the organization, that they were willing and in reality able to answer the objectives of the research. Additionally the nationality of that person in question was assessed because of the potential for biased in the answers given. A mixture of Estonians and Finns was felt overall the best balance for obtaining the research objectives, which was in the end the situation. This was because it gives a foreign and domestic perspective providing a wider view on the business reality and at the same time limiting any potential for bias.

4.2.2 Data collection

Interviews were the primary data source used because of the exploratory nature of the research and the fact that they are well suited to it. Additionally, interviews were considered the most appropriate method because of the need for depth and not breadth (Daniels and Cannice, 2004 p186).

Also interviews are acknowledged to be the most common way to obtain data in small business research (Curran and Blackburn, 2001). Consequently overall with SMEs also being the subject matter of the research, it was felt the appropriate choice for data collection. The people selected for the interviews were either suggested by the researcher after looking through relevant web pages, or recommended by the initial point of contact at the organization after the researcher indicated the subject matter detail of the interview. It is important to identify the right person for the interview as indicated by (Ghauri and Gronhaug 2005, p176), (Rowley 2002, p19). This is what the researcher tried to do through telephone negotiation or from the web pages of the cases involved.

In most of the cases only one person was interviewed from the organization in question and authors such as (Huber and Power, 1985 p174) that it should be the most knowledgeable about the subject matter/issue. Additionally, managing directors and senior managers are generally motivated to participate in such research as this, (Golden 1992 p856). This is because they understand its relevance and con-

sequently this gives them the motivation to give the information to the researcher (Van de Ven 1992, p188).

With this in mind the researcher identified the owner and founder of the SME case study in question (Riitta Kondolin of Marcon Holdings), as the most appropriate interviewee. Also founders are generally able to remember their firm's history, strategy and past performance better (Golden 1992, p849). The researcher felt that this was important as data could be obtained more accurately indicating any differences over a time period, and that the reality would be more accurately reflected. Riitta was Finnish and had lived and worked with SMEs for over 10 years including prior entrepreneurial experience in Estonia.

Consequently she was not a native of the country of the research in question, which would lead to no possible bias in her answers to the interview questions and she had experience over a number of years within the SME business operations field, Riitta Kondolin was interviewed for both the taxation and criminality circumstance.

The researcher also thought it was important to interview if possible experienced expert interviewees. This was so that he could get a broad but still in-depth view of the research objectives, in particular the overall reality with each of the 4 entrepreneurial circumstances. The researcher conducted 4 expert interviews with an expert within each circumstance. It was felt that a legal person at the sharp end of practical dealings with both domestic and foreign SMEs would be able to give answers to some of the research questions more thoroughly than a general business person. In particular, the expert knowledge and understanding of the area, relating to legal regulation wording and its implementation in practice.

From Sorainen law firm the expert interviewee was Ms Anne Adamson who had specialized in both entrepreneurial circumstances in terms of both domestic and foreign SMEs. She had given legal advice as well, as going through the registration process for business clients concerning company formation and land acquisition. Ms Adamson was Estonian, which needed to be accounted for when being interviewed in the sense of potential bias with her answers.

For the taxation circumstance there were 2 expert interviewees, from Borenius law firm Sami Tuominen specialist partner in taxation, based in Helsinki Finland and Egon Talur senior associate taxation, based in Tallinn Estonia. Both had experience of taxation law and registration for SMEs as well as interpreting regulation, in Estonia.

For the criminality circumstance, a former police inspector was interviewed, Ms Jekaterina Tantu, she was Estonian now residing in Finland. She had been employed as a police inspector In Narva,(between 1999 and 2003).As an ex-police officer it was thought by the researcher that she would be able to give a relatively free expert opinion of what was a sensitive area,in particular the organized crime and unofficial costs. Additionally she would be able to assess crime rate relevant to SMEs from a specialized opinion.

Table 1. Case studies and expert interviews

Case/Organisation	Expert/Nationality	Position	Interview Type	Thesis Article/Entrepreneurial Circumstance
Sorainen Business Law Firm,Tallinn Estonia	Anne Adamson Estonian	Associate-Company and Property Lawyer,Tallinn	E- mail	Article 1- Company Formation Article 2-Land Acquisition
Marcon Holdings,Textile Manufacturing SME	Riitta Kondelin Finnish	Owner,Tallinn	Face to Face	Article 3-Tax Article 4- Criminality
Borenius,Law firm Helsinki	Sami Tuominen,Finnish Egon Talur,Estonian	Specialist Partner Taxation,Helsinki. Senior Associate Taxation Tallinn	E-mail	Article 3-Tax
Narva Police, Estonia	Jekaterina Tantu,Estonian	Ex-Police Inspector, Narva	Face to Face	Article 4 - Criminality

To become more familiar with the cases and interviewees and in order to increase the credibility of the researcher during the interviews he visited their relevant internet webpages.

There are different types of interviews recognized academically, including structured, semi-structured and un-structured (Ghauri and Gronhaug, 2005). Structured interviews have a standard format and answers are systematically collected. Whereas unstructured interviews the interviewee is simply invited to express himself freely, with the interviewer leading the discussion. Semi-structured interviews lay somewhere between with the researcher having a list questions and

themes to be covered but which may vary in each interview. Combinations of structured and semi-structured interviews were used in this research.

All the interviewees were contacted initially by telephone and the objectives of the research were explained to them, including the sensitive nature of any areas such as unofficial costs. The reasons for this was to establish some kind of personal contact with the interviewees and attempt to build some kind of trust which the researcher felt was important particularly because of the sensitive nature of some of the research questions. This could then hopefully lead to the interviewees expressing themselves more openly with their answers to the questions of the research.

In entrepreneurial circumstance 1 (company formation) and entrepreneurial circumstance 2(land acquisition) there was one case study in each, the same one and the interviews were completely structured and the interview was by email. Entrepreneurial circumstance 3 (taxation) and entrepreneurial circumstance 4(criminality) had two case studies in each (Riitta Kondolin of Marcon holdings was interviewed in both) and all interviews took place face to face and they were semi-structured.

The variations in the interview method in that some have been in written form via email and others face to face was necessary, to an extent because of the fact that some of the interviewees resided abroad and the cost involved for the interviewer. Research design may incorporate more than one method of interview as here, (Saunders et al 2009, p323). Topics which are impersonal, that is where understanding the emotions of an individual are not that important, are generally suitable an email type of interview, which was the case here, (Haley et al 2002, p98).

There are several advantages and disadvantages to both types of interview method. The email interview should be started by making contact (in this case by phone) and obtaining consent of the interviewee to participate. Initially introduce the topic with an email and then follow that up with the questions in an email, which was the situation here. It has been advised that no more than ten questions be included in an email interview message, (Haley et al loq cit), which was the situation for the email interviews in this research.

(Lee 1993) emphasises that because of the nature of email communication it may last for some days but it has the advantage of allowing the interviewee to respond in their own time and find any information that might be required. This allows for a broader range of people to agree to and is suitable for a busy person, who is more likely to commit to this type of interview. This was the situation with this research as the interviewee was a busy lawyer.

Other advantages include, that bias is minimized, in a sense that in the email situation the interviewee is not able to look at the interviewer to see whether a certain response is expected. Also any miscommunication about technical aspects of the topic is avoided and a thoughtful response is likely, (Haley et al *loq cit*). The latter point is supported also by (Saunders et al 2009) p351) who argue that a time delay between questions being asked and answers given can be an advantage as it allows the interviewer and the interviewee to reflect and provide a considered response.

In this research it was agreed that either interviewer or interviewee could contact each other by telephone to ask anything further connected to the questions or the answers. The answers were given within a few days of receiving the questions and no telephoning was required by either party.

There are however certain disadvantages to this kind of interview as pointed out by (Hayley et al p98), including the fact that email information does not allow for a free flow of information with give and take and the interviewer does not get a good sense of the person being interviewed. Certainly, that was the case with the email interviews for this research. Particularly getting the sense of a native Estonian and feelings of patriotism affecting the honesty of the answers relating to possible corruption was a concern.

The face to face interviews were the other type of interview used and they also have advantages and disadvantages. They are known in particular for their synchronized communication in time and place and because of this it is the only interview method where advantage of social cues such as voice, intonation and body language can be taken. This can give the interviewer a lot of extra information and can be added to the verbal answer of the interviewee when answering a question, (Opdenakker, 2006 p1). An advantage of this communication is that the answer of the interviewee is more spontaneous. But due to this, the interviewer must also concentrate much more on the questions to be asked and the answers given. This is especially the situation when a semi structured interview is used, and the interviewer has to formulate questions as a result of the interactive nature of communication.

(Wengraf 2001, p.194) comments on the need for "double attention", which means "that you must be both listening to the informant's responses to understand what he or she is trying to get at and, at the same time, you must be bearing in mind your needs to ensure that all your questions are liable to get answered within the fixed time at the level of depth". Face to face interviews can be recorded, of course with the permission of the interviewee and using a recorder has the advantage that the interview report is more

accurate than writing out notes. The collection of the data in this research process involve both taking notes and recording the conversation

4.2.3 Evaluating the quality and validity of the research

There are various criteria used for evaluating research (Yin,2003) mentions measures that include :internal and external validity and reliability which are often applied in case-study research. Some authors however indicate that qualitative research should differ from the criteria used in quantitative research and include credibility, transferability, dependability and confirmability. (Tynjälä 1991, p388) and (Lincoln and Guba 1985,p295-296).

This research uses the latter criteria which were specifically designed for qualitative research.

Credibility refers to how well the researcher is able to provide data and findings that correspond to reality (Lincoln and Guba 1985, pp295-296).This criteria is related to internal validity and is widely used quantitative and qualitative research (Tynjälä 1991, 390). This is appropriate given the objective of this research, and business reality of the entrepreneurial circumstances including the confirmation of prior secondary quantitative data.

The sensitivity of the research topic could have been a threat to the credibility of the collected data. Particularly the general area of unofficial costs (corruption) and organised crime, crime detection and reporting within the criminality circumstance (thesis article 4).Measures were taken consequently in order to reduce the actual sensitivity and the sensitivity perceived by the interviewees. This included informing all interviewees that their contact information and identity could be kept, secret and confidential if they required. However none of the interviewees required such measures.

Additionally, the researcher tried to create an atmosphere of trust and relaxation prior to the face to face interviews, during the telephone contact before the email interviews. This was done by explaining why he was carrying out the research and his own background .It included in particular for the criminality circumstance (thesis article 4) that he in the past been a serving police officer. Also the place of the face to face interviews was outside, in a restaurant area which provided an open pleasant atmosphere.

Emphasis should be placed on selecting the right persons to be interviewed (Hirsjärvi and Hurme 2000,p189).To increase the credibility of this research a

founder of an SME as well as regulation and crime experts relevant to each circumstance were chosen (see section part 4.21 of the thesis). This was because they were likely to be the most knowledgeable about the research topic (Cresswell 1994, 148).

Another thing which has an influence on credibility is interviewee motivation (Lincoln and Guba 1985, p302). It is fair to say that the interviewees were all highly motivated to participate in the study commenting on its importance and asking for copies of the relevant thesis articles when they were published. The way a question is framed can also influence the answers given by the interviewee. In all interviews the researcher used specific probing questions in order to make sure that the interviewee understood what was being asked. Also, open ended questions to get as fuller information as possible. The researcher avoided leading questions and trying to manipulate to get a certain type of answer, this ensured the reliability of the results, (Huber and Power 1985, pp177-178).

Transferability, which is the external validity of the research refers to how the findings can be generalized beyond the case study in question (Lincoln and Guba 1985, pp269-298), (Yin 2003 p42). (Hartley 1995, p226) also comments on the fact that multiple case studies can increase the potential for generalization, which was partly the situation in this research, with both thesis articles 3 and 4. The cases used for the research (1) Marcon Holdings and (3) Borenius in thesis article 3 (taxation) produced some similarities as did cases (1) Marcon Holdings and (4) Narva Police in thesis article 4 (criminality). General patterns emerged in unofficial costs, that the regulation in practice operates as it is written, and the adaptability of the system which could be connected to legal origin theoretical aspects.

This provides evidence of external validity and allows analytical generalisations to the theoretical framework. The single case study in thesis article 1 (company formation) and 2 (land acquisition) also provided such evidence of the importance of the separate legal entity concept for companies and that it operates in practice in Estonia as well as the importance of land security.

Additionally, this study was conducted in a specific country with specific entrepreneurial circumstances for SMEs, however its results are able to be replicated in other countries from similar Soviet backgrounds as the same general transition to a market economy took place.

Dependability measures the ability of the researcher to present honest and reliable information about the concepts which are being investigated (Lincoln and Guba 1985 pp 298-299) which is similar to the idea of reliability in quantitative studies (Tynjälä 1991, p 391). In a practical sense it should be possible for anyone to do

the same study and get similar findings and conclusions (Yin 2003, p45). However it is important that in order to replicate the research there is clear documentation of the procedures followed in the earlier study (Yin loq cit).

In this study the interviews were carefully prepared and it was based on a theoretical framework and previous quantitative secondary data, which supported the conducting of the interviews. If interviews are conducted in the same way it decreases variation in data collection as commented on by (Ghauri and Gronhaug 2002,p 49)

However, although, there was a variation (as indicated in 4.2.2 of the thesis) of the type of interview used, which could potentially have provided different levels of dependability, in reality it did not. The interviews by email had specific written answers with no verbal alteration by telephone and the face to face interviews were recorded. Consequently, in the analysis part of the research the researcher was able to read the written answers several times and with the recorded interviews listen to them whenever required. This enabled the facilitation of direct quotes in all the 4 thesis articles and description of the case studies.

With regard to truthful information, (Saunders et al 2009, p 264) make the point that when an interview is recorded, it could reduce the interviewees' willingness to respond openly and honestly. This is a good point which could also be attributed to the email interviews as they are in a similar permanent form. However, overall, the researcher got the impression that the interviewees were very willing to express themselves honestly. There was one exception to this mentioned within thesis article 4 (the criminality circumstance) and the dealings with organized crime. This was the difference between the spoken comment given and the simultaneous body language of the interviewee, which in the researcher's opinion indicated a lack of honesty.

Confirmability is connected to the objectivity of the evidence found in the research as indicated by (Lincoln and Guba, 1985) and is very much connected to the ability of the researcher to identify the essential characteristics of the concepts of the research topic in an objective way (Hirsjärvi and Hurme 2000, p 189). One thing that can have an effect on such objectivity, is the relationship which develops through interviews between the researcher and the researched (Yeung 1995, p 322). There is also the possibility that the background and experience of the researcher can lead to a situation where it influences the interpretation of the data and consequently affects the objectivity, a point made by (Ghauri and Gronhaug 2002,p102).

The email interviews did not provide any opportunity for relationship development because of the nature of the interview method itself. The researcher did try to provide an open, friendly atmosphere for the face to face interviews and there was dinner and general conversation prior to them. However, this did not in any way influence the objectivity of the interview data and its analysis. With regard to the background of the researcher, it was a number of years ago that he was in the police force and for a relatively short period. Consequently although it gave him greater practical insight into the issues discussed, it did not influence the interpretation of the data and did not have an effect on objectivity.

5 SUMMARY OF THE ARTICLES AND REGIONAL COMPARISON

5.1 Summary of the thesis articles

In this chapter the 4 articles of the dissertation are briefly presented and their purposes, theoretical background and findings are introduced. The general as well as academic contribution is presented in the introductory chapter, the methodological position in the methodology chapter with cross-article analysis. Also the EU law and Estonian compliance within each thesis article is assessed in detail within chapter 3 although some general assessment is commented on here. More specific and detailed information can be found in the original articles. There is then a summary of the other Baltic States (Latvia and Lithuania) in relation to the same 4 entrepreneurial circumstances and regulation procedures and costs from similar secondary quantitative data. Also the compliance with relevant EU law through the specific wording is assessed, although there is no empirical qualitative data for Latvia and Lithuania. The purpose of the summary of the regulation procedures and costs in the other Baltic States countries (Latvia and Lithuania) is to get an overall picture. To compare Estonia's entrepreneurial circumstances with its neighbours. This gives a regional perspective which was something that was mentioned in the introduction chapter of this dissertation. All 3 Baltic State countries are closely connected and have been part of the Soviet Union as well as becoming members of the EU at the same time in 2004.

5.1.1 Article 1: company formation

The purpose of this study was to investigate and assess academic literature and to use and partly validate previous relevant quantitative work (World Bank Business Surveys) together in relation to business regulation for company formation in Estonia, for SMEs. In short, to evaluate the reality of the company formation regulation for SMEs, in terms of how it reads and operates. "Key" components from a legal perspective for company formation were identified academically through secondary quantitative research and used in the thesis article.

These were the necessary procedures and the time involved together with the cost, and the minimum capital requirements in the registration process. This was assessed through quantitative research (World Bank Business surveys) and was partly validated through the qualitative empirical research, within thesis article 1.

The other very important aspect identified as “key” within the academic literature was the legal wording and operation of the concept of the separate legal entity principle that a company has on formation. This had not been investigated before and was not within the secondary quantitative research used, consequently it was completely new. It was assessed through both wording and implementation through an expert witness, as to its legal operation in Estonia.

To assess the full reality it meant looking at the actual Estonian company formation regulation wording and at the same time evaluating if it had complied with (or indeed was wider than) EU company formation laws which included both directives and regulations. This was done through a primary business law source by reading the English language version wording of the actual relevant Estonian statutes and sections. The quantitative data from the World Bank Surveys indicated that there had been some minor unofficial costs within the procedure for company formation, which was also assessed and validated through the qualitative empirical research (the interview with Sorainen law firm).

The results from thesis article 1 show that firstly overall, the legal wording of the Estonian company formation regulation complies with the EU directives. Secondly that the “key” parts of cost, time and authorised capital in the company formation circumstance, considered through the secondary quantitative data are very positive (including speedier more convenient electronic changes) for SME development.

However it is indicated within thesis article 1 through the secondary quantitative data that the authorised capital amount is the same for 2007 as in 2004 and if it was reduced, then it would encourage SMEs to form more companies. Although, there are also comments that Estonia compares favourably with Finland, an established EU Member State (which has a similar minimum amount). Consequently, the overall view must be that it is positive.

Thirdly, the qualitative empirical research brings new empirical evidence giving further details as well as validating parts of the quantitative research, as to the reality of company formation and its ‘key’ aspects for SMEs. This empirical research in thesis article 1 confirms that it would be more time consuming and expensive for a foreign SME to form a company. An application to the registrar for company formation in Estonia by a foreign SME could take longer if there are exceptional circumstances (which documents of foreign origin would be). Also a foreign SME has to get Estonian ID to be able to take advantage of the speed and cheapness of the electronic system which needs to be looked at with further research as to how difficult that would be. Additionally, the empirical research (the

interview) validates that unofficial costs are virtually non-existent within the company formation process.

Fourthly, the other “key” aspect for SMEs the separate legal entity principle, identified in the academic literature operates both in principle and practice. This is shown in the Estonian company law wording and in practice as indicated through the empirical research. Both aspects were completely new findings. The qualitative empirical research shows that the registration process in the regions may be quicker than in the capital Tallinn again this is a new finding.

Overall thesis article 1 found that the company regulatory environment is very conducive for SME development within Estonia, in relation to the identified “key” aspects of the company formation registration process for SMEs.

5.1.2 Article 2: land acquisition

This article assesses and investigates academic literature and business regulation for land acquisition in Estonia in relation to SMEs. The purpose of the paper is to assist all SMEs and particularly foreign SMEs decision making related to land acquisition within Estonia. One important issue identified within thesis article 2 is that land acquisition because of its long term nature and commitment by an SME, has to be scrutinised even more during the decision making process. Additionally, in reality foreign ownership of land may be a sensitive issue within the country itself which brings barriers to such an acquisition.

World Bank Surveys providing secondary quantitative data are used and there are primary business law sources (wording of actual EU and Estonia law) viewed and assessed. This together with qualitative empirical research is laid out, commented on and evaluated within thesis article 2. The secondary quantitative data which is used in the article is partly validated through the interview.

The “key” aspects from a legal perspective were identified academically and through the secondary quantitative research for land acquisition. They were the perception of how safe land acquisition was and the security of land title, together with the time and cost of registration. Some of the time and costs of registration were assessed using the previous quantitative research and validated through the qualitative empirical research. Part of the costs includes the area of unofficial costs, secondary quantitative data including both a World Bank Survey and a domestic survey, were used and compared with the results from the interview.

Thesis article 2 in particular assesses Estonia's exemption from the movement of free capital within the EU, which affects land acquisition by a foreign SME. However, this exemption has now lapsed, although the thesis article assessed whether the exemption operated both in theory and practice, at the time it was in force. This had not been investigated before and was not within the secondary quantitative research used, consequently it was completely new. It was assessed through both the wording (a viewing of the Estonian law text) and implementation via an expert witness through interview, as to its legal operation in Estonia.

The results from thesis article 2 indicate that, firstly the reality, for a foreign SME acquiring land over 10 hectares of agricultural or forest type land in Estonia is that because of the exemption under the Treaty of Accession 2004, it was allowed legally only with permission of the county governor. This took more time and there was a wide discretion in the legal wording for a county governor in relation to giving permission. The exemption operated in theory through wording within the Estonian laws legal wording and operated in practice. However that exemption has now lapsed and so no restriction is there for a foreign SME.

Secondly that the "key" parts of cost and time as indicated through the secondary quantitative data are positive, except for the time for registration of land which is still very much affected by the notarisation process leading to a time period of 51 days compared to 14 days for Finland. The cost of registration for land acquisition itself compares very favourably with other established EU countries, such as Finland and the UK. However on close evaluation, the reason for this is the stamp duty which is much lower in Estonia (0.4% of property value) than in the UK (4.1%) or Finland (4%). In reality the security of title for an SME is good with around 80% registered, which helps perception of land security which is high. Both are "key" parts of the circumstance for SME's. The Estonian Law of Property Act 2004 supports this through s56 as land acquisition on the basis of information entered in the land register is stated to be legally correct. The other issue which helps perception of land security and security of title is confidence in the courts.

Thirdly, the qualitative empirical research brings new empirical evidence giving further details as well as validating parts of the quantitative research (World Bank Surveys and a domestic survey relating to corruption) as to the reality of land acquisition and its "key" aspects for SMEs. The secondary quantitative research used (World Bank Survey) suggests it might be a slower process outside the capital cities. However, the interview indicates that outside Tallinn can be sometimes quicker for land ownership registration procedures as well as with no extra costs. This empirical research in thesis article 2 confirms that it would be a little more

time consuming and expensive for a foreign SME to acquire land, through notarization, apostille and translation costs. It also indicates that the land rights of foreign-owned SMEs are guaranteed in the same way and to the same extent as the Estonian SMEs. This supports the positive perception of land security indicated through the academic data as a “key” part of land acquisition.

Also, that in practice the operation of an EU exemption was “got round”. This shows that despite getting an exemption, it being written in both the EU and national law and the sensitive nature of an issue it can be circumvented. This indicates what other EU Member State countries may do in reality with exemptions often obtained to satisfy public sensitivities. Additionally, it validates that unofficial costs are virtually non-existent within the land acquisition process. The interview indicates that they are non-existent, however both a domestic survey (2%) specifically on land registration and World Bank Survey (16.2%) to get things done generally with officials, indicate something small and decreasing over the years. The fact that the interviewee was Estonian may be an influencing factor in acknowledging the existence of something unofficial in a cost sense albeit very small.

Overall thesis article 2 indicates that the “key” aspects identified academically for SME land acquisition are as indicated earlier in the paper; the perception of how safe land acquisition, the security of land title which are linked, together with the time and cost of registration. It must be stressed that perception of land security is improving steadily. Additionally, as more land becomes titled it will improve further. Added to which, confidence in the judiciary in Estonia is high for a former Soviet Union country and as the empirical evidence indicates foreign SMEs have strong confidence that their land acquisition rights will be legally enforced. The cost of registration for land acquisition itself also compares very favourably with other established EU countries, such as Finland. The findings within thesis article 2 also indicate overall that it was slightly more difficult for an SME from another EU Member State to acquire land. Additionally the notarisation process could be reformed in Estonia which would quicken and cheapen the procedure for land acquisition by SMEs.

5.1.3 Article 3: taxation

This was the longest thesis article and the most difficult to write and compile. At the start of the thesis article, the point is made that under the Soviet system there was no real VAT system and the overall tax system was based on equalization, heavy taxes on profitable firms and lighter taxes on others, the result was massive

corruption and tax evasion. This is the starting point that puts the current tax regulation environment in perspective.

The objective of this thesis article was to investigate and assess academic literature and to use and partly validate previous relevant quantitative work (World Bank Business Surveys) together in relation to taxation regulation for SMEs in Estonia. To evaluate the reality of the taxation regulation for SMEs, in terms of how it reads and operates. “Key” aspects from a legal perspective of taxation were identified academically and secondary quantitative research used in the thesis article. Part of the overall assessment of this reality also involved describing and assessing EU and Estonian tax regulation through primary written business law sources (wording of actual EU and Estonia law). Additionally, the researcher himself viewed Estonia’s tax website and assessed its format which was used in assessing certain tax aspects relating to electronic use.

To partly validate (particularly the unofficial costs) and give more depth to the secondary quantitative data, qualitative empirical research was part of thesis article 3. There were 2 different experts interviewed from different case studies, an Estonian SME in Tallinn and a specialized Finnish business and tax law firm which had an operational tax branch in Tallinn. The SME, (interview 1) was chosen bring a cost procedure view within a business operations perspective and the tax lawyer (interview 2) to bring an interpretative, frequency of change and drafting perspective. However both the interviewees give their opinion on the overall tax environment for SMEs.

This thesis article identifies 3 main taxes that an SME will have to pay (Income, Social, and VAT) as well as relevant local taxes. It then describes the taxes individually and assesses them from the perspective of the “key” aspects; firstly the tax rate, secondly the compliance procedure and cost including registration and thirdly the overall tax regulation (vague drafting, inconsistent interpretation, frequent change). The findings from thesis article 3 are extremely positive including the following main points. Firstly overall, the legal wording of the Estonian tax regulation complies with the EU directives and in fact Estonia has initiated aspects of EU tax recommendations (which are not obligatory) through its flat tax system. That is because the Commission Recommendation of 1984 recommended that SME ownership forms should not be subject to different tax rates and by having a flat tax rate on income it does not distinguish between partnerships or sole traders who wish to change to a limited company.

Secondly that the “key” parts assessed through the secondary quantitative data are very positive (including speedier more convenient electronic changes) for SME development. The tax rate is generally low, (21% Income, VAT 22% ,although

the Social tax is 33%, and possible local tax of 1%) which encourages SMEs. The compliance procedure and cost is very positive with the electronic changes described allowing 24 hour accessibility for an SME and having reduced the extent of the unofficial cost to virtually zero. There has been no frequent change as Estonia has carried on with the same basic tax system for the last decade, and at the same time there has been specific detailed regulation including the introduction of binding rulings, helpful for both clarity and interpretation of tax regulation, (commented on by interviewee 2). The drafting is assessed within thesis article 3 and the use of section headings (EST IT, EST VAT) make it easier for an SME manager to view and read. In a theoretical generalisation sense the Germanic feature of detail and adaptability has had a beneficial influence on the Estonian tax regulation which can be seen through this attention to detail in the section headings.

Thirdly, the qualitative empirical research through 2 interviews brings new empirical evidence giving further details as well as validating parts of the quantitative research (World Bank Surveys), as to the reality taxation and “key” aspects for SMEs. Also, interview 1 validates that unofficial costs are actually non-existent within the taxation process and goes on to state that it is impossible because of the electronic changes and lack of personal contact in procedures. Both interviews, also comment on the fact that clarity, consistency of interpretation and no frequency of change, have been within the Estonian tax system. Additionally, the interviews also support the features of adaptability and detail relating to German legal origin theory through their comments on the adaptability Estonia has shown through its new efficient electronic system. This theoretical legal origin aspect is mentioned within the article and within the theoretical framework of this dissertation.

Estonia has transformed its system to one of no real corruption with an excellent encouraging environment for SMEs. It is the most remarkable and biggest achievement within the 4 circumstances of this study, given the background.

5.1.4 Article 4: criminality

The objective of this thesis article study was to investigate and assess academic literature and to use and partly validate previous secondary quantitative work (World Bank Business Surveys, European and domestic surveys). This was used and assessed together in order to find the business reality of the criminality environment in Estonia, for SMEs. “Key” components from a legal perspective for criminality were identified academically and through the secondary quantitative research and used in the thesis article.

The "key" legal parts identified and assessed in thesis article 4 were the crime rate (for the specific crimes robbery, crimes against the person or property) and the transaction costs (bribes, protection money). It meant also reading and evaluating the criminality regulation for SMEs, including EU and Estonian criminal law (through a primary source) in terms of how it reads and operates. The written criminal law in relation to those "key" legal parts is important because that gives the authority as to when such laws are broken and the punishment. All of which can be a deterrent and through implementation affect the crime rate which is connected to the transaction costs through the security costs. So as indicated within this thesis article if you lower the crime rate the security costs will become lower as direct consequence.

To partly validate and give more depth to the secondary quantitative data, qualitative empirical research was part of thesis article 4. There were 2 different experts interviewed from different case studies, an Estonian SME and an ex-police officer from Narva police, Estonia. The results from thesis article 4 show that firstly, overall, the legal wording of the Estonian criminal law complies clearly with the relevant EU laws. However, as indicated within the article there are one or two exceptions, for example as to the wording and exact meaning of burglary within the Estonian criminal law (further assessment is in thesis part 3.2.)

Secondly that the "key" parts crime rate and transaction costs for criminality through the secondary quantitative data and qualitative empirical research are generally positive. The crime rate has been steadily going down over the last few years, although to put it in perspective it is still amongst the highest in the EU (European Crime and Safety Survey, 2007). Further it is higher in reality, because the crime rate is higher than the one recorded due to mainly a reluctance to report. Nevertheless, as (Salla et al, 2008 p121) comments the general crime rate is a stable one. The transaction costs (bribes and protection money) are low, indicated by the secondary quantitative data used. It is validated by the primary qualitative data (interview 1) and assessed at around 40 euros a month.

However, the extent of organised crime within the transaction cost (protection money) is something which is a very sensitive area and there is reluctance within Estonia to discuss it. Certainly, it appears to be greater in reality, indicated by body language in interview 2 and by actual comment in interview 1. It is also fair to say that the academic literature, the secondary data used as well as the empirical research within this thesis article support such a view.

The thesis article also covers bribes as part of the transaction costs and it overall is a useful indicator and support as to the overall picture of unofficial costs (through bribes) within all 4 entrepreneurial circumstances. The secondary data

from the Estonian surveys on bribery and entrepreneurs show that bribery is still present within the Estonian business environment even if it is small in cost to an entrepreneur (Criminal Policy Department of Ministry of Justice Estonia, 2004 and 2006) and that it is more of a problem for a foreign SME. A bribe is in fact more likely to be asked of men, younger people, Non-Estonians and residents of Southern Estonia and Tallinn (where it is more widespread).

However the 2006 survey also indicates that there is a reluctance to report (as with crimes) and therefore it is probably more widespread than this secondary quantitative data shows.

Thesis article 4 also indicates that “Russification” within Estonia, academically commented on by Uslener, 2008 p22) has taken place in some areas in Estonia such as Tallinn and Narva. Ethnic Russians are more likely to be involved in bribes and are more tolerant of it, and “Russification” which took place during the Soviet period (when there was a massive migration to those areas) will take some time to completely go.

The empirical research also validates parts of the secondary quantitative research and academic literature as to the reality of criminality and its “key” aspects for SMEs. Both interviews support the academic opinion of (Salla, 2008) in relation to the stability of the crime rate, but that it was higher than the statistics because of non-reporting. The acceptance of some level of organised crime within Estonia is also supported by interview 1 and that it has a level of impunity from enforcement authorities, interview 2. It is possible to deduce that because of the stronger body language and the impact of “Russification” in Narva, where the interviewee was based.

Overall thesis article 4 found that the criminality environment is conducive for SME development within Estonia, in relation to its identified “key” aspects for SMEs. Because the crime rate is stable and transaction costs are low. The capital city Tallinn has the highest crime rate and bribery is more widespread there (which as a capital city is perhaps quite normal). However, in reality both (which are connected) maybe somewhat higher than appears because of the reluctance to report and the perception of the need for security payment is high at 85 % (World Investment Survey, 2009).

5.2 A comparison with the other Baltic States (Latvia and Lithuania)

Evaluation company formation

Firstly, as to the (safeguards for company formation) the concept of limited liability for company formation circumstance is clearly written in the Latvian law. That it is a separate legal entity and the date of commencement of the concept is at the point of registration at the Commercial Register²⁸. Also in Lithuanian law it is referred to in very clear words²⁹. Consequently, this important principle is written in clearly within all three of the Baltic States. This has a positive effect on security and freedom of innovation within the region as it is an important part of the SME company formation circumstance.

Secondly, as to relevant EU directives, the Company Harmonisation and Protection Directive has been complied with generally, by the wording of the regulation within both Latvia and Lithuania. Latvia has a few omissions and differences in the wording, for example, the compliance part of the details of a company's registered office stated on invoices³⁰. Additionally, with the responsibility of disclosure of formalities and penalties, the appropriate penalties are worded at a lower level than in Estonia³¹. Lithuania has more words than Estonia or Latvia within its regulation and some parts have wider coverage than the directive³². However, it is not as clear as Estonian regulation.

²⁸ See s135 (1) and (2) of the Latvian Commercial Law Act.(CLA) 2002.

²⁹ For example in the Lithuanian Law on Companies Act (LCA) 2003 it states "a company is a legal person with limited liability". Also by article 11(1) of the Civil Code (CC) 2000, it states that "a company shall be deemed incorporated from the date of its registration in the register of legal persons". However, it does not state that the legal form of the company has to be on the commercial documents e.g. letters (that it is a private limited liability company)

³⁰ The Latvian law by s17 (1) covers this as the wording is "particulars of a merchant" and a limited company would be within this. It refers to business letters, invoices and other documents of a merchant, so it is wider than the directive's wording of "letters and order forms".

³¹ Article 6 (appropriate penalties for omission) is covered by, s150 (4) "If the founders have not performed their duties in good faith, then they must compensate the shareholders who have requested a founding examination, and disputes about expenditure are settled by a court". With the responsibility of disclosure of formalities and penalties, the appropriate penalties are worded at a lower level than in Estonia ("if any incorrect information is submitted to the commercial register the person who signed shall be solidly liable for damage caused"). Doing their duties in good faith may not include liability for negligence and third parties. For example, third parties dealing with companies going through a liquidation process, where no such indication is given on letter headings or order forms.

³² Article 4 (company details). The CC 2000 article 2.44 covers this by ss 1 of the article, "documents of a legal person used in his business relations with other subjects (business letters, invoices, trade documents etc.) shall have to supply the following information: 1) business name

This means that an SME is not as sure exactly (in a few areas) what the position is under the company formation regulation. So it provides more uncertainty in the wording³³. Generally, however all three of the Baltic States have complied, with the directive which is helpful for regional development of company formation. Additionally there is the directive concerning single member private limited companies and by s140 of the LC Law 2002, a company may be founded by one founder in Latvia. In Lithuania a single member private limited liability company may also be formed³⁴. Consequently a single member private limited liability company is now part of the limited liability types, which can be legally formed within all three of the Baltic States. This gives SME activity greater limited liability protection. It also gives wider protection and generally more possibilities as to ownership forms for SME activity within the region.

Thirdly, the other important part of the circumstance for SME's, the cost of procedure and the minimum authorised capital. In Latvia the (World Bank Doing Business Survey, 2007) shows that there are now 5 procedures, it takes sixteen

of a legal person; 2) juridical form of a legal person; 3) head office of a legal person; 4) code of a legal person; 5) register which stores and safeguards the data on the given legal person". This is quite wide covering and the important words are "have to supply". It covers trade documents, as well as invoices and letter headings, so it is wider than the directive guidelines. If in the documents the capital of the company is stated it should be subscribed and paid up. Where the assets of a legal person are mentioned in the documents specified in paragraph 1 of the article, authorised capital and the amount of paid-in authorised capital have to be indicated as well. So that is clearly covered. Also at the end of the CC article 2.44 it states, "the above-mentioned information must also be given in the company website, where available" So the coverage of the wording is wide as to the information the private company must give in its documents and more than the directive guidelines.

³³ CC 2000, Article 2.68 provides a penalty where there is a refusal to register or register alterations by 3) "where data and documents produced to the Register are not in conformity with one another, are vague or misleading". However is it enough coverage? It is a directive, consequently it is only guidance from the EU, and its effect depends on the interpretation and implementation. If companies were using invoices for example which did not show their liability and registered office and were registered with the Register. The question is does the Register check and if a third party complains of an error what happens. For SME's one of the important parts of the company formation circumstance is the principle of a separate legal person. It is important the principle works in practice and part of that is showing the information. Article 2.73 covers redress for errors in the Register of Legal Persons and redress by the state but it would depend on interpretation. Does it mean that if documents or details in the Register and on letter headings are not the same and there is third party damage that the state will pay? I think that the wording indicates probably not, only where they have unlawfully refused registration.

³⁴ By the LCA,2003 article 7, Instrument of Incorporation and Act of Establishment. "If the company is formed by one person only, the act of establishment shall be drawn up". A company may therefore be formed by one founder, so this would cover the position of a single director for a private limited company as stated in the EU directive.

days and costs only 137 lats (195 euros) to form a company. Although, the procedures have been reduced to 5 from 7 (in 2004), the publication procedure and paying a registration fee were separate procedures which they are not now. So although the number of procedures is less, the time involved for an SME is similar (2 days less). It is possible for signatures of the founders to be checked by the company registration staff which lowers time and cost.

However there is still the involvement of a notary because the application to the Commercial Registry has to be notarised. So it probably takes longer and costs a little more for an SME than officially stated because of the notary involvement. However it is positive that the role of notaries is less although the changes are not as wide as for Estonia in this area. The most positive thing in Latvian company formation procedure is that the authorised minimum capital has been reduced to 1000 lats (1,422 euros). It has lowered the cost by 100% from 2004. In my opinion this is a change which will have most effect on SME's because it is the lowering the cost of one of the important parts of the circumstance for company formation by a large amount.

In Lithuania the same 2007 survey shows that there are 7 procedures, it takes 23 days and costs 628 litas (181 euros). The third registration procedure has an increased cost for an SME of 198 litas compared to 120 litas in 2004. There has been no electronic changes or reduction in the notaries role to help SMEs by lowering the time and cost. The authorised capital for company formation (the other important part of the circumstance for SME's) is 10,000 litas (2,896 euros) and has been the same for the last few years. On comparison, the minimum authorised capital required to form a company in Lithuania and Estonia (2,500 euros) is similar. However, it costs approximately half that for an SME in Latvia. It is a big saving and more of a financial incentive than any procedural cost differences between the countries.

Evaluation land acquisition

Firstly, the EU exemption for agricultural land which was a temporary provision which was an exemption from the EU Treaty of freedom of movement of capital obtained by all 3 Baltic States Countries on their accession to the EU in 2004. However, as it was a temporary provision it lapsed in May 2011, although an assessment of its application is still useful in seeing how it was complied with through the wording as well as its extent showing the reality of any sensitivity to foreign SME land acquisition.

The exemption was a total one in both Latvia and Lithuania. Latvia had a complete restriction on all agricultural land so that a non-Latvian SME cannot acquire such land³⁵. The wording for land acquisition, generally was complex and it is the “and/or” which is important and the fact that a company has to be listed in the Latvian Enterprise Registry. If you are not a private limited company and registered in the Latvian Enterprise Registry, it is more difficult and takes more time. It involved a plan for use and it could take twenty days, to be approved ” may” being the important word³⁶. In Lithuania, again it was a complete restriction for agricultural and forest land to non-Lithuanians³⁷. Estonia had in comparison a smaller restriction for foreign SMEs in that the restrictions applied to agricultural land and woodland with the size of 10 hectares or more.

Within the Lithuanian law that covers land acquisition, one of the big differences between Lithuania and the other Baltic States was the passing of ownership to the purchaser. In Lithuania this happened on ‘delivery of the immovable thing’ whereas in Estonia and Latvia it is on registration of the land. Additionally, in all 3 Baltic States the notarisation process is strong within land acquisition. Stronger within both Latvia and Lithuania than Estonia, but essential in Lithuania and has recently been strengthened. Failure to notarise the agreement on sale-purchase of the land makes it void by law in Lithuania. .

Secondly, land ownership security. The title to the land registration system has a very wide coverage in Latvia which should provide security for an SME³⁸. Compared to Lithuania it is almost twice the area which has registered ti-

³⁵ What the Law on Land Privatisation in Rural Areas 2003 Act (LLPRA), states is that the legal restrictions in Latvia apply to all agricultural land and woodland, s6 of the 2003 Act.

³⁶ A summary was made by the (OECD, 2004 p50) of an investment by an established foreign controlled enterprise. It reads s follows (c) Companies listed at the Enterprise Registry of Latvia provided that more than 50% of fixed capital is owned by Latvian citizens and/or Latvian government bodies and/or natural or legal persons from countries with which Latvia has signed and ratified an international agreement on the promotion and protection of investments by 31st Dec 1996, or agreements concluded after that date, provided that the agreement provides for reciprocal rights to land acquisition. Other physical and legal persons can obtain land (apart from the exceptions e.g. land for agriculture) having got permission from a local authority in whose territory the land is situated.

³⁷ The Constitutional Implementation Act 2003 article 9 states, that foreign subjects may not acquire amongst other types of land ‘3) agricultural land 4) forestry land’. Further, a foreign subject is identified via article 4 to include a national or SME from another EU member state.

³⁸ The Land Register law appears clear and the procedure solid. In fact according to (Review of Real Estate in The Baltic States, 2004 p3) the registration procedure is the best of the Baltic States. “The registration of land property and land assigned for use in

tle³⁹. However, if there has been a previous claim (even without prior special registration) how safe would ownership be for an SME? ⁴⁰.

SMEs have a low confidence level in Latvia that the judicial system will enforce their land ownership rights⁴¹. So even if the title is 100% registered the perception of land security is lower because of lack of judicial confidence in enforcement. In Lithuania the public needs of the state is strong, because even with secure title, if the state needs it can be taken⁴². Additionally, SMEs are not confident that the judiciary will enforce property rights⁴³. In Estonia the level of judicial confidence is quite a lot higher than the other Baltic State countries, although there is not 100% registration of land title.

Thirdly, the other important part of the circumstance for SMEs, is the procedural cost. The (World Bank Doing Business Survey, 2005) states that Lithuania, (3 procedures, 3 days, cost % of property value 0.8), is followed by Latvia (9 procedures, 54 days, 2.0% cost of property). Consequently, on assessment of the regulation Lithuania has by far the easiest and cheapest cost compliance for SME activity. However it must be balanced with the security of land acquisition for SMEs and Estonia overall is the best of the Baltic States. This is more important for an SME, as land acquisition, is generally part of a long-term strategy of an SME.

the national real estate cadastre is completed and it covers 100% of the total area of Latvia, that makes Latvia a leader in this case”.

³⁹ Ibid pp13 to14 “Regarding the total area of state that is registered in the Cadastre, it is only 54.4%....However technological and software options of the Real Property Cadastre and Register database have got positive evaluation. A multi-purpose Real Property Register information system has been acknowledged as one of the most advanced systems in the Eastern and Central Europe”.

⁴⁰ This was commented on by (Zimele, 1997).”The general approach to Land Reform is restitution of ownership rights to pre-war owners or their descendants. Where Restitution is not possible or not applied for, other similar land is given, or compensation paid.” It may take more time for SMEs to know that land ownership is secure.

⁴¹ The (World Investment Climate Survey, 2005) assessing courts in Latvia asked 205 SMEs if they agreed with the following statement “I am confident that the judicial system will enforce my contractual and property rights in business disputes”. It was 48.2% for small 44.4% for medium and 58.3% for foreign SMEs

⁴² In Lithuania, Article 32 of the Law on Land 2002 covers the taking of Land for public needs, although it states only in ‘exceptional circumstances’ can land be taken for ‘state needs’, there is a long list of needs and it includes on request by ‘any other administrative institution’ which has wide coverage with the wording. There is an appeal system for an SME and when land is taken alternative land of the same value within the locality must be given and compensation for ‘other losses resulting’. However, for SMEs it is a worry and it affects their perception of land security

⁴³ op cit In Lithuania It was 43.8% for small 50% for medium and 62.5% for foreign SMEs.

Additionally, an overall conclusion is that land acquisition compliance for foreign SMEs, in all 3 Baltic States, is more difficult. This is because of the documentation required which means it takes more time and also the decision making which is more arbitrary for example it includes decisions by county governors.

Evaluation taxation

Firstly, in relation to EU law. Latvia has a flat direct tax rate on profit, although the rates are different, depending on the ownership form. For example, a company registering with the Enterprise Register pays a rate of 15% on direct income, compared to a partnership where individual partners have their income taxed at a rate of 25%⁴⁴. The position is similar in Lithuania⁴⁵. The EU VAT Directive exemption in both Latvia and Lithuania is for annual turnover of less than 10,000 lats and 100,000 Ls respectively (14,316 euros)⁴⁶. This is not quite as high as in Estonia. Latvia and Lithuania did not have an exemption for the taxation of undistributed profits on income by subsidiaries, which Estonia had.

Secondly, the tax rates, unevenness of collection, vagueness of regulation, frequency of change and inconsistent enforcement. The rates of the main 3 taxes are as follows. The Income Tax rate is 25% in Latvia and 24% in Lithuania, consequently not as low as Estonia's. The Social Tax rate is 33% in both Latvia and Lithuania (the same as in Estonia) and the VAT is 18% in both Latvia and Lithuania, as in Estonia. The main tax rates are flat and quite similar in all 3 Baltic States countries. The rates for any local taxes in both Latvia and Lithuania are

⁴⁴ The two important statutes are, the Enterprise Income Tax Act of 2004(EITA) and the Law on Taxation and Fees Act 2004(LTFA). By s15 LTFA, the Enterprise Register can register undertakings, and the tax rate is 15%. S2 (3) of the EITA, states "partnerships shall not pay enterprise income tax independently. Each partnership shareholder shall pay the relevant personal income tax or enterprise income tax according to the share of income due to him or her"

⁴⁵ In Lithuania, the income tax is covered, by article 6 of the Income Tax Act 2002, activities including distribution of profits, are taxed at a rate of 15%. The tax rate for limited companies is stated in article 7 of the Law of Profits Tax 2002, at 24%. However zero% if it invests as stated and there is a special category for foreign companies for certain business activities at 15%

⁴⁶ Within the Latvian Vat Act 2005 it is referred to by s6 (5) "if the total value has not exceeded 10,000 Lats in the previous year natural and legal persons have a right not to register. Within the Lithuanian legislation it is referred to at article 71 of the VAT Act Of 2004, for natural and legal persons. They are exempt from registering, if in the previous year the total value of annual turnover is less than 100,000 Ls. This is particularly small for Lithuania given the amount allowed under the EU exemption (up to 29,000 euros) and not that encouraging for SMEs.

discretionary (as in Estonia) but the amount paid by an SME would not be at the level of the main taxes⁴⁷.

In Latvia there is some unevenness for an SME in collection compliance.⁴⁸ The regulation is more vaguely drafted than in Estonia because of its thickness and in fact this is a common feature of Latvian taxation regulation⁴⁹. Also, it is difficult to assess the exact date of collection and the exact rate for VAT as there are different levels for different services. The language used particularly in the Enterprise Taxes Act is difficult to interpret for SMEs because it is not clear. In Lithuania the direct and indirect taxes are levied quite evenly except for the advance payment of profit tax for companies and the miscellaneous taxes.

As with Latvia there are some examples of vague drafting, particularly as to the punishment parts of the taxation, a lot of the Lithuanian tax law is very detailed. As within the Income and Value Added Taxes this detail, masks the clearness and there needs to be less language which is more specific⁵⁰.

The compliance procedures provide uncertainty for SMEs if they are changed frequently and Latvia has changed the procedures for taxation since transition. However, frequency of change can be positive for SMEs if it reduces the compliance cost, and Latvia has done this for SMEs with the introduction of its electronic registration system. The wording of the regulation makes it easier for an SME

⁴⁷ For example in both Latvia and Lithuania there is a Natural Resources Tax with a discretionary rate. The Natural Resources Tax Act in Latvia affects SMEs who deal with chemicals or hazardous waste who require a permit from the authorities as well.

⁴⁸ For example the advanced payment of taxes referred to under s23 of the Enterprise Income Tax Act 2004(EITA)

⁴⁹ S2 (3) of the EITA, states "partnerships shall not pay enterprise income tax independently. Each partnership shareholder shall pay the relevant personal income tax or enterprise income tax according to the share of income due to him or her". Further, the section then adds that "enterprise income tax shall not be paid by natural persons and individual family undertakings" Further, the section then adds that "enterprise income tax shall not be paid by natural persons and individual family undertakings" (this includes farms) who do not have to submit annual accounts. The owners of such undertakings shall also pay personal income tax on the undertakings income. However there is an exception "if you are registered as an individual undertaking as a payer of enterprise tax within 5 taxation periods, from the taxation period when they were registered as an enterprise tax payer". The wording could be clearer in the main section and within the exception.

⁵⁰ For example the VAT Act of 2004 gives a thorough definition section at the start of the Act, which is helpful. However within the penalty section of the Law of Taxation Act 2001 of articles 122 and 123, whether failing to submit on time (122) which is an obligation on SMEs or failing to comply (123) "the unjustifiably reduced amount" is wide in how it could be interpreted and 'the form of guilt, other circumstances recognised by the tax administrator as relevant'.

to register in the Enterprise Register rather than with the State Tax Authority, and the Enterprise Register has been more consistent with its compliance procedures. The only important change has been for the registration of a company. Now a company automatically gets registered for tax registration at the same time as its registration in the Enterprise Register⁵¹.

In Lithuania there have been some changes to the tax compliance regulation. Since, May 2004, the compliance procedure for the registration of companies as VAT payers has been made longer and more complicated, including attending interviews and answering detailed questions, about the company. This affects compliance cost for an SME (preparation) it is also arbitrary, in the sense that it could take a long time period depending on the interviewer. A new law the Tax Administration Act 2004 changes some of the compliance cost for SME's by providing for electronic submission of tax declarations, if there is assurance of identity of the submitting person⁵². Another change to this act compared to the previous Tax Administration Act of 2001 is the introduction of a new concept, that of an agreement between a tax administrator and a taxpayer on the amount of tax⁵³. The Lithuanian tax compliance regulation through its wording has changed the most for SME's within the Baltic States.

Finally if the regulations are interpreted or enforced inconsistently then this in a similar way to frequency of change of the regulation (or vaguely drafted regulation) increases the burden on SMEs through the compliance. The (World Investment Climate Survey, 2005) shows the consistency and predictability of officials interpretations of regulations affecting the firm which were assessed. The percentage of firms who agreed with the statement "In general government officials interpretation of regulations affecting my establishment are consistent and predictable" In Latvia, it was 49% and in Lithuania it was approximately 40% for all

⁵¹ The Law on Taxes and Duties 2001 also states that an eleven digit registration number is issued to the company. This is compliance change but positive as it makes it easier and less costly for an SME.

⁵² So this is a change for SMEs, but a positive one. If a sole trader has for example, concluded an agreement electronically with the local tax administrator after submission of forms and declarations.

⁵³ What this means is that an SME may conclude an agreement with a tax administrator, if after calculation of taxes none of the parties have sufficient proof to base their calculation on. Upon signing the agreement, the SME would lose its right to appeal against the tax calculation as would the tax administrator to calculate a higher one than in the agreement. Although this is not direct compliance for an SME, because it doesn't have to do it, it's an example of a change in the way things are done and the future possibilities.

SMEs⁵⁴. Although this does not just cover tax regulations it gives some idea as to such consistency within the region and Estonia is the best of the 3 countries with a figure of 60%.

Thirdly, the compliance procedure .The (World Bank Business Survey, 2007) shows that (in relation to the 3 main taxes Income, VAT and Social) taxation compliance time in Latvia for SME's is 7 payments and 219 hours spent. For Lithuania it shows that compliance time is twenty four payments, and 166 hours spent. Estonia has the easiest compliance with ten payments and 81 hours spent. Additionally, the same survey also assessed the time spent with tax officials in terms of days per year. For Latvia it was 1.96, Lithuania 3.57 and Estonia 1.54. Consequently compliance time for an SME is greatest in Lithuania and least in Estonia.

Overall it is fair to say that Estonia has the most favourable tax environment of the Baltic States for SMEs.

Evaluation criminality

Firstly, in relation to EU law. Latvia has signed the EU pact on organised crime and consequently has to comply with directives connected to it .An example is Directive 91 on the Prevention of Use of the Financial System for Money Laundering which it has complied with.⁵⁵ However, in relation to the Crime Victim Compensation Directive currently there is no Latvian law to read (the date of compliance was January 2006).

⁵⁴ In Latvia there was a big difference between the different enterprises 31.9% for small 52.6 for medium and 64% for foreign.

⁵⁵ There is a section of the Latvian Criminal Law of 2004 s195 which provides the penalty for "laundering the proceeds of a crime". The wording allows for a sentence to be greater, through subsection (2) for repetition of the activity. This includes where it is on a large scale and involves organised groups. It provides for a sentence of not less than five and not exceeding ten years with confiscation of property. The Money Laundering on the Prevention of Laundering of Proceeds Derived from Criminal Activity Act 2003 regulates to prevent money laundering connected to financial institutions. There is a Latvian control service with overall responsibility, and there is also co-operation with international authorities as well, covered by s29 (5). Consequently, the directive is covered by the wording. Gangs and group crime are also deterred throughout by the greater sentences provided.

Lithuania has also signed the pact against organised crime and the Money Laundering Act is a positive example of EU law that has been covered⁵⁶. Also, Lithuania has been active with its legislation on organised crime, but it is weak as to the penalties, giving only warnings, which are not going to have much effect. Particularly given the wording of the Resolution of the Republic Of Lithuania, Long-term Development Strategy of the State 2002, which frequently refers to organised crime and ‘constant attention to combating organised crime’ The Victim of Crimes Directive has been complied with in 2006 and this shows Lithuania’s desire to fight criminality. However, the wording of the directive only covers “intentional violent crimes” so it is not wide.

One EU protocol of significance for Lithuania within the EU Accession Treaty 2004 is no 5. That is the arrangements for transit of persons by land between the region of Kaliningrad and other parts of the Russian federation by simplified visa arrangement. The strengthening of the external border with Kaliningrad and the co-operation with Poland, which shares a common border with Lithuania and an external border with Kaliningrad, is very important. This is because it is essential in preventing and detecting criminal offences (as stated by SCH/com-ex (99) decision of 18 April 1999 of the Schengen acquis)⁵⁷.

Secondly, the important parts of the criminality circumstance are the crime rate which is affected by the penalties to deter, together with the transaction costs (protection and bribes). Under the Latvian law, gangs, group crime and repeat offences are given long enough sentences to deter. The Latvian legislation for property offences covers appropriate areas, although the wording and what it covers is not specific enough. It says the same thing and repeats itself. For example, or “ overt ” or “concealed” used within the theft legislation. Is there a difference as to what they are because both are a dishonest taking of property belonging to another? The wording of the sentence possibilities does not state any difference, so why distinguish between the two. The use within the legislation of the word

⁵⁶ It states that it has been harmonised with the EU directive and covers the main points of the directive.

⁵⁷ For an SME it means that Lithuania may have more organised criminality and crime rate increases. The reason is the freedom of movement allowed under the Single Market of the EU. It is consequently important for the borders to be secure, and the money available (under the Schengen facility, 90 million euros from 2005/2006) used to prevent criminality. The movement of persons and goods has been made easier by the Single Market, and there is a high level of Russian organised crime and crime rates. So it is likely that there would be a rise in criminality which would affect the important parts of the SME criminality circumstance if the Lithuanian EU borders are not secure. The real worry is that Lithuania will be affected by its location to Kaliningrad and the arrangement of simplified visas.

“or” is a worry⁵⁸. The sentence possibilities, generally within Latvian criminal law cover the seriousness of the crime including the mens rea (intention) part⁵⁹.

In Lithuania the Penal code 1998 covers special aggravating circumstances for both theft and robbery including repeated breaches or by a group, and theft involving breaking into property and property of high value⁶⁰. The wording of the law which puts such offences in a special category with greater sentences should help SMEs by affecting the crime rate which is an important part of the criminality circumstance. Provided the sentencing penalties are implemented consistently it should have an effect on the cost-benefit decision making of a thief.

Because of Lithuania’s location next to Kaliningrad SME activity may be lower in the future because of an increase in transaction costs. Strict criminal laws in this area are needed to protect SME’s. This is because of the potential for increased criminality which could affect the Baltic region.

Thirdly, the (World Bank Investment Climate Survey, 2005), for Latvia and conflict resolution and crime found that of small firms security costs % of sales was 1.09 and losses due to crime 0.46. For medium firms security costs were 0.85 and losses due to crime 0.45. There was 0.01 costs to the mafia for small firms. The main problem is the security and protection cost for small firms which was over 1% (1.09) of sales costs together with some payment to the mafia. This indicates that organised crime is the biggest criminality problem for SMEs in Latvia, particularly for small enterprises.

The same survey in 2005, for Lithuania concluded. For small firms security costs % of sales was 0.31 and losses due to crime 0.29. Medium firms security costs were 0.69 and losses due to crime 0.64. There were zero payments in both cases for the mafia. These figures are quite similar to those of Estonia. However it is important an SME considers Kaliningrad and its location next to Lithuania. There

⁵⁸ For example, at s177 of the Criminal Law Act fraud “or a fine” even if repeated. This gives wide judicial discretion as to the penalty possibilities on implementation. This affects the deterrent part, which affects law and order (in this case a thief’s cost and benefit decision making) and the important part of the criminality circumstance, crime rate for property offences.

⁵⁹ For example, the “negligent destruction of property” has a lower penalty possibility than “intentional destruction”. As to the financial penalties, fines, these are subjective. Because it is likely to be interpreted that it is the minimum monthly wage of the particular individual, which rises with the more serious nature of the offence, even if it means the minimum monthly wage nationally within Latvia. To deter, repeat offences and large scale organised groups, a penalty of 150 times the minimum monthly wage is provided, as in the case of s177(3) for fraud within the Criminal Law Act 2004.

could be a future increase in organised criminality which would affect SMEs, because of greater transaction costs. Strict criminal laws in this area are needed to protect SMEs. This is because of the potential for increased criminality which could affect the Baltic region and further research is needed on the reality of the implementation of the criminal laws.

Looking at the overall crime rate statistics for the 3 countries, a domestic survey gives a slightly different picture. Taking the populations of Latvia (2.2 million) Lithuania (3.3million) and Estonia (1.3) it puts the level much closer for the 3 countries⁶¹. Although, as indicated earlier within the dissertation statistics cannot totally be relied on as a lot of crime is not reported. For the effect on SME's of criminality the World Bank Surveys are probably more reliable

With regard to bribes as part of the criminality circumstance, the (World Investment Bank Survey, 2005) gives the percentage of firms that provide gifts or informal payments to government officials to get things done. In Latvia, this was 32.7%.for small 23.5% for medium enterprises and for foreign SMEs it was 28.5%⁶². The trend for the number of SMEs doing this in Latvia is getting lower, which means the cost is being reduced. There are some SMEs who give some extra payment (which increases the compliance cost) but it is less than one fifth of the SMEs and is more likely to be given by a small enterprise in Latvia. In Lithuania it was 46.5% for small 51% for medium enterprises and 42.1% for foreign⁶³. It is quite a high number nearly half of the SMEs and is quite similar for all the enterprises. The percentage figures show that this trend is going upwards from 2002 overall for all SMEs even though only slightly. It shows in reality the strength of the historical legacy in this area and how difficult it is to reduce it in Lithuania.

However, the same 2005 survey in Latvia shows the average value of gifts or unofficial payments to officials to get things done (percentage of annual sales) was 0.55 for small and 0.33 for medium enterprises and 0.48 specifically for foreign

⁶¹ See (the Information Exchange among Latvia, Lithuania and Estonia in Criminal Statistics, 2009).The total number of registered criminal offences for 2008 has Latvia at 57,475, Lithuania at 78,060 and Estonia at 50,977. However, the level of crime per 100,000 inhabitants has Latvia at 2530,8,Lithuania 2306,1 and Estonia 3780.Although the figures for homicide and robbery show the least in Estonia of the 3 countries.Robberies,Latvia1,441,Lithuania3,452andEstonia909.Homicide,Latvia119,Lithuania333, and Estonia104.Thefts, Latvia19,182, Lithuania 35,318 and Estonia 22,471.

⁶² In 2002 the amount was 38.1% for small enterprises and 52.9 for medium (World Bank Investment Climate Survey, custom query 2002).

⁶³ In 2002 the amount was 37%, 46% and 35% *ibid* Lithuania.

SMEs. In Lithuania this was 0.86 for small 1% for medium enterprises and 0.42 for foreign SMEs. In reality it is small unofficial cost but for quite a high number of SMEs.

Overall it is also a useful support for assessing unofficial costs throughout the 4 circumstances in Latvia and Lithuania. Compared to Estonia this is a relatively high expectation for both Latvia and Lithuania but the value of such bribes is of a similar low value, as in Estonia. These are relatively similar for both Latvia and Lithuania and both are higher than Estonia. However the fact that such bribery takes place indicates how difficult it is to totally get rid of corruption completely and the strength of the Soviet legacy discussed earlier in the thesis.

This is supported by academic literature that corruption (bribes) in particular that Lithuania has the most but that it is implementing the most effective anti-corruption policy⁶⁴. Additionally, although it is not directly connected to business and bribes a cross country survey on corruption in health care supports this view. Estonia is the cleanest and Lithuania has the most⁶⁵. Consequently it is reasonable

⁶⁴ See (Reed,2003) "The prevailing wisdom on anti-corruption policy in the Baltic countries is that, Lithuania stands out as a model for anti-corruption policy particularly through the creation of a truly independent anti-corruption agency (the Special Investigations Service); Latvia has been one of the most active countries in the region in anti-corruption policy implementation has been troubled by a lack of coordination and political will; while Estonia has been criticised for not making such a policy a priority, the apparent poor functioning of several institutions with a role in fighting corruption. The main common denominator of existing research findings on corruption in Lithuania is that the country appears to suffer from considerably higher levels of what the World Bank terms "administrative corruption": "the intentional imposition of distortions in the prescribed *implementation* of existing laws, rules, and regulations to provide advantages to either state or non-state actors as a result of the illicit and non-transparent provision of private gains to public officials. According to both the World Bank and other survey findings, unofficial payments for services such as licences are considerably more prevalent than in the other two Baltic countries, while the annual percentage of revenues businesses believed to be allocated to unofficial payments is approximately double the level of Latvia or Estonia".

⁶⁵ See (Cockcroft et al, 2008). Unofficial payments in the health sector are sparse in 2002 we conducted a social audit of the health sector of the three Baltic States. METHODS: Some 10,320 household interviews from a stratified, last-stage-random, sample of 30 clusters per country, together with institutional reviews, produced preliminary results. Separate focus groups of service users, nurses and doctors interpreted these findings. Stakeholder workshops in each country discussed the survey and focus group results. RESULTS: Nearly one half of the respondents did not consider unofficial payments to health workers to be corruption, yet one half (Estonia 43%, Latvia 45%, Lithuania 64%) thought the level of corruption in government health services was high. Very few (Estonia 1%, Latvia 3%, Lithuania 8%) admitted to making unofficial payments in their last contact with the services. Around 14% of household members across the three countries gave gifts in their last contact with government services. CONCLUSION: This social audit allowed comparison of perceptions, attitudes and experience regarding unofficial payments in the health services of the three Baltic States. Estonia showed least corruption. Latvia

to say that Lithuania is the most corrupt and Estonia the least. Consequently, overall, Estonia is the most compliant with the EU laws and has the least security costs and losses due to crime. Organised crime was only admitted to by SMEs in Latvia. However there probably are some payments to SMEs as protection costs in Lithuania, as in Estonia, which is not admitted to. Again further research is needed to find out exactly.

The involvement of organised crime is very hard to assess for SMEs in all 3 countries, Latvia is the only country that some SMEs admitted that there were payments albeit small. I think given the academic literature it is higher than the surveys suggest and a few SMEs are not actually giving the information.

5.3 Overall comparison

The wording of the regulation for the important parts of the four SME circumstances shows that Estonia has the cheapest cost compliance procedure and best regulated business environment for SMEs. This is for security, for example as to company formation and the separate legal entity principle and land ownership evidenced by judicial impartiality confidence. The wording itself is also the clearest and most specific in its use of legal language.

Estonia is also the only country with a flat rate taxation system for all SME ownership forms and this provides certainty, as it has not changed for some time. The criminality % figures are quite low, for Estonia and Lithuania for security costs, and Latvia would be the most costly for an SME. All 3 Baltic States have a similar crime rate % with Estonia a little better than Lithuania's. Consequently Estonia is probably the best with criminality for SMEs, also there is greater confidence in the judiciary than in the other two countries.

The conclusion is in favour of Estonia overall as the best country for SMEs. However other important comments can be made for SMEs when comparing the 3 countries. The compliance cost for land acquisition, is easier and cheaper within Lithuania for SMEs. Latvia has a 100% registration system for land and cheaper cost compliance for company formation. Further, reading the wording of the taxa-

was in the middle. Lithuania evidenced the most unofficial payments, the greatest mistrust towards the system. These findings can serve as a baseline for interventions, and to compare each country's approach to health service reform in relation to unofficial payments

tion regulation Lithuania does not distinguish between foreign SMEs tax compliance, and Lithuanian SMEs tax compliance. So it is not more difficult, for foreign SMEs.

6 CONCLUSION

6.1 Cross-article themes and analysis

The first theme that is displayed and acknowledged within all 4 thesis articles is compliance with EU law through Estonian law. This is both in the sense that the wording covers any relevant EU regulation or directive and consequently it shows Estonia's compliance with EU law within the 4 circumstances from a theoretical perspective. This theme is also supported in a practical sense by the qualitative empirical research (the interviews) throughout the 4 thesis articles, that in reality that relevant EU law has been also generally implemented. There are one or two exceptions but they are exceptions.

The second cross-article theme shown is that in thesis article 2 and 3 the theoretical influences of German legal origin are shown. In article 2 (land acquisition) the historical influence and establishment of principles of German law in the Estonian Land registration cadastre are shown indirectly through the qualitative research (the interview). This is in the sense that the interviewee comments on the guaranteeing of foreign property rights and security of land ownership as if it was certain.

In article 3 (taxation) there is an assessment that Estonia has provided a detailed, clear consistent yet adaptable tax environment through its electronic changes. It comments on the drafting of the tax regulation and the German feature of detail, as well as the academic comments of (Ayani, 1998) on the successful importation of German codes by Estonia which chose that model on independence. Interview 2, within the article supports that view with comments on the overall clarity and simplicity of the tax regulation as well as consistency of interpretation, over the last decade in Estonia.

Additionally, it is fair to say as a theoretical generalization that the general adaptability of Estonia to the EU laws also supports the influence of German legal origin. There is an attention to detail generally within all relevant laws viewed and assessed when with one or two minor exceptions. Consequently this one part of the theoretical framework has to be acknowledged as one cross-article theme.

The third theme is that in all 4 thesis articles it is shown that the "key" legal parts of each entrepreneurial circumstance are generally positive and is therefore a positive and welcoming trend throughout for entrepreneurial activity. For example with the company formation (thesis article 1) the separate legal entity principle

there is both theoretical and practical implementation, also security of land title (thesis article 2).

The fourth theme is that all 4 articles comment on the significance of SMEs, (particularly for countries from the former Soviet Union) and the correlation with the relevant business regulation of the specific thesis article. However, thesis articles 2, 3 and 4 further acknowledge that the development of SMEs within the former Soviet Union countries such as Estonia, has not yet reached other high growth countries, despite their being at an advanced stage of transition to a market economy.

The fifth theme relates to the whole research in that the qualitative research partly validates the secondary quantitative research in all the thesis articles. This is in the sense of the unofficial costs for an SME within the procedures for company formation (thesis article 1), land acquisition (thesis article 2), taxation (thesis article 3) and as to security costs and crime rate in the criminality (thesis article 4). All the interviewees indicate impliedly or expressly that such costs are very low or non-existent within a downward trend. The qualitative research through the interviews does give more depth in areas such as the amount of security costs and as to why the crime rate is higher in reality (in thesis article 4).

The sixth theme relates to that of a foreign SME and that overall it is generally a little more difficult within the procedures for registration and compliance, (time and money). This is mainly because of the fact that foreign documents need to be obtained (article 2 land acquisition) and a foreign SME has to get Estonian identification (ID) to take advantage of speed and cheapness of the electronic systems (article 1 company formation) and (article 3 taxation). This needs to be looked at with further research as to how difficult that would be.

The final theme relates to “Russification”, academically commented on in thesis article 4 by (Kirch, 2001) that is the significance of the Russian migration to Estonia, in towns where they form a majority in particular in Tallinn and Narva. The capital city Tallinn has the highest crime rate and bribery is more widespread there (which as a capital city could also be argued as normal), as indicated within the article. However, bribery affects all the circumstances of the dissertation and thesis article 4 (criminality) can be used as support as to the reality of the other unofficial costs within the other 3 entrepreneurial circumstances. Consequently, it could be deduced that the concept of “Russification” can be applied across all the 4 thesis articles. That is in the sense that the influence is within all the circumstances as a general cross article theme and an SME is more likely to encounter unofficial costs within procedures in Tallinn, simply because of “Russification”.

6.2 Answers to the research questions

Why SMEs are important is answered in all 4 thesis articles which all emphasise the importance of SMEs to an economy, providing economic growth. What is also emphasized in all 4 thesis articles is the greater need for SMEs with in a transitional economy and particularly because of the so called “Socialist black hole” (the absence of small firms from the socialist structure). Thesis articles 2, 3 and 4 also point out that that the importance of SMEs for a country like Estonia is an ongoing thing, even though it could be argued that Estonia is no longer a transitional economy. (Kirkby and Watson, 2003 p193) comment on the need for SMEs in both developed and transition economies as the engines of growth.

The important parts of the 4 circumstances for SMEs from a legal perspective are academically answered within part 2.2 the theoretical framework of the dissertation.

Also, within each thesis article there is reference and comment on the identification and significance of these important legal parts. With regard to the Estonian written law in relation to those important parts and how it is worded and affected by EU law. Within each of the 4 thesis articles the written Estonian law of the important parts of the circumstance is described, assessed and compared with EU law. This is for company formation (thesis article 1), land acquisition (thesis article 2), taxation (thesis article 3), criminality (thesis article 4). There is also in part 3 of the dissertation a thorough assessment of the Estonian wording and applicable EU law.

The overall assessment is that the wording of the written law for all 4 circumstances is generally clear and detailed (with one or two minor exceptions). It also copies and in many cases goes further than the EU directives and in some cases (e.g. taxation) follows EU recommendations.

With regard to the research question as to the written law being different in practice through corruption, all the thesis articles assess and answer that point. In all 4 thesis articles, the question as to unofficial costs is asked and answered in the qualitative empirical research (the interviews), which generally validates the secondary quantitative research used. The reality is that it is very low if existing at all.

Within the taxation regulation (article 3) the empirical research through both interviews indicates that it is non-existent almost impossible, due in particular to the electronic changes which have affected the way the tax is collected and complied with. This is a big change compared to the view from the secondary data used in

the article of (World Bank Survey, 2005) when the % of SMEs who expected to give gifts to tax inspectors was 12.9. It can be accounted for by the non-personal nature of the interaction and the fact that tax inspectors are not used in the same way. So with more certainty it is possible to say that the tax regulation is as it is written. Interview 1 specifically comments that “it has always been as it is written and I have never been asked for an unofficial payment”.

Within thesis articles 1 and 2 company formation and land acquisition respectively, it is not as certain to say that the regulation is absolutely as written. This is because there has not been the extensive electronic change as within the taxation circumstance. However the conclusion is that both secondary quantitative and primary empirical indicate that it is extremely low in the sense of the extent and any amount involved and has been getting lower progressively down the years.

Thesis article 4 on criminality has the additional supporting aspect of covering bribes as part of the transaction costs within its important legal parts. Consequently it can be used to help with an overall assessment as to the reality of unofficial costs within all the circumstances. It does support the conclusion that in reality it is generally very much as it is written with however a word of caution that bribery is more widespread than appears for SMEs. This is because there is a reluctance to admit to it, and that in certain regions such as Tallinn and Narva due to “Russification” it is more likely to be present. Although, the real cost to an SME within regulatory procedures is very low.

6.3 Limitations and further research

Firstly, with regard to the empirical research the SME involved in the interviews was only a small firm (5 employees) and a larger one used as well would have brought greater comparative outcomes, particularly as they have generally more financial resources and ability to deal with regulatory problems. Also the secondary quantitative data used in many of the thesis articles was able to give a comparative breakdown of a small firm and a medium sized one, so in that sense a comparison would also have helped further outcomes.

Secondly, the qualitative research had geographical limitations, it was predominately from a capital city perspective (Tallinn), except for thesis article 4(criminality) which also involved Narva. Although, there were comments within some of the thesis articles, for example in thesis article 1, and 2, in particular of the situation in other parts of Estonia, in relation to company formation and land

acquisition procedures. Certainly future research of SMEs and regulation experts outside the capital would be beneficial and provide wider knowledge.

Thirdly the summarized comparison of Estonia with the 2 other Baltic States countries is useful to see regional picture of the regulation reality. However, it only relates to secondary quantitative data (apart from the primary viewing of the legal wording of their regulation and EU comparison). Consequently, qualitative empirical research of the kind used for Estonia, would be very useful in the future for both Latvia and Lithuania to see greater depth and validate the secondary data on unofficial costs.

The sensitive area of organised crime is an area that needs more research, as to its extent and reality within the SME sector, in Estonia. The comment from interview 1 shows within thesis article 4, that it is common knowledge that there is an involvement within the security/protection costs and it being part of the older organised syndicate of previous years, and this is a concern. It also is contrary to secondary data view from World Bank Surveys that it does not exist, although not to the overall academic view e.g. (Jaako,2001), who states that to think that it is non-existent is an illusion and underestimating the danger of organised crime.

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Company formation and regulation compliance for SMEs (Estonia)

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Abstract

Purpose – The purpose of this paper is to examine academic literature and business regulation for company formation in Estonia in relation to small to medium-sized enterprises (SMEs). It is an example of a country which is a new member of the expanded European Union (EU) and its regulation.

Design/methodology/approach – This exploratory paper makes use of World Bank Surveys, primary business law sources together with an interview from a business within the country assessed giving a grass-roots perspective.

Findings – The investigation reaffirms the importance of SMEs within transitional economies from a Soviet background such as Estonia because of the Socialist black hole. It also emphasizes the correlation between SME development and business law and the significance and key aspects of company formation for an SME. Furthermore, transition economies like Estonia have complied with EU directives for company formation and advanced within the regulation process quickly. However, it is still more difficult for a person or entity from another EU Member State to form a company in Estonia.

Practical implications – This research demonstrates that compliance on EU regulation for company formation by a new EU member has been provided for within the regulation of the wording. It also indicates that for an entity from another EU state (other than Estonia) it is slightly more difficult to form a company. Unofficial costs, a legacy from the Soviet period are almost non-existent within the Estonian company registration system. Some of the gaps within the World Bank Surveys are filled by the interview, although further evaluation is needed from other academics.

Originality/value – The research highlights the importance of company formation for SMEs, the compliance of a new EU Member State with EU directives, and the reality of company formation regulation for an SME in Estonia.

Keywords Estonia, Small to medium-sized enterprises, Business formation, Commercial law, European Union

Paper type Research paper

Introduction

Since the fall of the Berlin wall in 1989, Eastern and Central Europe has been through changes, particularly political and economic which have had a profound effect not just on Europe, but on the world as a whole. One area of Europe undergoing such change but perhaps underestimated, and indeed overlooked in terms of its significance by many commentators is the north east corner of the Baltic Sea area. Within that north east corner is Estonia. The importance of Estonia has been enhanced in recent years by the adoption of the European Union's (EU) "Northern Dimension" and the accession of Finland and Sweden in 1995 to the EU. It has been further emphasized by the enlargement process and the strengthening of EU co-operation.

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The idea behind that it seeks to ensure that EU activities continue to take account of issues facing Northern Europe and for the Baltic Sea co-operation to create a functional frame work for the Northern Dimension policy. One significant reason, as to why it was conceived, was to increase prosperity of the countries in Europe's northern regions.

There is a strong evidence for linking increased small to medium-sized enterprise (SME) entrepreneurial activity, economic growth and prosperity for a country or indeed a region. Consequently, any entrepreneurial activity and significance within Estonia must be taken within a regional context in the sense of its development and influence. Regional and cross-border co-operation is one of the ten priority sectors of The EU action plan for the Northern Dimension. According to the action plan, "Further enhancing regional and cross-border co-operation is an essential element of the Northern Dimension concept to ensure peace, stability and sustainable development" (EU, 2000).

Estonia is a new member of the EU and although small in area size and population, its process of transition from a planned to a market economy is significant. Estonia is the most northerly and the smallest of the Baltic States in area, 45,226 sq km, it has a population of approximately 1.6 million and the capital city is Tallinn. The country borders with Russia to the east and Latvia to the south. It is important because of its location next to the vast size and mineral wealth of Russia, and the established EU economies of Sweden and Finland as well as the EU's largest newest member Poland. Additionally, its accession to the EU has involved numerous directives that have had to be complied with. Those relating to company formation perhaps also give some indication as to Estonia's general progress in adhering to the EU's legal guidelines. Furthermore, it is a model as to compliance reality for other ex Soviet bloc countries with the Baltic Sea region, with similar backgrounds and new to the EU club.

The paper examines the reality of company formation regulation for SMEs in Estonia. This reality includes how the regulations are worded, their conformity with EU legislation and an evaluation of their implementation. The objective of the paper is to give information beneficial for the enhancement of the business environment for SMEs. It acknowledges the significance of SMEs and their activity, in particular, economic growth and the correlation with the business regulation and links the significance of company formation and its "key" identified aspects for SME activity. Added to which, recent World Bank Surveys are assessed in relation to company formation which are used as base for assessing the cost and time for SMEs.

Within the identified "key" aspects of company formation, time and cost are significant.

Also, the specific business law applicable for company formation in Estonia is reviewed. It is then evaluated and related to the World Business Survey conclusions. This assesses EU conformity with relevant company regulation requirements and also to the procedure. This includes important parts not covered by the World Business Surveys for SMEs, such as company formation's (separate legal entity principle). However, in evaluating the regulation within the overall reality such surveys have limitations, which also need to be identified for a complete evaluation of company formation and its "key" aspects within Estonia. It covers the formation of a company, in terms of how the regulation reads and operates. An interview with a business law firm within Estonia adds to the empirical evidence and fills some gaps from the survey as to the reality of company formation and its "key" aspects for SMEs.

The role and importance of SMEs

Small to medium-sized enterprises are considered as engines of growth in both developed countries and developing countries for the following reasons: they provide low cost employment since the unit cost of persons employed is lower for SMEs than for large size units. Assist in regional and local development, and they accelerate rural industrialisation by linking it with the organised urban sector. Help achieve fair and equitable distribution of wealth and regional dispersion of economic activities, and contribute significantly to export revenues because of their low-cost labour intensive nature. Have a positive effect on the trade balance since SMEs generally use indigenous raw materials. They assist in creating an entrepreneurial culture by bringing together skills and capital through various lending and skill enhancement schemes. Finally, they give the resilience to withstand economic upheavals, maintaining a reasonable growth rate since being indigenous is the key to sustainability and self-sufficiency (SME Bank, 2005).

Small to medium-sized enterprises are consequently a significant part of a capitalist economy essential to long-term growth of a country. For a country like Estonia which in many ways is a model for other former Eastern European countries from a communist background, the significance is even greater. The time period which has elapsed from the fall of the communist system over 15 years and admission to the EU club should not diminish the enduring necessity of such SME development.

It was agreed by many authors that the role of the small-scale private sector was central and significant to the success of the reform programmes entered into by the Eastern European countries. Koves (1992) commented on the importance of small-scale privatization quoting Stanley Fischer of the Massachusetts Institute of Technology and former president of the World Bank, "the key to the long-run transformation of the former socialist economies (FSEs) may be less in the privatization of the very large industrial firms . . . than in the development of new firms and the growth of existing smaller firms. For that reason rapid progress in other areas, such as the creation of a suitable legal environment, price decontrol, industrial deregulation and trade liberalization, is as important to the development of a vibrant private sector as privatization of large firms".

The significance and importance of its role was further illustrated by Welford and Prescott (1996) who indicated incisively that a significant small-scale business sector carries an immense potential of making an economy not only prosperous, but also distributes that prosperity to a greater section of a country's population. Furthermore Tyson *et al.* (1994) suggested that entrepreneurial teams were needed to establish modern small enterprises to fill so called "Socialist black holes". She illustrated her hypothesis by referring to a study by Vahcic and Petrin (1989).

The "Socialist black hole", appeared when comparing the size distribution of enterprises in a mature market economy close to equilibrium with the size distribution of enterprises for a Socialist economy in a sector. It showed a significant absence from the Socialist industrial structure of small firms of up to 200 employees. This vacuum was a communist legacy of pre-form state planning which led to large firms and artificially high concentration and which allowed micro-enterprises little scope to expand. Tyson *et al.* (1994) emphasized, "Even in industries for which optimal unit size is small, for example the many service industries, that in developed economies consist primarily of small firms providing support to industrial enterprises, small firms are rare in Eastern Europe. The share of manufacturing employment accounted for by

small firms is between one-third and two-thirds in developed Western economies. In central and Eastern Europe by contrast the employment share is only about 3 per cent”.

This is indeed a compelling argument for the significant role, the small-scale private sector should play in the economic development of the transforming economies of Eastern Europe. It is important to remember that as far as small-scale enterprise was concerned that the communists generally suppressed it to the extent that it was illegal to start and own a business. Profits were regarded as socially evil and anyone who was engaged in a business unofficially was liable to arrest and imprisonment. In fact before the Gorbachev era, the Soviet Union more often than not used to shoot its best businessmen every year on charges ranging from corruption to hooliganism! So well into the new millennium it is still strongly arguable that SMEs with entrepreneurial spirit are needed within such economies.

The correlation with business law

A relatively recent global study on entrepreneurship (Reynolds *et al.*, 1999) indicated that entrepreneurship is critical to economic growth. The Global Entrepreneurship Monitors of 1999 and 2000 found that the most critical, innovative aspect of the survey (1999) was identifying which was the most important factor enhancing entrepreneurial activity in a given country. It was found that it was a set of social and cultural values, along with appropriate institutions legitimising and encouraging its pursuit. On further evaluation, it is logical and reasonable to conclude that the best way of legitimising entrepreneurship would be by legalising it, for a person to be able to pursue such activity in an open legal form. The correlation is there that the business law environment is critical to SME entrepreneurial activity which is critical to a country's economic growth.

The additional significant issues are why SMEs are so important to entrepreneurial activity and why in particular to Eastern European countries coming from a communist run economic system. The “Socialist black hole” gives the answer.

This then links to the correlation with the business law environment as a crucial factor in sustaining and developing the SME sector. A point mentioned by Koves (1992) is acknowledged at the 31st International Small Business Conference (September 2004) in Warsaw, Poland, by Mirosław Marek, chief executive officer of the Polish agency for enterprise development. “A series of factors influence the competitiveness of small and medium-sized enterprises, amongst which one of the most important is the legal environment of business operations, and not only in the sense of creating favourable conditions for economic activity but also of ensuring the stability of valid regulations”.

Company formation has been identified as significant for SME activity

Company formation relates specifically to a private limited liability company not a sole trader, a partnership, a co-operative, a joint stock company or a corporation. The reason for the restriction is because limited liability companies are the most prevalent and from an entrepreneurial standpoint the most significant. From a management strategy perspective forming a company is the safest option, as entrepreneurial activity is increased (business investment) when the potential losses are limited to their capital participation. Furthermore, historical evidence from certain developed countries (Ireland, USA and the UK) suggests that the introduction of limited liability dramatically increased the number of companies seeking registration. Added to which, limited liability companies account for over 55 per cent of registered businesses and 93 per cent of output (World Bank Surveys, 2004, pp. 17-19).

The formation of private limited companies is beneficial for SME activity for several reasons. Resources can be pulled together as shareholders join together in establishing the company's capital, there is perpetual succession of a registered private limited company despite the death of the founder, and most significant the entrepreneurial risk is reduced with formation. This is because registration provides in reality a "birth certificate" for the SME. It becomes a separate legal entity whereby the assets of the company are separate from any personal assets belonging to the members and cannot be taken to satisfy any company debts. Limited liability gives freedom for innovation and experimentation making a business venture from an SME less risky, increasing its longevity, and likelihood of success. From a management perspective, it is undoubtedly the optimum strategic SME ownership form (particularly when investing overseas), without the unlimited liability and personal risk of a sole trader or partnership.

What aspects of company formation are significant for the enhancement or deterrence of SME entrepreneurial development? The World Bank Surveys (2004, Chapter 2) indicates the following; the procedures, time, cost and minimum capital requirements together with conformity and operation of the separate legal entity principle. This includes procedure time and cost and the minimum authorised capital involved in the registration process. The number of procedures describes the external parties and steps the would-be SME faces.

At each procedure, the SME may be stopped and in some countries this may involve a government official who may have to be bribed in order for the process to continue. The number of days and the official costs associated with each procedure are also relevant. The more cumbersome and costly the registration process then the less likely the SME will want to register and form the company. The minimum capital requirement is the amount of capital that the SME needs to put into a bank account before registration starts, the account is frozen during business entry and in many countries remains so until the dissolution of the separate legal entity.

Cumbersome entry registration is associated with less private investment, higher consumer prices, greater administrative corruption and a larger informal economy (World Bank Survey, 2004, Chapter 2). Governments can go a long way with simple reforms, including adopting better information and communications technology to inform prospective SMEs and to serve as a virtual one stop-shop for SME company formation and registration.

EU company formation regulation and Estonia

Directives cover the main requirements of EU member states in relation to company formation.

Directives are referred to in (the Treaty of Rome, 1957) Article 189 "A Directive shall be binding as to the result to be achieved upon each member state to which it is addressed, but shall leave to the national authorities the choice and form of methods". How a member state implements a directive is a matter for that member state, as long as the desired result is obtained (Woods *et al.*, 1999, p. 131).

Firstly, there is the co-ordination of Safeguards Directive 68/151/European Economic Community (EEC) for private limited companies. The Safeguards Directive is about similar safeguards of liability for a company throughout the EU. This is important for SME activity particularly "limited legal liability" which is a "key" aspect.

It is clearly referred to in section (s) 3 of the Estonian Commercial Code (ECC), particularly in subsection (ss) 3 as it refers to the "passive legal entity of the company,

arising on entry in the commercial register". Also the lack of shareholder or company liability and private company liability as a body is stated in s135, which defines private companies. So, in Estonia this important principle for SMEs has been covered by the wording of the regulation. It is within the EU directive guidelines so that the protection exists within the statute. Further, the founder of a private limited company can be a natural or legal person as laid down by s137. This gives an SME wider legal scope to increase business activity and s34 of the ECC states that this happens upon signature of the person enforcing the judgement. This is important to know for legal liability.

Article 2 of the directive states that member states should take measures to ensure compulsory disclosure of the instruments of constitution. By virtue of s138 and s139 of the ECC, the private companies must give such information within the Memorandum of Association and Articles of Association (including amendments) and by s28 the public are entitled to see the files registered with authenticity by an assistant judge or authorised registrar or secretary. Article 2 also refers to the disclosure of the representatives of the company and their binding actions with third parties. This is covered clearly by ss 16 and 17 of the ECC, the "procurement" sections.

Article 3 is covered as to the Companies Register and a file for the limited company within the Commercial Register by s28, and the public are also entitled to see the Memorandum and Articles of Association (which gives details of the company). Publishing of the company details in a special press which is also required is covered. Also Member States are to take appropriate steps to ensure that there is no discrepancy between what is published and what is in the register. There is no specific mention in the commercial code of any such steps or the effect of such a discrepancy. Although under s146 (EEC), the management board are responsible for incorrect information given to the Registry and any damage caused.

Article 4 states that the member states must prescribe certain company details, for example, liability in the letters and order forms. The ECC, by s12 (2) states that "in commercial documents the company must specify its name, seat and registration details". Consequently is "commercial documents" specific enough to cover letters and order forms? Probably, it is because it would depend on implementation for the effect in reality and the available penalty for breach. However, s28 provides legal access for members of the public to the card register and business files. Consequently, the Memorandum and Articles should be available for inspection and the details in the Memorandum of the company as specified of name, liability, seat and area of activity.

Article 5 of the directive states that it is down to the member states to indicate who has the responsibility of disclosure of the commercial documents. In Estonia's case, it is stated under s144 that the obligation lies on the management board, the EU directive is allowing the national legislation to cover that part. Consequently, the compliance obligation for company formation would be on the management board of the SME.

Article 6 states that member states should provide "appropriate penalties for omission of the matters in Article 4 order forms, letters, and discrepancies in publication". The ECC s33 (8) covers some of this. It states that "if any incorrect information is submitted to the commercial register, the person who signed shall be solidly liable for damage caused". Incorrect information should cover omissions as well as false statements. The interpretation of solidly would be important, for example does it mean strictly liable with no defences or is it not so wide. Further, s54 allows a term to be set where there are omissions, in order that they can be so eliminated if not the petition can be denied. Also, s146 provides a penalty for incorrect information given by the management board of the private limited company, although what that liability

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may be is not clear because it is not stated. Whether it covers the consequences of their omissions to third parties who have acted on it is not certain.

Article 8 covers the position within the EU member states where there is some irregularity in appointment to represent. In the ECC, by ss16 and 17, it is a bar to be relied upon against third parties actions, if disclosure of formalities is complete. So, for example, if a single founder (one director) has not been notarised correctly under the ECC, but the company is still entered in the Commercial Register, and the director as procurator. The company cannot rely on this irregularity to escape liability to a third party, unless the third party was aware of the irregularity. Further, s34(3) covers this when stating “that facts which should be entered in the register, but are not only gives liability on third party awareness or deemed awareness”. Also s34 (2) states that an entry in the register is correct in relation to a third person, unless the third person knew that it is not. Although with regard to legal acts which are performed within 15 days after the entry, a third party may escape liability as detailed in the section.

Article 10 of the directive indicates that, if Estonia has not provided, preventive control, administrative or judicial at the time of formation then nullity of the company will take place. The legal wording of the EEC does give preventive control by providing law that controls, for example, notaries to certify, assistant judges and registrars to verify, and assess procedure.

This includes a longer time period because of greater examination of documentation connected to the filing of the registration form. It is also stated that there is responsibility for incorrect information given by members of the management board during the formation of the company.

The second directive which is important for SMEs is the 12th Council Company Law Directive 89/667/EEC of December 1989 on Single Member Private Limited Liability Companies. In Estonia, the ECC refers to this indirectly in s138 (5) by stating that “if there is only 1 founder the memorandum shall be substituted by a notarised foundation resolution signed by the founder”. This could mean that one founder could be one director. Further s180 (2) says that the management board may have one member (director) or several members. So the directive has been covered.

There is no directive or regulation from the EU in relation to a company name. However, an SME forming a company in Estonia will have to comply with the law in chapter 2 ss 9 and 12 and the restrictions of “distinguishable” not being “misleading”, and of “good morals”. It will need to have its name in its commercial documents which includes a foreign branch of a company. The reality of how it operates and its implementation effectiveness is governed by s52, the business name verification section. It states that “the registrar shall verify that the business name is in conformity with the requirements of the law”. Consequently it is at the judicial discretion of the registrar.

The monitoring report on Estonia’s preparations for membership (2003) commented on recorded decisions actually taken, legislation actually adopted, measures actually implemented and structures actually in place and functioning by that date. In relation to company law, chapter 5 of the report commenting on the harmonised rules required for the proper operation of companies in the internal market. Stated (Estonia, 2003, p. 22) “In the field of company law as such, Estonian legislation is to a very large extent in line with the acquis. Administrative bodies are in place and their capacity appears to be adequate”.

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Consequently it is fair to say that Estonia has complied overall with its EU company formation law obligations. It is important to remember that as indicated, a directive is a guideline only for Member States as long as the required result is obtained.

Company formation procedure in Estonia

The World Bank Surveys (2007) provides a guideline for the procedure for company formation in Estonia. The authorised minimum capital amount is 40,000 Estonian Kroons (EEK) (2,548 euros). Firstly, an SME must deposit the initial capital in a bank and obtain a bank notice certifying the payment, this takes one day and there is no cost. The full amount of authorized capital has to be paid up before registering the company. The bank issues a notice that serves as evidence at the Commercial Registry, and after the company is registered, the starting account can be turned into usual account that is available for everyday business. However, unless a company's bylaws prescribe otherwise, shares must be paid for in cash.

Secondly, the uniqueness of the proposed company name should be checked which takes one day and there is no cost. The Commercial Register refuses to register a company if the name resembles an existing company name or registered trade mark. An SME can use the www.eer.ee web site to check the names. The law provides that the business name of a company shall be clearly distinguishable from other business names entered in the Commercial Register in Estonia and from other business names deleted from the Commercial Register less than three years ago.

Thirdly, the registration application is submitted. This can be electronically by the SME to the Commercial Register which takes one day and costs 2,900 EEK (185 euros) although Estonian ID for all connected people of the SME is a prerequisite. The alternative is that a notary drafts the application to the Commercial Register cost 2,470 EEK (157 euros) + 18 per cent VAT, it takes 14 days and the state fee in this case is less at 2,200 EEK (140 euros) (World Business Surveys, 2006).

The application has to be reviewed legally by the registrar within 15 days of its receipt, although if there are extraordinary circumstances, this period can be extended to three months. The chief judge of the county or city court which maintains the Commercial Register may, on the existence of circumstances (i.e. complicated contribution in kind, some documents of foreign origin, etc.) requiring special investigation, further extend the term by up to 30 days. Where there is a positive judgment, the registrar shall make an entry not later than on the fifth working day after signing the judgment.

Fourthly, registering for VAT at the National Tax Board must take place. This takes up to three days with no cost. The general rate of VAT is 18 per cent. The management board of the company must file an application for registration of the company as liable for VAT with the Tax and Customs Board within three days as of the date on which the taxable turnover of the company, excluding imports of goods, exceeds EEK 250,000. This is calculated from the beginning of a calendar year. Registration is completed by the Tax and Customs Board within three days as of the filing of the application.

Fifthly, an SME must register with the Central Sick Fund of Estonia which takes one day with no cost. Health insurance in Estonia is through a compulsory scheme under which employers are obliged legally to pay social tax (the source of revenue for health insurance) for their employees.

The employer is obliged to register all new employees, board members and contractual workers with the Sick Fund within seven days from the date of their employment. The rate of social tax is 33 per cent of the taxable amount, which must be

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paid by the 10th day of the month following the taxable period and submit the corresponding tax return to the local Tax Board Office of the residence or seat of the payers of the social tax.

Some interesting changes have been made by the Company Code 2007. For example, the Management Board can submit an application for registration to the Commercial Register within one year (instead of six months) of concluding the Foundation Agreement, obviously this gives SMEs more time to do the task. The procedures for an SME to form a company have been reduced from six to five. However, a closer look reveals the reality, which is that the notarisation of the foundation agreement has been removed from 2006.

This is because a new system has been introduced in 2007 which basically states that if all connected people to the company (representatives of legal persons as well as private individuals) hold Estonian ID-cards this allows them to send electronically signed documents to the Commercial Register and takes one day. Under the old procedure, the foundation agreement had to be notarised and the notary fee was usually based on the value of the agreement being notarised.

No notary is needed for any part of the establishment procedures under these new rules although SMEs have the option of going through the traditional process with notary involvement. State fees have also been changed introducing fixed registration fees. For an SME using the old procedure, the cost is 2,200 EEK (140 euros) and under the new procedure 2,900 EEK (185 euros). Consequently, the state fees for registering the application are cheaper than the previous year in both cases for SMEs. In 2006, the cost was 0.2 per cent of the share capital minimum EEK 3,000 (191 euros) maximum EEK 20,000 (1,274 euros) and took 15 days or more (World Bank Surveys, 2006). The fact that there is a fixed state fee means that an SME will not have to pay a larger fee for having a larger authorised capital. This should encourage SMEs to increase their authorised capital sums.

The problem for a foreign SME is getting Estonian ID for all parties connected (e.g. founder/director), otherwise the old procedure has to be used which includes the notary system. So although in reality, the state fee is fixed and cheaper for an SME, the notarisation process could still add costs.

However with the new changes it is possible theoretically for an SME to now form a company within seven days electronically for 2,733 euros in Estonia. Furthermore, the World Bank Report (2005, p. 6) positively mentions Estonia in relation to starting business in relation to a principle of good practice, which is “the use of a single identification number” during the process. I use the term theoretically because in reality it probably takes a little longer, particularly for a foreign SME. The other aspect to be considered is that in reality is this making it easier for a foreign SME? The answer being probably not that much as they would have to obtain Estonian ID to benefit from the changes, consequently foreign SMEs may still mainly use the old procedure with the time and cost of having to use a notary.

The weakness in the methodology of the World Bank’s examination of the circumstances for SMEs is in the non-inclusion of corruption and unofficial costs as a cost and compliance aspect. Additionally, an assertion of further slowness outside the capital cities and the underestimation of compliance time and cost generally, but in particular for foreign SMEs and company formation (World Bank Survey Methodology, 2007).

Are there any unofficial costs for an SME during the company formation process? The World Bank Investment Climate Survey (2005) gives some help with this. The

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survey of SMEs in Estonia looked at 219 firms included foreign and domestic and within the manufacturing and service section. The enterprise surveys randomly sampled from registered businesses (World Bank Investment Climate Survey, 2005). The survey was completed by managing directors, accountants and human resource managers. The surveys include data on domestic and foreign SMEs and on small enterprises (1-19 employees) medium (20-99 employees) and larger SMEs (over 100 employees).

Two questions are relevant for the reality of compliance costs for company formation. The first was “the percentage of firms that provide gifts or informal payments to government officials to get things done?”. This included regulations and it was 16.2 per cent for small as well as medium enterprises and 12 per cent for large. For foreign SMEs, it was slightly less at 12.1.

In 2002, the amount was overall around 19.55 per cent (World Bank Investment Climate Survey, 2002). The reality is that there are some SMEs who give some extra payment (which increases the compliance cost), but it is less than one-fifth of the SMEs and is similar for both small and medium enterprises as well as foreign.

The second question gives further reality. “What was the average value of gifts or unofficial payments to officials to get things done percentage of annual sales?” This was 0.18 for both small and medium enterprises 0.12 for large and 0.12 specifically for foreign SMEs. In reality, it is small unofficial cost as it also included taxes and services as part of the answer so for company formation there is a very small amount of unofficial cost for a few SMEs. However, the fact, that there are unofficial at all costs shows that the legal origin from the Soviet period has left an amount of corruption within regulators that is hard to remove. However, it is improving as the difference in unofficial costs in 2002 compared with 2005 shows although it is not a quick process to remove the old tradition completely.

In a recent interview (Sorainen, 2007) with Ms Anne Adamson, Associate, with Sorainen the Pan Baltic Business Law firm, based in Tallinn Estonia, I raised some of these issues. I asked her the following questions in relation to private company formation using in particular the example of SMEs from Finland, who have had a lot of business dealings within Estonia and between whom there is an established country relationship:

- Would you say that from your experience of dealing with Finnish SMEs the cost of registration, for example forming a company has some unofficial costs that you have to pay if you are not Estonian SME but a Finnish one?
- Also generally for a Finnish SME does it take longer to carry out business procedures like registration than an Estonian SME?
- Is it slower or more costly for an SME going through registration processes such as company formation registration outside Tallinn?
- Does the legal principle of a company being a separate person from its members as to liability operate in practice within Estonia in your opinion?

“Company establishment is in no way associated with the citizenship or residency of a person (legal or natural), therefore, no unofficial costs are charged. Of course it is more time-consuming and expensive to start a company for a foreign entity here in Estonia due to the fact that all materials have to be verified and mostly *Apostille*'d[1], and furthermore translated into Estonian. There is no distinction between companies on grounds of the residency of shareholders. However, if the documents needed to run or

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set up a company in Estonia have to be authenticated (usually by a Notary Public) then naturally it would take more time and incur costs if the latter need to be translated or a signature is to be authenticated and consequently affixed with Apostille in another country.

These procedures usually generate additional costs only for foreign entities. We are not aware of any “unofficial costs” to be mentioned for Finnish SMEs operating in Estonia. The legal system is developing constantly, but the development is more stable than during the last decade. Taking into consideration the size of Estonia and the level of digitalization and current e-system availability, the process of carrying out registration tasks is in fact equally efficient across the country and the same procedural rules apply (to notaries or judges in registries) across the country.

Furthermore, the procedures of registry departments outside Tallinn are occasionally even speedier and more efficient due to the fact that there is no big workload. The costs (notarial costs and state fees) are prescribed by law and identical to all entities. Legal fees (registration advice, etc.) may vary per regions and service provider. We are not aware of any unofficial costs needed or generated by foreign-owned SMEs registered outside Tallinn. The tradition of giving gifts (flowers, sweets) has survived from the Soviet times only in regard to family physicians and teachers, but not in regard to notaries or registrars.

The shareholders of a private limited company type are generally not personally liable for the obligations of the company. This principle is well-established and recognized throughout Estonia. However, the shareholders may bear liability on the basis of the Commercial Code upon certain conditions, especially in case they wilfully acted against the best interests of the company and consequently generated damages to debtors or third parties”.

Some of the significant evaluation relates to the unofficial cost and when comparing the interview with the World Bank Business Report Survey deficiencies, it is possible to obtain a clearer picture of the reality for SMEs in Estonia. If there is an unofficial cost which is very doubtful for company formation it is extremely low and negligible. Further given Ms Adamson’s comments on gifts and the Soviet legacy that now only applies for teachers and physicians, I would suggest that it is almost non-existent. The World Bank Survey suggests slowness outside the capital cities. However, in this case, it appears that outside Tallinn can be sometimes quicker for company registration and there are no unofficial costs for a foreign SME either. Also it confirms the operation of the separate legal entity principle within Estonia as established, a “key” aspect for SMEs in relation to company formation.

Conclusion

Overall, the legal wording of the Estonian company formation regulation complies with the EU directives. The company formation circumstance and its important parts are very positive for SME development. The notaries process has been eliminated which was an unnecessary and an extra compliance cost to an SME and electronic changes have taken place which bodes well for the future. Although the authorised capital 40,000 EEK 2,500 euros is the same for 2007 as in 2004. The authorised capital amount is a “key” aspect for SME activity. It is arguable that it would encourage SMEs to form more companies if it was reduced. However it compares favourably with Finland, an established EU member state (which has a similar minimum amount). Although the UK has no such minimum capital amount. The time and cost otherwise

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for SMEs also compares favourably with Finland 21 days 330 euros, and UK 13 days 250 euros.

However, it is the fourth procedure within the World Business Survey (2007) referred to, which is the critical one for a foreign SME, particularly from a time and cost perspective. An application to the registrar for company formation in Estonia by a foreign SME could take up to four months if there are exceptional circumstances (which documents of foreign origin would be) and theoretically it could be even longer. The interview with Sorainen business law firm confirms that it would be more time-consuming and expensive for a foreign SME to form a company. However given Estonia's positive business environment and rapid advances within the area, an application for registration from another member State national or entity is very likely to be dealt with as expeditiously as possible.

With regard to the procedures on comparison of the World Bank Surveys (2004) and (2007), time has been reduced dramatically with electronic submission and the removal of the notarisation process. However, a foreign SME has to get Estonian ID to be able to take advantage of the speed and cheapness of the electronic system. This begs the question as to how difficult it is to obtain that and whether a foreign SME would in fact want to.

Estonia has come a long way in a short time and should be given recognition for its achievements. From a managerial SME perspective, it is very well positioned geographically with a good infrastructure and a relatively safe place for company formation. Its location next to the vast Russian market (without the well documented risks of having a business there) makes it an inviting prospect for any SME. Unofficial costs are in reality virtually non-existent in Estonia within the company formation process although as indicated there is more time and cost for a non-Estonian generally.

The company regulatory environment is very conducive for SME development within Estonia, in relation to the identified "key" aspects of the company formation registration process for SMEs (time, cost and authorised capital). Additionally, the other "key" aspect for SMEs, the separate legal entity principle operates both in principle and practice. The registration process in the regions may be quicker than the capital Tallinn which gives a wider choice for registration within Estonia and bodes well for the future.

In my opinion there is no deterrent to a managerial decision to form a company in Estonia, in fact it has a very positive business environment including a flat tax rate of 22 per cent from 2008. Strategically Estonia could easily be described as a "jewel within a Baltic Sea crown" and given the speed of positive change between 2004 and 2007 it will only get better. It is a good example for others from similar backgrounds in the Baltic Sea area of positive progression for SMEs, including compliance with EU company formation laws.

Note

1. *Apostille* is a French word which means a certification. It is used in English to refer to the legalisation of a document for international use under the terms of the 1961 Hague Convention Abolishing the Requirement of Legalisation for Foreign Public Documents. Documents which have been notarised by a notary public, and certain other documents, and then certified with a conformant apostille are accepted for legal use in all the nations that have signed the Hague Convention.

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Foreign SMEs and land acquisition the reality of regulation (the case of Estonia)

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Abstract

Purpose – This paper seeks to examine academic literature and business regulation for land acquisition in Estonia in relation to small and medium enterprises (SMEs). The objective of the paper is to give information beneficial for the enhancement of the business environment, for SMEs. Furthermore, to assist foreign SMEs decision making related to land acquisition within Estonia, an important country within the “Northern Dimension” of the expanded European Union (EU).

Design/methodology/approach – This exploratory paper makes use of World Bank Surveys, primary business law sources together with an interview from a business within the country assessed giving a grassroots perspective.

Findings – The investigation reaffirms the importance of SMEs within former economies from a Soviet background such as Estonia. It also emphasises the correlation between economic growth, land acquisition and business law and identifies the significance and “key” aspects of land acquisition for an SME. Furthermore, it assesses Estonia’s exemption from the movement of free capital within the EU affecting land acquisition by a foreign SME. It shows it is slightly more difficult for an SME from another EU Member State to acquire land (including a size restriction on agricultural land). Additionally, the notarisation process could be reformed in Estonia which would quicken and cheapen the procedure for land acquisition by SMEs. It emphasises that overall a very positive progression has been made by Estonia within its business law environment conducive to land acquisition by SMEs.

Practical implications – This research demonstrates the reality of Estonian land acquisition regulation and its positive progression. It shows that for an entity from another EU state (other than Estonia) it is restricted from acquiring certain types of land. Additionally, unofficial costs, a legacy from the Soviet period are almost non-existent within the Estonian land registration system. Some of the gaps within the World Bank Surveys are filled by the interview, although further evaluation is needed from other academics.

Originality/value – The research highlights the importance of land acquisition for SMEs, a new EU Member State’s exemption from the free movement of capital and the reality of land acquisition regulation for an SME in Estonia.

Keywords Estonia, Small to medium-sized enterprises, Commercial law, Land, European Union

Paper type Research paper

Introduction

Within the North East corner of the Baltic Sea area sits the small but strategically located country of Estonia. She is the most northerly and the smallest of the Baltic States, in area, 45,226 square kilometre a population of approximately 1.6 million. The country borders Russia to the East and Latvia to the South and it is relatively

The interview and useful comments on the paper by Sorainen Pan-Baltic Mergers and Acquisitions Business Law Firm, Tallinn Estonia are gratefully acknowledged.

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speaking richer in natural resources than the other Baltic States Latvia and Lithuania. Forests cover 43 per cent of the territory and agricultural land accounts for 33 per cent, transport and communication systems are good and due to its favourable geographic location Estonia has good transport connections with other countries. This includes, possibilities of intermediating transit in both East-West and North-South directions (Lugus, 1996). Strategically, from a managerial business development perspective it is well located, next to the vast market of Russia (150 million population and large mineral resources), and an established flat tax rate of 21 per cent (2008).

The importance of Estonia has also been enhanced in recent years by the accession of Finland and Sweden to the European Union (EU) in 1995 together with the enlargement process and the strengthening of EU co-operation. The changes taking place within the Baltic region politically, economically and legally after the fall of the Soviet Union have been both rapid and profound.

Estonia has been part of this change including becoming a new member of the EU. Although small in area size and population, its process of transition from a planned to a market economy is significant as it also located next to the established EU economies of Sweden and Finland as well as the EU's largest newest member Poland.

Additionally, the adoption by the EU of a "Northern Dimension" adds further shine to this Baltic Sea "jewel in the crown" country. The idea behind it is basically that it seeks to ensure that EU activities continue to take account of issues facing Northern Europe and that the Baltic Sea co-operation can create a functional framework for the Northern Dimension policy. One significant reason, as to why it was conceived, was working with the countries of Europe's Northern regions to increase prosperity. There is strong evidence linking increased small and medium enterprises (SME) entrepreneurial activity with economic growth and prosperity for a country or indeed a region. Consequently, any SME's significance and circumstances within Estonia must be taken within a regional context in the sense of its development, and influence. Furthermore, regional and cross-border cooperation is one of the ten priority sectors of The EU action plan for the Northern Dimension.

According to the action plan "Further enhancing regional and cross-border cooperation is an essential element of the Northern Dimension concept to ensure peace, stability and sustainable development" (EU, 2000).

It appears that there are good reasons for SME entrepreneurial activity in the Baltic Sea region and particularly, Estonia. However, taking into account in particular the speed of the changes it is important that any management decision to invest or engage in business activity within Estonia is carefully assessed and strategically right. Any manager making such a decision must look closely at the business reality in order to reap the most rewards. Land acquisition because of its long-term nature and commitment by an SME, has to be scrutinised even more during the decision-making process. Additionally, in reality foreign ownership of land may be a sensitive issue within the country itself which brings barriers to such an acquisition.

The paper examines the reality of land acquisition regulation for SMEs in Estonia. This reality includes how the regulations are worded, relevant EU legislation and an evaluation of their implementation. The objective of the paper is to give information beneficial for the enhancement of the business environment, for SMEs. Furthermore, to assist foreign SMEs decision making related to land acquisition within Estonia, an important country within the "Northern Dimension" of the EU. It acknowledges the

significance of SMEs and their activity in particular, economic growth and the correlation with the business regulation and links the significance of land acquisition and its "key" identified aspects for SME activity. Added to which, recent World Bank Surveys are assessed in relation to land acquisition which are used as base for assessing the cost and time for SMEs. Within the identified "key" aspects of land acquisition time and cost are significant.

The specific business law applicable for land acquisition in Estonia is reviewed. It is then evaluated and related to the World Business Survey conclusions. This includes important parts not covered by the World Business Surveys for SMEs, such as unofficial costs. However, in evaluating the regulation within the overall reality such surveys have limitations, which also need to be identified for a complete evaluation of land acquisition and its "key" aspects within Estonia. It covers the acquisition of land in terms of how the regulation reads and operates. An interview with a business law firm within Estonia adds to the empirical evidence and fills some gaps from the survey as to the reality of land acquisition and its "key" aspects for SMEs. This enables a fuller picture to be given helping any managerial decision about land acquisition.

The importance of SME development and the correlation with business law

It could be suggested that it is nearly 20 years since the collapse of the Soviet Union and therefore the need for SME development in Estonia is not as great now. However, the development of SME activity needs to be on-going even if the country is at an advanced stage of transition. Additionally, because of the history of countries like Estonia and the "Socialist black hole", it is more important to maintain SME development[1]. This is because they have no historical SME background to fall back on. Academics such as Kirkby and Watson (2003, p. 193) reaffirm the need for SMEs in both developed and transition economies as the engines of growth.

For countries that approach an advanced stage of transition to a market economy (such as Estonia), there is also the need for internationalisation. They comment on the importance of European SMEs becoming more efficient and providing further economic growth. Furthermore, Winiński *et al.* (2004, pp. 94-95) comment on the fact that the size structure in the EU is dominated by small firms, yet there still remain a gap to be filled by future expansion in SMEs. The jump-start of SMEs in East-Central Europe was one of the most important developments in post-communist transition. However, the development of SMEs has not yet reached other high growth countries.

The legal environment is a crucial factor in sustaining and developing the SME sector (SEM Bank, 2005). This was point mentioned (early in the post-communist transition process to a market economy) by Kovács (1992). The same issue was acknowledged at the 31st International Small Business Conference (September 2004) in Warsaw, Poland, by Mirosław Marek (Chief Executive Officer of the Polish agency for enterprise development):

A series of factors influence the competitiveness of small and medium-sized enterprises, amongst which one of the most important is the legal environment of business operations, and not only in the sense of creating favourable conditions for economic activity but also of ensuring the stability of valid regulations.

The significance of land acquisition for SME activity

The correlation between land acquisition and SME entrepreneurial development (from a long-term perspective in particular) is important for the former Soviet economies.

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Undoubtedly “green-field site development” that is developing completely new enterprises and acquiring the land to do so embeds entrepreneurial activity within a given country.

A stable system of well-defined property rights is required and it is the legal regulation that provides this. Tyson *et al.* (1994) in the early days of transition for post-communist economies made that very significant point. Specifically, if potential SMEs are uncertain about the state’s commitment to respecting property rights, they may invest only in projects involving short-term horizons and requiring little fixed capital, which implies an economy based on exchange rather than production, which is rarely a recipe for sustained economic growth. The key is property rights as she stated, “The foundation stone on which entrepreneurial promotion must rest is a stable system of property rights.”

Other academics such as Tolonen and Toporin (2000) add further weight to Tyson’s argument. They comment on the fact that the development of entrepreneurship requires paying special attention to the legal provision of the right to private property.

A proper system of property rights is required, that is clarified and defined because without this individuals will not exercise their rights in a way enhancing production. Tyson *et al.* (1994) also indicate strongly and succinctly the central features of property rights and what is needed. In particular, protection of SME entrepreneurs allowing them to invest without fear of later claims by former property owners, a legal framework for resolving disputes among property holders (including between them and the state), and circumscribing the states right of eminent domain.

SME management decision making and land acquisition

The “key” aspects identified academically for SME land acquisition are as follows: the perception of how safe land acquisition and the security of land title, together with the time and cost of registration (McMillan and Woodruff, 2002; World Development Report, 2006, Part 2, Chapter 4). These are the issues which will influence an SME management decision to purchase land.

The perception of how safe land acquisition is (which a significant factor for SME entrepreneurial activity) is linked to the security of land title. This is because security of land title fosters an improved perception of safety encouraging an SME entrepreneur to make land acquisitions. McMillan and Woodruff (2002) conducted a survey of entrepreneurs, who had formed small manufacturing firms within five European transition countries (Poland, Romania, Slovakia, Ukraine and Russia). They concluded that the entrepreneurs reinvested less of their retained earnings when they perceived their property rights to be insecure. This was irrespective of whether they own the collateral that is generally needed to obtain credit. This effect is significant, because those entrepreneurs in the sample with the least secure property rights invested nearly 40 per cent less of their profits than those with the most secure property rights.

If the security of land title is good within a given country providing secure land acquisition rights it will reduce the risks of fraud and mistakes within transactions. Thus, allowing buyers, renters, lenders wanting to acquire an interest in land for entrepreneurial activity, the confidence that they will get what they bargained for. Undoubtedly secure rights to land encourage SME entrepreneurial activity, and registered titling of land provides this better than anything else. Land ownership is an important indicator of credit worthiness and a registered title allows lenders to easily verify ownership. Titled land is also accepted more easily as collateral.

The reason for this is that lenders can determine whether others have an interest in the land (third parties other than the SME for example). Consequently, assessment of the ability of seizing the land, if the borrower refuses or cannot pay the debt can be more easily made (World Development Report, 2005, p. 81).

The perception of how safe land acquisition is clearly interconnected with the security of land title and the greater the land titling the more confident any budding SME entrepreneur will be in making such an acquisition.

The other “key” aspect is the time and cost of registration within the land acquisition process which will be a part of an SME management decision to acquire land. The more regulation there is extends the time involved and often increases the cost, which deters land acquisition. The other connected issue is whether there are any additional unofficial costs during the registration process, as this makes any positive management decision in relation to land acquisition less inviting.

Estonian law in relation to land acquisition

First, on an analysis of the regulation connected to the procedures for land acquisition in Estonia. The first aspect to be considered is the relevant EU (2004) regulation given Estonia’s accession in April 2004 to the EU. They have negotiated an exemption, by virtue of Article 24 of the Treaty, a transitional measure from the free movement of capital until May 2011.

For seven years from the date of accession, its own legal regulation as to the acquisition of agricultural land and forests by nationals of member states and by companies formed in accordance with the laws of another member state will apply. However, if the SME is registered, and has a local branch in Estonia then the regulation will not apply.

So what does the Estonian regulation specify? The 2003 Estonian business regulation states that the restrictions in Estonia (2003) apply to agricultural land and woodland with the size of ten hectares or more. In such cases, foreign SMEs (which include other EU Member State nationals) are allowed to acquire land only with the permission of the county governor[2].

However, putting the exemption into perspective, it does only relate to agricultural and forestry land to that over ten hectares and it is only valid until 2011. It is not as wide as the other recent EU members from the Baltic States, Latvia and Lithuania, which have a total restriction for agricultural and forestry land regardless of size until 2011. Given the history of foreign land ownership in Estonia it certainly could be argued that such an EU exemption is understandable and reasonable. Furthermore, any registered SME company from another EU Member State, which has a branch in Estonia, will not be subject to the regulation. Consequently, it is not that far reaching either and there are ways around it.

Second, with regard to the prevailing Estonian law the Law of Property Act (LPA) is the defining act for land acquisition. By s1, it indicates that, by its use of the terms, “ownership” and “creation”. In Estonia it is the requirement of registration, which is the ultimate test of ownership. That is being entered in the register. It is at that point that an SME will have obtained legal ownership. Because the information is deemed correct in the land registry it provides certainty and clarity for SME land acquirers. This is positive in terms of the position in relation to security of land title, a “key” aspect,

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of land acquisition by SMEs. It is also quite typical of most Western registration systems such as Finland's or the UK's.

One of the major concerns of an SME acquiring land is how secure is that land from an ownership perspective (for example from the state and previous claims to land ownership). The Ownership Reform Act of 2004 goes some way to addressing this area and any concerns. First section states that "the purpose of ownership reform is to restructure ownership relations in order to ensure the inviolability of property and free enterprise, to undo the injustices caused by violation of the rights of ownership and to create the pre-conditions for the transfer to a market economy."

Certainly, the wording covers such situations, although of course, the reality is in the implementation. It can take some time to show in particular budding foreign SMEs that, is the situation. That once entered on the land register and the creation of immovable property ownership (as LPA 2004 s119, indicates) that the land is yours, and you are the legal owner in every respect.

However, there are solid historical legal roots in Estonia in relation to land registration.

Tiits (1998, p. 1) points out that the civil code in Estonia developed during centuries along the principles of German Law (there was a title book in Estonia, also a relatively well developed land surveying and cadastre before the Second World War). This shows a foreign SME considering land acquisition that Estonians are used to a registration system. The other aspect for an SME considering land acquisition in Estonia is how much of Estonia is under a land registration system? The answer is quite a high level as the Review of Real Estate in the Baltic States (2004, p. 3) indicates:

As of 2004, 78 per cent land area has been registered in the land cadastre. Land reform has been slower in the Northern and Western parts of Estonia and faster in the Southern part.

So, from a foreign SME perspective, and the "key" aspect of security of land title, the coverage of registration of nearly 80 per cent is good, as registration increases security of ownership, although land acquisition in the south of the country may be preferable for an SME. The general perception of how safe land acquisition is the other "key" interconnected aspect with the security of land title. The perception for SMEs is that the south again would be a safer area in Estonia, at present.

Third, there are also various regulations that SMEs and their manager when making such a decision perhaps need to be aware of when acquiring land. This is particularly because of the nature of the acquisition, it is likely that the erecting of buildings may be sought. An SME manager would have to prepare and submit for approval a detailed building plan^[3]. Consequently, any management decision by an SME to acquire land and to construct a building on it, has to consider that it takes more time and cost. Certainly any management decision on land acquisition in Estonia needs to assess in particular for what purpose the land is to be used and then review the other law affecting future development. Otherwise the SME will have further unexpected cost and delays which may defeat the object of the initial land acquisition.

The EU exemption as to agricultural land for a foreign SME makes it a longer and more expensive process for such land acquisition. Although, as indicated it could be circumvented by an SME which was a registered company in another EU state and had a branch in Estonia. The level of registration of title within Estonia is high

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and therefore provides security of acquisition. The next issue is what is the procedural regulation for land acquisition for an SME in Estonia?

Land acquisition procedure in Estonia

The World Bank Report (2005) provides a guideline for the procedure for land acquisition in Estonia. It examines the steps, time and cost involved in registering a standardized property value of 570,500 Estonian Kronas (EEK) which is (€36,461).

First, an SME must prepare a sale purchase agreement. The involvement of a notary is something that an SME manager will have to consider carefully at this point. The participation of a notary is mandatory under Estonian law, although it is possible for the parties to prepare the sale/purchase agreement themselves. However, as the notary is responsible financially for mistakes or breaches of the law his/her approval of the agreement is essential. Consequently, the notary will have to review it. If the agreement is not in accordance with the law, then the notary will amend the agreement or ask parties of the agreement to modify the agreement in accordance with the law.

It is perhaps therefore wise for an SME manager to get a notary involved from the start of the land acquisition process. Copies of all documents related to the agreement (transaction data, power of attorneys, documents concerning acquisition of the property, copies of identity documents, etc.) must be delivered to the notary's office three to four days before the conclusion of the agreement. All originals shall be submitted to the notary on the day of the conclusion of the agreement. In case a document has not been issued in the Republic of Estonia, the document shall be certified by an *apostille*[4] or legalized and translated into Estonian prior to the conclusion of the agreement. This would affect a foreign SME in the sense of greater time and more cost. The time involved overall is between ten and 30 days for this procedure.

With regard to the cost there is a scale for notary fees according to a table of fixed fees. In this case the fee would approximately be 21,820 EEK (€1,650) and an 18 per cent VAT payment is added to notary's fee.

Second, payment of the state fee (stamp duty) has to take place by an SME. The cost of the stamp duty is based on a table of fixed fees again and in this case would be 10,400 EEK (€665) based on 2007 data. The time compliance for an SME at this point is only one day. However, this state fee, for making the changes in the land register has to be paid at a commercial bank, prior to the application for registration.

Third, for no cost to an SME a notarised application is filed to the land register, which takes around 30 days for completion. This is legally what transfers ownership of land to the buyer in the land register book. Consequently, from an SME management decision perspective it is the most important step as security of ownership for the SME has been provided. In a practical sense the documentation which is required to be forwarded by the SME is the notarised sale/purchase agreement and the receipt of stamp duty payment.

There is a fourth procedure identified within the land acquisition registration process by the World Bank Report (2005). That is public notice of the transfer within the official state gazette, which costs 100 EEK (€6) and takes 14 days. However, on evaluation it does not affect ownership for an SME (that is title to the land) which is legally valid on the transfer in the land register. It is the latter that is of real significance for an SME manager.

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On evaluation of the World Bank Report (2005), there is no doubt it is an important and a useful procedural survey which can act as a guide for an SME manager considering land acquisition, in Estonia. However, it has some limitations[5].

The notarisation process has been identified as a "bottleneck" for business activity[6]. It could be reformed, to further alleviate unnecessary hurdles and compliance cost to the entrepreneurial activity of SMEs.

When comparing the same registration procedure with established EU economies such as UK (no notary involvement) and Finland (one day) with attestation of identity and signatures (World Bank Report, 2005). It is the notary involvement which slows the process down in Estonia for SMEs and can take up to 30 days as indicated with the cost. Although having made that point, it must be stated that Estonia has progressed quickly and openly within the last few years to reduce the cost and time compliance for SMEs. Additionally, the stamp tax is very low in Estonia at €665.

Unofficial costs and land security in Estonia

To further understand the reality more and to give a foreign SME a clearer picture the questions of unofficial costs (as a cost and compliance aspect) and the security of land rights need to be addressed further. They are part of the "key" aspects identified earlier affecting land acquisition by SMEs. Additionally, any research which addresses the methodology weaknesses within the World Bank Survey is useful for SME managers.

The World Bank Investment Climate Survey (2005) gives some help with this[7].

Assessing courts in Estonia the survey asked if they agreed with the following statement "I am confident that the judicial system will enforce my contractual and property rights in business disputes." Overall, 70.4 per cent agreed (slightly lower than in 2002 at 71.4) and for foreign SMEs it was 88.5 for both 2005 and 2002. It was similar for all SMEs. The reality for land acquisition security is that foreign SMEs have very high confidence, that in Estonia the judicial system will enforce their land ownership rights.

Two questions are relevant for the reality of compliance costs for land acquisition. The first was "the percentage of firms that provide gifts or informal payments to government officials to get things done?" This included regulations and it was 16.2 per cent for small as well as medium enterprises and 12 per cent for large. For foreign SMEs it was slightly less at 12.1.

In 2002, the amount was overall around 19.55 per cent (World Bank Investment Climate Survey, 2002). The reality is that there are some SMEs who give some extra payment (which increases the compliance cost) but it is less than one fifth of the SMEs and is similar for both SMEs as well as foreign.

The second question assists with further reality. "What was the average value of gifts or unofficial payments to officials to get things done percentage of annual sales?" This was 0.18 for both SMEs 0.12 for large and 0.12 specifically for foreign SMEs. In reality, it is a small unofficial cost as it also included taxes and services as part of the answer. Consequently, for land acquisition there is a very small amount of unofficial cost for a few SMEs. However, the fact that there are unofficial at all, shows that the Soviet period has left an amount of corruption within regulators that is hard to remove. However, it is improving as the difference in unofficial costs in 2002 compared to 2005 shows, although it is not a quick process to remove the old tradition completely.

In support of this assessment of very low unofficial costs (through corruption). A domestic survey indicated only 2 per cent of respondents had experienced corruption connected to land registration (Monitoring the EU Accession Process, 2002, p. 198).

In a recent interview (November 2007) with Ms Anne Adamson, Associate, with Sorainen (2007), the Pan Baltic Business Law firm, based in Tallinn Estonia, I raised some of these issues together with the scope of the EU restrictions on land acquisition in Estonia. I asked her the following questions in relation to land acquisition using in particular the example of Finland, which has had a lot of land dealings within Estonia and between whom there is an established country relationship.

Would you say that from your experience of dealing with Finnish SMEs the cost of registration, for example in relation to land acquisition has some unofficial costs that you have to pay if you are not Estonian SME but a Finnish one?

Also generally for a Finnish SME does it take longer to carry out business procedures like registration than an Estonian SME?

Is it slower or more costly for an SME going through land acquisition registration processes outside Tallinn?

No additional notary or other administrative costs for land purchase. The only additional costs are translations, notarization or apostille costs. Purchasing land, however, has some restrictions for EU citizens and companies and this restriction will exist until 1 May 2011. For example, in order to acquire ten hectares or more of agricultural or forestry land, the buyer has to be a legal entity an undertaking and branch of a foreign company registered in Estonia which has operated in Estonia for at least the past three financial years in the area of production of agricultural products (or forest management for forestry land). Other persons are entitled to become owners of land on rather limited grounds (such as approval of the county elder). In practice these restrictions can be circumvented by acquiring a company, which complies with these requirements. Taking into consideration the size of Estonia and the level of digitalization and current e-system availability, the process of carrying out registration- or purchase-related tasks is in fact equally efficient across the country and the same procedural rules apply (to notaries or judges in registries) across the country.

Furthermore, the procedures of registry departments outside Tallinn are occasionally even speedier and more efficient due to the fact that there is no big workload. The costs (notarial costs and state fees) are prescribed by law and identical to all entities. Legal fees (registration advice, real estate due diligence, etc.) may vary per regions and service provider. We are not aware of any unofficial costs needed or generated by foreign-owned SMEs registered outside Tallinn. The tradition of giving gifts (flowers, sweets) has survived from the Soviet times only in regard to family physicians and teachers, but not in regard to notaries or registrars. The (property and any other) rights of foreign-owned SMEs are guaranteed in the same way and to the same extent as the Estonian SMEs. There is no reason to assume that under EU legislation the security of land ownership in Estonia might be any different than in another Member State.

When comparing the interview with the World Bank Survey, it is possible to obtain a clearer picture of the reality of land acquisition in Estonia for foreign SMEs. The interview with Ms Adamson confirms the extent of unofficial costs in Estonia as being extremely low and in reality negligible. Consequently, an SME acquiring land in Estonia can assume it is almost non-existent. She also confirms the reality of the EU exemption although as she indicates a foreign SME could get around the EU exemption relatively easily. The World Bank suggests it might be a slower process outside the capital cities. However, in this case it appears that outside Tallinn can be sometimes quicker for land ownership registration procedures as well as with no extra costs.

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In reality the security of title for an SME is good with around 80 per cent registered, which helps perception of land security which is high. Both are important parts of the circumstance for SMEs. The Estonian Law of Property Act 2004 supports this through §56 as land acquisition on the basis of information entered in the land register is stated to be legally correct. The other issue which helps perception of land security and security of title is confidence in the courts.

The time and cost of registration for SMEs the other important parts of the circumstance, appear to have been reduced in procedures from four to three from 2004 to 2007 (World Bank Survey, 2007). However, this is because procedure 4 has been taken out, but the time and cost is similar. This is because in reality procedure 4 does not affect ownership for an SME as it is publishing details of the transfer (14 days). So, officially it could take 41 days minimum for an SME to acquire land.

It is possible for the parties to the land acquisition agreement to prepare it themselves, an SME could try to do this and this may help reduce the time involved for the agreement, nearer ten days than the maximum of 30. However, the reality is that a notary still has to be involved under Estonian law, as he is responsible financially for mistakes or breaches of the law, and his approval of the agreement is essential.

This means in reality it probably takes longer than 41 days, how much longer depends on the notary. The cost of registration is in reality difficult to assess exactly because of the different notary fees, and stamp duty which depends on the value of the property. However, the World Bank Survey (2007) gives an example of property value of €36,461 which has a notary fee of €1,650 inclusive of 18 per cent VAT and stamp duty of €665 based on a table of fixed fees. This gives a cost of registering land of approximately €2,315 for the land valued.

Although, it must be pointed out that the methodology of the World Bank Survey included that the land was already registered and free of title disputes. So, in practice if an SME was acquiring land which had a title dispute or was not registered it would take a little more time and cost a little more.

Conclusion

Tyson *et al.* (1994) indicated that the central features of property rights (and what was needed for protection of SME entrepreneurs), was an environment that allowed them to invest without fear of later claims by former property owners. Particularly, a legal framework for resolving disputes among property holders (including between them and the state), and circumscribing the states right of eminent domain. Overall, in Estonia there is a very positive stable regulatory environment with a legal framework free from state interference.

The "key" aspects identified academically for SME land acquisition are as indicated earlier in the paper; the perception of how safe land acquisition, the security of land title which are linked, together with the time and cost of registration. It must be stressed that perception of land security is improving steadily. Additionally, as more land becomes titled it will improve further. Added to which, confidence in the Judiciary in Estonia is high for a previous Communist state and as the empirical evidence indicates foreign SMEs have strong confidence that their land acquisition rights will be legally enforced.

The cost of registration for land acquisition itself compares very favourably with other established EU countries, such as Finland and the UK. Furthermore, unofficial

costs are either non-existent or negligible at worst. However, on close evaluation, the reason for this is the stamp duty which is much lower in Estonia (0.4 per cent of property value) than in the UK (4.1 per cent) or Finland (4 per cent). The time for registration of land is still very much affected by the notarisation process leading to a time period of 51 days compared to 14 days for Finland and 21 days for the UK (World Bank Report, 2005). The business cliché “time is money” is particularly significant however for an SME. It normally does not have the capital reserves of larger organisations and would resonate strongly with any managerial decision.

In the UK, there is no notarisation process and in Finland it is minimal, merely an attestation of identity and signature. Consequently, the notarisation process could be reformed in Estonia which would quicken and cheapen the procedure for land acquisition by SMEs.

The reality, for a foreign SME acquiring land over ten hectares in Estonia is that because of the exemption under the Treaty of Accession 2004, it is allowed legally only with permission of the county governor. This takes more time and there is a wide discretion in the legal wording for a county governor in relation to giving permission. An action plan submitted by an SME together with its financial means and professional and economic experience is assessed by the county governor. So, in reality the more money and business experience a foreign SME has, the more likely it is that permission will be granted. This is also more cost and time because of the application and supporting documents involved.

Overall, it is fair to say that it is a more difficult procedure, for a foreign SME to acquire such agricultural or forest land. This means more time involved, although the empirical evidence assessed indicates that there would be negligible unofficial costs. The sensitivity to land acquisition by a foreign SME in Estonia was shown by the exception obtained by the government within the EU Accession Treaty. However, Gunter (2003) gives further reality to the reasons, stating that political and farming interests were the main reasons for the restrictions for foreign arable land acquisitions over ten hectares[8].

The reality of the restrictions is that they can be circumvented by foreign SMEs, which is supported by the qualitative empirical evidence (the interview). Perhaps, it will cost more and take a little more time for a foreign SME to acquire land, even an EU one. However, this is perhaps understandable given Estonia's history of land occupation.

Foreign management decision-making needs to look at the whole picture carefully, after all is not a country affected by its history the same as a person and needs time and understanding to adapt to new circumstances. Perhaps, the more significant factor rather than cost or time compliance of the procedure for land acquisition is the land security itself. In that respect Estonia appears to be solid and progressing in the right way. There is increasing registration of title free from state intervention and a legal respect of land acquisition rights, which bodes well for future SME development. Particularly, as additionally research indicates SMEs will invest more of their retained earnings when they perceive their property rights to be secure (McMillan and Woodruff, 2002).

Estonia has come a long way in a short time and the country offers many benefits with its strategic location and low flat taxation rate of 21 per cent. From a managerial SME perspective it is very well positioned geographically, with a good infrastructure and a relatively safe place for land acquisition. Its location next to the vast Russian market (without the well-documented risks of having a business there), makes it

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an inviting prospect for any foreign SME. Despite understandable sensitivities to land acquisition by foreigners, EU rules (without restrictive exemptions) on land acquisition have been adopted and implemented by Estonia. It is showing the way for others from similar Soviet backgrounds by developing a positive, stable and adaptable land acquisition environment. It is the development of such an environment that is essential for encouraging foreign SMEs and subsequent economic growth.

Notes

1. The "Socialist black hole", appeared when comparing the size distribution of enterprises in a mature market economy close to equilibrium with the size distribution of enterprises for a socialist economy in a sector. It showed a significant absence from the socialist industrial structure of small firms of up to 200 employees. This vacuum was a communist legacy of pre-form state planning which led to large firms and artificially high concentration and which allowed micro-enterprises little scope to expand. Tyson *et al.* (1994) emphasized, "Even in industries for which optimal unit size is small, for example the many service industries, that in developed economies consist primarily of small firms providing support to industrial enterprises, small firms are rare in Eastern Europe. The share of manufacturing employment accounted for by small firms is between a-third and two-thirds in developed Western economies. In Central and Eastern Europe by contrast the employment share is only about 3 per cent."
2. What the regulation states is that if you do not meet the requirements of the exception (resident/farming/forest business, which requires verification by a notary which is expensive and costly to the foreign SME), then you need the authorisation of the county governor. This can take up to 60 days, and includes an opinion of the local government council on the location of the land. The regulation (Section 4(3) and 4(4)) gives a wide discretion to the county governor including reviewing an action plan, the means of disposal, that is financial and the applicants' professional/economic experience, which is taken into account in making the decision.
3. Gunter (2003) quotes Aku Sorainen a Finnish business lawyer operating in the Baltic States dealing with Estonian Land acquisition and it helps to understand the reality more. "The biggest problem we have encountered is the fact that not all Estonian land has yet been registered in the Register, these procedures may take an unexpectedly long time [...] also a company who wants to build on its land has extra costs and delays." Consequently, in line with other European countries, SMEs have to comply with other laws in relating to the land use, once the land has been acquired, further increasing costs.
4. *Apostille* is a French word, which means a certification. It is used in English to refer to the legalisation of a document for international use under the terms of the 1961 Hague Convention Abolishing the Requirement of Legalisation for Foreign Public Documents. Documents which have been notarized by a notary public, and certain other documents, and then certified with a conformant *apostille* are accepted for legal use in all the nations that have signed the Hague Convention.
5. It is based on the assumption of a standardized case of an entrepreneur who wants to purchase land and a building already registered and free of title disputes. It is not applicable to a foreign owner or buyer, it was in an urban area and the most populous city (Tallinn). Further, the time assumption was based on the fact that the survey was going off what the officials had indicated in relation to the duration (World Bank Survey Methodology, 2007). They may have not been accurate with that information. Also the costs may also have been affected by for example the need for some extra payment.
6. The World Bank Report (2004, p. xviii) indicates that "Reforms that require legislative change include [...] removing notarial authorisations [...] such reforms may be difficult to implement, as political will in government and the private sector may waiver."

7. The survey of SMEs in Estonia looked at 219 SMEs included foreign and domestic and within the manufacturing and service section.
8. "The seven year transitional exception [...] was a move lobbied for by interest groups concerned about the loss of arable land to deep-pocketed Westerners [...] despite the state's new found awareness statistics show that the issue is far from problematic, as in September 2003 only 1.7 per cent of Estonian territory was owned by foreign citizens." The paper also comments that the Ministry of Agriculture in Estonia thinks the restrictions are not effective and can be got round by a group pretending to be an agricultural company who then resell it to a land developer that will use it for residential construction. This reality is useful for a foreign SME to know.

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SMEs and the business reality of Estonia's tax regulation environment

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Abstract

Purpose – This article aims to examine academic literature and the taxation regulatory environment in Estonia in relation to small and medium enterprises (SMEs). The objective of the paper is to identify key areas of the taxation regulatory environment which affects SMEs and assess and link important academic literature in relation to those areas with the empirical research. In effect to explore that business reality including Estonia's Soviet historical background and compliance with her EU membership taxation obligations.

Design/methodology/approach – This exploratory paper makes use of World Bank Surveys and primary tax law sources, together with qualitative empirical research from an SME manager and a taxation law firm, both from within the country assessed.

Findings – It confirms the correlation between economic growth and taxation and identifies the “key” aspects of the taxation regulatory environment for an SME through academic literature reviewed which is linked with the empirical research. This qualitative research provides in-depth information and fills gaps from previous quantitative research. It emphasises a very positive progression including significant electronic development and compliance with EU directives and regulations has been made by Estonia encouraging SME activity.

Practical implications – This research demonstrates the business reality of the Estonian taxation regulatory environment. Unofficial costs, a legacy from the Soviet period, are virtually non-existent within the Estonian taxation system. Gaps within World Bank Surveys are filled by the interviews, which give a grass-roots perspective on taxation regulation affecting an SME.

Originality/value – The research highlights the importance of the taxation regulatory environment and the reality of the regulation and compliance work for SMEs within a relatively new EU member state. Estonia is an important country within Europe's “Northern Dimension” and a former member of the Soviet Union. Consequently, any assessment of its taxation environment can be used as a guideline/model for others from similar backgrounds with similar aspirations.

Keywords Estonia, SMEs, Business, Taxation, Regulation, European Union

Paper type Research paper

Introduction

Estonia is a small but strategically located country in the North East corner of the Baltic Sea area. She is the most northerly and the smallest of the Baltic states, in area, 45,226 km² a population of approximately 1.6 million having borders with Russia to the east and Latvia to the south. Transport and communication systems are good and due to

The interviews and useful comments on the paper by Riitta Kondelin, Finnish entrepreneur, owner of MarCon Holding Ltd, Tallinn, Estonia, and Borenus law firm (Sami Tuominen, specialist partner in taxation, Helsinki, Finland, and Egon Talur, Senior Associate, taxation, Tallinn, Estonia) are gratefully acknowledged.

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its favourable geographic location Estonia has good transport connections with other countries. Strategically, from a business development perspective Estonia is well located, next to the vast market of Russia (150 million population and large mineral resources).

Estonia's significance has also been enhanced in recent years by the accession of Finland and Sweden to the European Union (EU) in 1995 together with the enlargement process and the strengthening of EU co-operation. The changes taking place within the Baltic region politically, economically and legally after the fall of the Soviet Union have been both rapid and profound. Estonia has been part of this change including becoming a new member of the EU. Although small in area size and population, its process of transition from a planned to a market economy is significant as it also located next to the established EU economies of Sweden and Finland as well as the EU's largest newest member Poland.

There are good reasons for small and medium enterprise (SME) business activity in the Baltic Sea region and particularly, Estonia. However, taking into account in particular the speed of the changes it is important that any SME management decision to invest or engage in business activity within Estonia is carefully assessed and strategically right. Any manager making such a decision must look closely at the business reality in order to reap the most rewards. Taxation is an important part of that business reality. This paper examines the reality of the taxation regulatory environment for SME's in Estonia which includes how the regulations are worded, relevant EU legislation and applicable exemptions.

Clearly, from a historical perspective new types and systems of taxation had to be devised. The former Soviet system relied largely on the taxation of profits of enterprises and new forms of taxation. For example, value added tax (VAT), needed to be established or expanded. In the Soviet past taxation was dominated by the principle of "equalisation" (Elliott, 1997, p. 4). Under this procedure profit inequalities were reduced by imposing heavier taxes on more profitable firms, and lighter taxes on (or subsidies for) less profitable firms. As Litwack (1991, p. 114) indicates, managers within firms never knew what they could expect their taxes to be as tax rates were continually set and changed by superiors in the hierarchy. The effect of this practice was that it stimulated massive tax evasion, corruption, and shifts from legal to non-legal activities.

The objective of the paper is to assess the development of Estonia (an ex-Soviet state and now an EU Member State) within the important identified parts of its tax regulation environment which are significant for SME's and present that taxation reality to the reader.

This will provide beneficial business information for SME's and assist SME's management decision making related to taxation within Estonia as well as providing guidelines for other countries from similar backgrounds with similar aspirations. It acknowledges the significance of SME's and their activity in particular, economic growth and the correlation with the business regulation and links the significance of taxation and its "key" identified aspects for SME activity. Added to which, recent World Bank Surveys are assessed in relation to taxation which are used as base for assessing the cost and time connected to taxation issues for SME's. Within the identified "key" aspects of taxation rate and compliance cost are significant.

The specific applicable taxation regulation in Estonia is reviewed and evaluated and related to World Business Survey conclusions and identified academic literature. It covers taxation regulation in terms of how the regulation reads and operates as well as assessing any unofficial costs. Qualitative empirical research includes two interviews

one with a Finnish entrepreneur (who operates an SME within Estonia), and another with specialist tax lawyers (with experience of dealing with tax regulation in Estonia). This fills some gaps from the surveys and supports the literature review connected to the business reality of the tax regulation environment and its “key” aspects for SME’s. This enables a fuller picture to be given helping any SME managerial decision connected to taxation issues.

SME development, economic growth and the correlation with taxation

It could be suggested that it is nearly 20 years since the collapse of the Soviet Union and therefore the need for SME development in Estonia is not as great now. However, the development of SME activity needs to be on-going even if the country is at an advanced stage of transition. Additionally, because of the history of countries like Estonia and the “Socialist black hole”, it is more important to maintain SME development[1]. This is because they have no historical SME background to fall back on. Academics such as Kirkby and Watson (2003, p. 193) reaffirm the need for SME’s in both developed and transition economies as the engines of growth.

For countries that approach an advanced stage of transition to a market economy (such as Estonia), there is also the need for internationalisation. They comment on the importance of European SME’s becoming more efficient and providing further economic growth. Furthermore, Winieki *et al.* (2004, pp. 94-95) comments on the fact that the size structure in the EU is dominated by small firms, yet there still remain a gap to be filled by future expansion in SME’s. The jump start of SME’s in East-Central Europe was one of the most important developments in post-communist transition, however the development of SME’s has not yet reached other high growth countries.

Within the overall business environment, the legal environment (of which taxation is an integral part) is a crucial factor in sustaining and developing the SME sector. This was point mentioned (early in the post-communist transition process to a market economy) by Koves (1992). The same issue was acknowledged at the 31st International Small Business Conference (September 2004) in Warsaw, Poland, by Miroslaw Marek (Chief Executive Officer of the Polish agency for enterprise development):

A series of factors influence the competitiveness of small and medium-sized enterprises, amongst which one of the most important is the legal environment of business operations, and not only in the sense of creating favourable conditions for economic activity but also of ensuring the stability of valid regulations.

Within such a legal environment the importance of taxation for SME activity has been further amplified by some significant international business organizations which have stressed the importance of taxation policy and it can encourage or deter the development of SME’s:

The way governments regulate and tax firms and transactions both within and at their borders plays a big role in shaping the investment climate, sound regulation addresses market failures that inhibit productive investment [...] sound taxation generates the revenues to finance public services that improve the investment climate (World Bank Report, 2005, Chapter 5, p. 1).

Strategically, taxes affect the incentives for SME activity and investment by weakening the link between effort and reward. Also, by increasing the cost of inputs used in the production process. Making a business environment which is supportive and helpful

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for potential SME's includes a sound fiscal policy and tax design (Organisation for Economic Co-operation and Development, 2004, p. 9).

For SME's the significance of the taxation regulatory environment is that it encourages or discourages entrepreneurial activity across borders and within a country (such as Estonia) or group of countries such as the Baltic states. The impact of this is that the potential for economic growth is affected.

Tax rates, compliance costs and the overall tax regulation are all important. They have been identified as "key" aspects of taxation for SME's, as they can be either a deterrent or an incentive (World Bank Report, 2005). First, the tax rate itself which will affect whether SME's will engage in business activity as it will affect their amount of net profit. Second, the compliance cost will have an impact, that is when the taxes are collected and how even is the collection. Tax administration can increase both compliance costs as well as corruption and when compliance costs are the same for firms of different sizes they have a greater effect on smaller firms. The consequence is that when red tape and corruption are within a tax administration an SME has less incentive to comply. Third, the overall tax regulation itself can increase the burden SME's face when the regulations change frequently, are vaguely drafted or are interpreted inconsistently. It all leads to uncertainty and deters SME entrepreneurial activity. As a consequence of all this SME's often reduce their tax burden through informality and evasion and this can lead to an increase in criminality.

Estonian taxes and the three identified "key" aspects (rates, compliance and overall regulation)

There are three main taxes in Estonia that an SME will have to pay which are; income tax, social tax and VAT. Additionally, an SME will have to pay applicable local taxes such as a sales tax and possibly an advertising tax.

(1) Tax rates

The importance for a country of not having high tax rates and the benefit particularly for SME's is made generally by Huizinga and Luc (2008), they indicate that keeping tax rates at a reasonable level can encourage the development of the private sector and the formalization of businesses. This is particularly important for small and medium-size enterprises, which contribute to growth and job creation but do not add significantly to tax revenue. The tax rate itself will affect whether SME's will engage in business activity because of the effect on profits. An analysis of 25 studies that looked at the effect of tax rates on foreign direct investment concluded that a 1 percent increase in tax rates reduces foreign direct investment by about 3.3 percent (Baldwin and Krugman, 2004).

Consequently, it is quite clear that tax rates have an effect on both business development and SME activity both domestically and abroad.

Income tax. A recent study indicates that higher income tax rates are associated with fewer formal businesses and lower private investment. A 10 percentage point increase in the effective corporate income tax rate is associated with a decrease in the business entry rate of about 1 percentage point (Djankov *et al.*, 2010). What can be seen from that study and the figures provided is the effect of a high corporate income tax rates on SME start-ups. That clearly a low corporate income tax rate is beneficial for encouraging businesses to start.

In Estonia the income taxation rates are flat and low generally encouraging SME entrepreneurial activity and the rate of tax 21 percent on income is the same for all the SME ownership forms. Additionally, it is also worth noting that within the EU law there is a recommendation on the form of ownership not being subject to different tax rates (that is corporation or profit tax) and so being a deterrent to SME development (particularly partnerships and sole traders)[2]. By giving a flat rate tax on income in Estonia, that is not progressive it helps the SME ownership forms of sole trader and partnership. This is what the commission's recommendation of 1994 article 1, concerning the taxation of SME's, wanted[3].

Further article 2 of the same recommendation wants Member States to adopt measures to eliminate tax obstacles to changes in the legal ownership forms (for example the incorporation of partnerships or sole traders as limited companies). By having the same rate of tax which is flat and not progressive Estonia provides a tax environment where there are no great tax obstacles to such change and from an SME managerial perspective, this facilitates easier decision making in relation to any such ownership form change.

In reality, all corporate income tax is exempt when earned with Estonia imposing a corporate income tax only on distributions (e.g. profits, gifts) and the tax system defines the tax rate and the share of the profits that the company can distribute. Raidler and Partners (2005, p. 111) comments:

Estonia takes a unique approach to corporate income taxation that is designed to encourage investment and maximise corporate profitability. Pursuant to the Income Tax Act (ITA) income tax on resident corporations is payable not when income is earned but rather when profit is distributed. Resident corporations are not taxed on their profits unless those profits are distributed such as through dividends or other profit allocations.

Resident limited companies (and limited partnerships according to s50 Income Tax Act (ITA) 2004) pay 21 percent (2009) of profit distributed as dividends. However, only 21/79ths (according to the written regulation for 2009) of the profit is the taxable amount. This amount has been getting lower however, for example in 2004 the rate was 26 percent for a distribution of maximum 74 percent of the profit. Non-resident legal persons (which could be a limited partnership or company) also pay the income tax at 21 percent. Natural persons such as sole traders or partnerships pay a specific low flat tax rate 21 percent (2009) and they have the basic exemption of 27,000 kroons (€1,533)[4].

ITA s48-s53 covers the tax on fringe benefits and gifts and divides the sections up to cover both natural persons and resident and non-resident companies. The effect however for SME's is the same as the rate is 21 percent. The overall effect of the income tax cuts in particular has been succinctly summarized by one astute academic commentator as follows:

Estonia enacted an innovative corporate tax reform whilst redistributed profits were kept taxable, reinvested profits became tax free [...] Corporate income tax rates were cut from 26% to 24% in 2005, 23% in 2006. Dynamic effect has been shown in Estonian case because tax cuts resulted in higher tax revenues due to more investments, production and taxable income (Hinst, 2010, p. 12).

Although, recently in a controversial decision, the Estonian Parliament decided to postpone the income tax rate reduction because of changes in the economic environment. The ITAs had provided for a reduced income tax rate for each year from 2009 to 2011 (Deloitte, 2009). This was confirmed by (Roschner, 2009):

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As a result of the amendment the time frame for reducing the income tax rate is changed and the next reduction is postponed by a year. Thus, the income tax rate for 2009 remains at 21%. In 2010 the income tax rate drops to 20%, in 2011 to 19% and stays at 18% from 2012.

Officially, the gradual tax rate reduction (1 percent per year, from 21 percent in 2008 to 18 percent in 2011) was postponed by one year. However, according to the new regulation the 21 percent rate which applied in 2009 continued in 2010 and 2011. The reality then for an SME is that the Estonian Government for 2010 and 2011 decided to keep the income tax rate at the same rate, 21 percent, which perhaps sets a precedent. So that it may keep the same rate for the next few years because of the economic situation and the global recession. An SME manager when looking at its strategy may want to consider this.

VAT. Although, on first glance as an indirect tax, it would appear that this is a financial obligation which the SME would pass on to the customer. In a real sense the rate of VAT must not be so quickly ignored, as having no impact on an SME itself. In reality their potential customers may be deterred by the higher cost of goods, an astute SME manager thinking of starting or expanding a small business would consider that. Additionally, a forward thinking manager, would also be interested in the trend towards a potential rising VAT rate because of the extra cost of resources involved, to run their SME.

In Estonia VAT has a general rate of 20 percent (under s15 VAT 2004 as amended). The regulation through s1(1) also gives detail as to the transactions, which an SME would have to calculate the VAT on. This includes the acquisition of goods and taxable supply. Further, under s 3(1) more detail is given as to the definition of supply, which includes "transfer of goods and provision of services in the course of business activities". The rate is quite low although it must be pointed out that it was increased by 2 percent in 2009, which indicates perhaps a slight change in direction and like many other countries was a necessary response to the global financial crisis. Estonia however still compares favourably with other EU countries and the other Nordic countries. It has the lowest rate of the Nordic countries with Finland 22 percent and Norway, Sweden and Denmark all at 25 percent.

Also, VAT in Estonia has an EU exemption which affects SME's (the EU Annexe 9 exemption from the 1977 Directive on the Harmonisation of a Common System). This is important as it is a permanent provision which affects the rate of the tax by allowing a total exemption to taxable persons, whose annual turnover is less than €16,000. This is an incentive for a small business which does not grow that much initially and within the Estonian tax regulation it is referred to at s19 of the VAT Act of 2004. It gives an exemption from registering as taxable transactions if turnover is less than 250,000 kroons (approximately €16,000), which is calculated from the start of the calendar year. Although it does not sound a large amount, it is something to encourage an SME as well as showing Estonia's compliance with an EU tax directive.

Additionally, there are exceptions written clearly within the regulation with lower rates of 9 and 0 percent, respectively[5]. Although overall these exceptions will perhaps not have the same impact on SME activity because they will not affect most SME businesses.

Social tax. This tax has a rate of 33 percent which is for all SME's and is covered by s2 of the Social Tax Act 2005 (STA). It states that it is payable on "wages, remuneration and fringe benefits of employees and managers". This also means (as well as an ordinary employee) that a partner within a partnership or a director of a company given remuneration would also have to pay social tax. s4 of the STA further identifies the payers of the social tax and for SME purposes this includes, natural persons, resident

legal persons and non-residents who have a permanent establishment in Estonia. On assessment, it covers all SME ownership forms including a non-resident SME providing there is a permanent establishment.

Some academics have indicated that this is the most burdensome rate of all the taxes for an SME (Jurgenson, 2006, p. 1) comments:

The Estonian tax system has had a good impact on the small entrepreneurship. Since 1993 the income tax for the companies and the persons has been the same rate regardless of the amount of income [. . .] The problem is the high rate of labour tax which exceeds 33%.

Local taxes. The local taxes which may be applicable for an SME are the sales tax and the advertising tax which are covered by the Estonian Local Taxes Act 2004. The sales tax is payable at a rate of 1 percent of the goods or services provided, so it is a very low rate and in that sense is not going to have a big impact on SME's. The advertising for notices and advertisements posted within the territory of the local government, with a rate which is discretionary, in the sense that it is for the local council to decide. Although this provides some uncertainty for an SME, as a business has to advertise in some form or other, it is very small part of the tax rate picture in Estonia.

Certainly, overall in Estonia the tax rates are generally low (even taking into account the social tax rate) and inviting for SME activity. Yet, in spite of this positive picture in Estonia, it is always worth an organization's manager being aware of the future business reality, and particularly the changing trend in relation to both VAT and income tax rate. However, it is also important to remember a point referred to in the introduction of this paper, that when Estonia was a member of the Soviet Union the managers within firms never knew what their tax rates were going to be as they were continually set and changed by superiors in the hierarchy. Clearly, Estonia has come a long way from that position.

(2) Compliance

Compliance with tax laws is not to be underestimated for an SME and it is also important for a country in order to maintain revenues. To encourage compliance one of the critical factors is to keep the rules as clear and simple as possible. As one academic comments (Djankov *et al.*, 2010) complicated tax systems bring high tax compliance costs which are associated with larger informal sectors, more corruption and less investment. Its undoubtedly true that simple, well-designed tax systems are able to help the growth of SMEs and consequently, the growth of overall investment and employment.

However, to directly measure the cost of assessing tax law for an SME is difficult to do but there is evidence of the high cost incurred in order to remain in compliance with the tax system. Calculating tax liabilities, completing requisite forms, maintaining records and providing documentation all contribute to what is termed the compliance burden. For an SME manager it can be not only onerous but also a reminder of the old business cliché "time is money". The European Commission (2004), for example, reported survey results indicating that compliance costs for the VAT and income tax are around 0.02 percent of turnover for larger enterprises, but 2.6 percent for small businesses. Furthermore, in Russia the reporting requirements of the Russian tax system are so demanding that SME's have to employ a full-time accountant in order to comply (Mudd, 1996). Its of course important to remember, that Estonia was a member of the Soviet Union and as such within its taxation environment with that legacy of general uncertainty, as well as a non-existent VAT (referred to earlier in the paper).

Registration requirements. The taxation compliance factor which affects SME entrepreneurial activity, is controlled by the separate acts which indicate what the taxpayer must do and when. Additionally, the Taxation Act (consolidated) 2004 covers the tax authority's obligations and registration requirements and under S18 (1) the regulation requires that companies register in the Commercial Register or at the Estonian Tax and Customs Board (regional tax centre of their residence/place of business). From 2009 natural persons have to register with the Commercial Register rather than the Estonian Tax and Customs Board (Estonian Tax and Customs Board, 2010) and registration according to the regulation must take place "prior to the commencement of activities".

Registration for VAT must also take place by all SMEs with the Tax and Customs Board. However, the advances mean that registration compliance can take place for both VAT and as a taxable person or entity electronically, with an ID card. This should substantially reduce the time involved and there is no official cost to register. "Within three working days as of the receipt of the application, upon registration, we shall issue one VAT identification number for all purposes and for all taxable persons", according to Estonian Tax and Customs Board (2010).

There does not appear on first glance at the regulation, any difference for a foreign SME in terms of work compliance, however a closer look reveals some slight differences. One interesting thing is upon registration, for VAT it is required that if an SME is foreign then he or she has to attend the procedure in person, i.e. the person seeking for registration cannot e-mail or send the registration form by post or fax. Although, it is possible to use either an authorised person or a tax representative for the procedure (Estonian Tax and Customs Board, 2010).

The regulation generally provides slightly more work for all foreign SME types because of documentation tasks within the overall registration work. Although, I think that is quite a normal situation for most countries when dealing with non-native SME's because of the need for extra checks. The registration requirements are covered by s21 and by ss (3) ITA which deals with the permanent establishment of foreign associations in Estonia. This includes bank account details, for example a document of authority, as to who is responsible, e.g. the managing director, certification from the home country in relation to the Articles of Association for a limited company, and a notarised signature. This slightly increases the time required and that costs money for an SME, and also there is the cost of getting the documentation and items such as the notary's signature.

However, what also must be taken into account in assessing the business reality is the impact of the electronic changes, which has improved the overall registration picture for SME's in Estonia.

Compliance work.

Income tax. As to its collection, an SME which is a natural person has to submit an income tax return by the end of March of the year after the period of taxation. The taxation board completes the income tax assessment on the basis of the data given by the sole trader or partner for example which would include the deductions available. So the wording of the regulation means the natural person has to make the information available for the taxation board which then has the compliance work, as to calculating the amount to be taxed. So a natural person should look at the business deductions available under s23-28 of the act and make sure the board has the data available[6].

It is possible to do this submission electronically from 15 February of the same year. This is stated clearly by s44 (1). What it means for an SME which is a natural person

such as a sole trader or partner is that, for example income from the financial year 2010 (from April 2010 to the end of March 2011) has to be submitted to the regional tax board in Estonia, by the end of March 2012. An electronic submission has been possible from 15 February 2008 for such income. S44(6) also makes it clear that a sole trader or partner will not have to submit an income tax return, if the income received by the SME does not exceed the exemption allowed under s23 of the Act. The basic allowance can be used for one period of taxation. So if an SME which is a sole trader does not exceed that, then there will be no compliance cost for that taxation year.

With regard to SME's which are limited companies the income tax regulation distinguishes between a resident and non-resident type which affects the compliance as to its collection. A resident limited company which would have a monthly compliance obligation as to collection compared to a non-resident company which would have an annual submission (like a sole trader under s44). Residence then becomes important for an SME because that affects the calculation and collection.

S54 covers the collection of the income tax for an SME which is a resident limited company. It is different from that of a natural person. Because by s54(4) the income tax which is payable under s50 (profit distributions) must be paid to the bank account of the Tax and Customs Board, not later than the 10th day of the calendar month following the period of taxation. This is very clear language and it is greater compliance work because it is every month. There is further compliance for private limited company because of ss55 and 56. Depending on whether you are resident or non-resident it includes a report, declaration and a notice. First, a signed original copy of the annual report must be submitted to the Regional tax board within six months following the end of the financial year. The wording consequently, makes this mean before the end of September of that year and both resident and non-resident companies must comply.

Second, under s56 there is more compliance if you are a resident company which must submit to the tax board under s56 (2) a declaration as to the amount of profit distributed as dividends and to whom. This includes a notice giving quite detailed information on the recipient of the profit. It includes their personal ID and the value of the persons share before and after the payment is given. However, it is even compliance as it is by the end of the 10th day of the following month, that both the notice and the declaration must be given. Although, the recent electronic advances mean once it has registered and obtained an ID number, a company can submit its annual report and notices electronically (Estonian Tax and Customs Board, 2010).

Additionally, an SME also needs to consider expenses and benefits as part of the income tax collection and calculation. For legal persons which are resident, such as private limited companies this monthly calculation and compliance will take place at the same time as the calculation notification as to profit distributions. However, for a partner or sole trader or non-resident company, it will not. Where for example, somebody is employed by this SME type and granted a fringe benefit, the tax return will have to be submitted before the 10th day of the following calendar month. Also, as well as transferring the income tax by the same time period into a bank account of the Tax and Customs Board. This is clearly stated by the wording of s54 (1) and (4). It is particularly important for natural ownership forms, such as sole traders. This is because the compliance and the collection become monthly for the tax on fringe benefits. It is then not even as to its collection, as the submission for income tax is annual at the end of the financial year.

VAT. There is no distinction here within this indirect tax as to the ownership form and the tax compliance. It applies to all SME's once they are registered. There is more detail given under s11, which states very clearly what a taxable person has to do. Again the compliance is clearly stated as from registration and includes calculating the VAT amount for the taxable value of goods or services transferred. It also states that the taxable person should calculate:

[...] the amount of tax pursuant to the procedure provided for in s20 of this Act and preservation of documents and maintenance of records pursuant to the provisions of s27 and issue of invoices in accordance with the requirements of s28.

For SME's this is an important section because it gives an outline of the compliance required and refers to other sections of the Act for further detail.

Registration by an SME means that there must be a daily calculation and recording of tax together with the responsibility of records, invoices and deductions under s20. Within s27 and 28 of the VAT Act there is clear detailed regulation as to the records and invoices. It includes the keeping of invoices received and issued as to goods and services for VAT. These documents must be kept for a period of seven years and in date order. Invoices under s28 given to a purchaser must comply with specific details. This includes the name, address, registry code and the seller's registration number as a taxable person. Further detail is also required within ss 2 and 6 of s28, including the number and date of issue of the invoice and the rate of the VAT on the invoice.

The collection of the VAT that an SME must comply with is covered by s13 of the act. It involves compliance by the 20th day of every calendar month following the taxable period (once the SME has been registered). It means by the wording that an SME must submit to the tax board the calculated amount of VAT, by for example the 20th of May for the month of April. One note of caution however, it may be that the assessment of VAT is harder than it appears and consequently compliance work is more difficult. This is commented on by Lind (2007) who indicates that taxable value is the taxation basis of VAT in Estonia. The taxation basis is the specific monetary expression of the taxation object after having been multiplied by the taxation rate:

The taxable value must also be calculated in the case of tax exempted turnover and turnover taxed with zero rates since the turnover needs to be declared. The taxable value also has relevance in determining the time when the obligation to register as a person liable to VAT occurs.

So for an SME this is important to know that you still calculate if you are exempt and when you have taxable value you must register. Lind (2007), also comments that:

[...] the general regulation seems to be simple at first glance, but such an impression is deceptive. Finding the taxable value can be extremely complicated in some transactions and this still creates problems for the tax payer (and probably also in the future).

The reality for all SME's is that VAT compliance is more time consuming because of this. However, as with the income tax recent electronic changes have meant that it is now possible for all SME types to submit electronically its VAT. Consequently, this on the other hand will have reduced the time involved for both registration and submission and should outweigh any problems an SME may have in calculating the taxable value.

Additionally, what should also be noted is that there has been some EU law which has affected VAT and Estonia as an EU member. An SME manager operating in the country or considering business operations there, would be interested to know not only

about relevant EU VAT law but also as to whether Estonia is generally complying with it, as that also affects the business reality of operations for an SME. The VAT Directive (the EU Annex 9 exemption from the 1977 Directive on the Harmonisation of a Common System) like all directives lays down the minimum coverage as a guideline that must be covered by the Member State. It relates to the harmonisation of Member States' VAT law and is also an example of Estonia (as a relatively new Member State) carrying out her EU legal obligations in a positive way.

For example, the Estonian VAT Act of 2004 complies with the EU Directive as to objects of the tax article 2 "goods or services supplied and imported", through s2 of the Estonian legislation, which includes those elements of goods or services and the import element. It refers to other sections for exemptions, like s17 and s18 making it easy to then find the exemptions. The parts of article 4 of the EU Directive "taxable person" are covered by s3 of the Estonian legislation, "independent economic activity producers mining, agriculture, etc." is not defined in the same way but given a detailed explanation by s10, for example in relation to the services covered. However, s4 goes into some detail as to VAT being applied as a tax on value and in the definition ss (5) and (6). Also, electronically supplied services are also detailed, which is an example of the modern technological developments in Estonia.

Overall, on assessment the Estonian VAT legislation complies, with the EU directives as to content that is in the meaning of "taxable amount", "services" and "goods". The regulation is written quite clearly with exceptions and there is detail within the regulation which is helpful for SME's. A further directive was enacted in 2001 in relation to the simplification and harmonisation of VAT invoices. This was to take into account the modern electrical changes that have taken place and to help the EU Single Market function better when dealing with VAT (Council Directive 2001/115/EC). The Estonian regulation covers the minimum requirements laid down by the directive. The Estonian regulation allows simple but important details that the directive lays down as well as the use of electronic invoicing if agreed by the parties. Additionally, the Estonian regulation allows more simplified invoicing within certain specific businesses[7].

Tax compliance is less time consuming in economies where VAT is administered by the same tax authority as the one that deals with income tax and the use of online filing and payment also greatly reduces compliance time. Additionally, streamlining the compliance process and reducing the time needed to comply is important for VAT systems to work efficiently. This was commented on by Symonds *et al.* (2010), and looking at the Estonian system it is administered by one authority and the electronic system has reduced the compliance time so this is certainly an area of positive progression.

Social. The social tax has a monthly compliance cost which consists of calculating the tax, submitting a tax return to the tax board and employees as well as transferring the tax to the bank account of the tax board. The taxable period is one calendar month. Under s9 (4) STA 2005 an SME must calculate the tax, submit a tax return to the tax board and payees, e.g. employees. At the same time transfer the social tax to the tax authority's bank account by the 10th day of the month following the taxable period.

On assessment of the evenness of collection the 9th of the month would then coincide with the other tax payments. It would not have a negative effect for SME's on collection compliance work. However, for natural persons the compliance calculation and collection are different. The regulation stated under s9 (3) means that the natural person must calculate and pay social tax for one quarter of the year as an advance

payment to the Tax authority's bank account, by the 15th day of the third month of each quarter. It must be at least triple the monthly rate. This means for a sole trader a greater compliance costs in a rate sense because it is three times 33 percent and in advance, for example by 15 March of that calendar year.

Local taxes. The compliance part of the main local tax that an SME will have to pay (the sales tax) appears to be good. This is because it coincides with the VAT payment (the 20th of the month) which does makes greater evenness of total tax payments. So for an SME it should mean adding the sales tax submission every quarter of a year. However, the downside to that is that it is not possible to pay these local taxes electronically, at least at the present time anyway. Consequently, all SMEs are going to have to pay the sales tax for example separately and not electronically. Additionally, the compliance part for the advertising tax, as with the rate, is discretionary and for the local council to decide which does also provide a little compliance uncertainty for an SME.

Compliance comparison. The collection evenness and frequency of payment are important parts of the tax compliance and is to some extent determined by the SME ownership form. An SME which is a natural person has a monthly compliance for VAT and an annual submission for income tax, although if the SME is a limited company then the compliance cost is more even. This is because there is the income tax payment before the 10th of the month after a profit distribution and additionally there is the VAT compliance payment before the 20th of the month. The social tax transfer has to take place before the 10th of every month except if you are a natural person when it must be transferred by the 15th of the month of each quarter. Consequently, a company could make collection even by paying all three taxes before the 10th. For a natural person which was an SME to have collection evenness is more difficult. This is because it is quarterly, monthly and annually that they are collected, although the frequency of the payments would be less.

Additionally, an SME which is a natural person has the compliance burden of advance payments which a company does not. Not only as indicated with the social tax but also in certain circumstances with the income tax, although in reality the latter be circumvented, by calling oneself seasonal for example[8]. These advance payments are burdensome particularly the social tax and must be regarded as the greatest compliance cost in reality for any SME.

Recent electronic changes have reduced the compliance work as it is now possible for all SME types to submit electronically a lot of the requirements. For example, according to the Estonian Tax and Customs Board (2010):

It is possible to submit by electronic means and view and correct all submitted returns. This includes; Income tax returns of a natural person, enterprise's declarations of income and social tax, value-added tax returns (form KMD) The persons submitted the value added tax returns and TSD returns shall receive immediate information about the returns not submitted or incorrect returns, in order to correct the mistakes immediately and fulfill the tax liability without any problems.

World Bank Surveys are an additional useful guide with the assessment of procedural compliance and taxation for SME's. In the Estonian survey three taxes (income, VAT and social) were assessed. Although, it related only to a limited company (not a natural person). The World Bank Survey (2009) assessing the three taxes and compliance time concluded it took ten payments and 81 hours for an SME. This was quite a large reduction from the 2004 survey which had made an assessment of 104 hours.

This shows that the compliance time is getting less and with the recent electronic advances it should improve further. However, in reality there would be more compliance work in practice, for an SME because of local taxes.

Tax compliance is less time consuming in economies where VAT is administered by the same tax authority as the one that deals with income tax and the use of online filing and payment also greatly reduces compliance time. Additionally, streamlining the compliance process and reducing the time needed to comply is important for VAT systems to work efficiently. This was commented on by Symonds *et al.* (2010). Assessing, the Estonian system it is administered by one authority and the electronic system has reduced the compliance time (as shown by the difference in the World bank surveys of 2009 and 2004 referred to) so this is certainly an area of positive progression by Estonia within the last few years affecting the business reality of an SME and its operations.

(3) Overall taxation regulation (frequency of change, vague drafting and interpretation)

(a) Frequency of change. As with any business an SME manager's primary interest is net profit and frequent changes in tax regulation provide uncertainty as to what that is going to be. As one academic put it "frequent changes in tax law can generate uncertainty about the return on an investment in future periods" (Edmiston *et al.*, 2003, p. 6). Looking at Estonia, in recent years the compliance parts of the tax regulation have generally been quite similar which has provided an encouraging environment. If you compare the 2004 Tax Act with the Tax Act of 2001, for example, the compliance procedure is quite similar. With regard to compliance and frequency of change, the argument here could be also that it may be better for SME's, through being less difficult. However, overall the more frequency whatever it is, still provides uncertainty for SME's future development. This is due to the different amount of time spent because of change of detail as to procedure, as well as the change due to increase in the number of procedures and the introduction of any new taxes. Quartey (2001, p. 15) succinctly comments that, where the taxation regulations are continually changing SMEs have transaction costs in leaving and entering a new system. Furthermore, Ollington and Reuvud (2004, p. 82) comments that Estonia negotiated heavily with the EU to keep its very simple and entrepreneurial friendly system of taxation and once changed this system has basically remained the same which has unquestionably helped SME's.

(b) Vague drafting. There are strong academic suggestions that historical influences have played a strong influence on legal drafting, for countries like Estonia, which found independence on the collapse of the Soviet Union. Although, the Soviet background of Estonia should be remembered as important, Estonia's legal history was influenced by its occupations and there has been a strong German legal connection and tradition. Topornin (2000, p. 14) comment:

Already during the Russian Empire, before the World War 1, there was a very strong German tradition in Russian law. From the time of Peter the Great, German experts have exerted influence on the formation of Russian law and its concepts and the way of thinking of law in general. This feature did not vanish during the Soviet period, quite on the contrary, the German conceptual thinking continued to live in new circumstances. One has to remember that the socialist doctrine prevalent in the Soviet Union was originally German. To combine Marxist thinking with German legal concepts was not so difficult, because Marx and Engels themselves expressed their legal ideas through German notions.

Consequently, through Soviet rule and German colonisation, German legal origin is an important part of the historical legal development in Estonia. She has always had a strong German influence within her legal historical development. Terterov (2003, pp. 49-52) comments:

German influence has always been very important to the development of Estonian legal thought and that is obvious up to the present day [. . .] The legal system has absorbed many foreign influences but the German legal system remains the most influential. Civil law has a tendency towards detailed codification of most legal issues, minimising the influence of judicial discretion.

Ayani (1998, p. 5) in an article on the adoption of new codifications by the ex-Soviet bloc countries, indicates that even though there is much similarity between European civil codes he emphasises. “The importation of civil codes from abroad always presents the problem of their unsuitability to the society which they have been transplanted”. He goes on to comment, that when considering the status of the process of re-codification one can say that the successful importation of German codes has resulted in adaption to the countries which have imported it and that Estonia chose the German model.

Consequently, in terms of vague drafting the Germanic feature of detail in its law drafting, should have had a beneficial influence on the Estonian tax regulation.

In the most general terms, tax laws should be drafted so as to best fulfill their role in the tax system, which is to specify such matters as how much each taxpayer is liable to pay and what the taxpayer’s rights and obligations are:

A well-drafted tax law spells out with precision the matters that are within its scope. But precision is not enough. A law should not be precise at the expense of being complicated and impossible to understand. The easier a tax law is to understand, the lower will be the compliance costs, both for taxpayers and for tax administrators (Thuronyi, 1996, p. 2).

The use of section headings makes it much easier to read and understand the law and it acts as a discipline for the drafter. If the drafter cannot think of a good heading for a section, it may be because the section contains disparate subject matter, which would best be broken into more than one section. Recent tax regulations in a number of transition countries now contains section headings, such as Estonia (Thuronyi, 1996, p. 6). Certainly, on viewing the Estonian tax regulation it is fair to say that section headings are used in many of the recently adopted ones such as EST IT, EST VAT. This makes it easier for an SME manager or his accountant to view and understand the relevant regulation more easily and clearly.

The main taxation regulation in Estonia is in my opinion detailed, for both the indirect and direct taxes and there are exemptions quite clearly written in, although there is not a vast amount of them. This helps SME’s generally because “Tax systems riddled with exemptions are not transparent” (World Development Report, 2005, p. 110). The regulation covering the local taxes, however, is not as clear or specific. In particular as well as no clear rate (for the advertising tax) there is no clear detail in the regulation, as to exactly what kind of advertising is covered. The regulation indicates “posted” but how wide covering is that, does it include on the internet for example through a business web site?

(c) *Interpretation.* Even if there is certainty in the tax legislation, uncertainty may arise from unpredictable application of tax rules by tax officials (Alm, 1996; Bagchi *et al.*, 1995). Consequently, if the regulations are interpreted or enforced inconsistently then

in a similar way to frequency of change of the regulation (or vaguely drafted regulation) it increases the burden on SME's through the compliance. According to the World Bank Investment Climate Survey (2002/2005) 60 percent of SME's were happy with a consistent and predictable interpretation by officials of regulations in Estonia however it must be pointed out that it was not targeted at taxation regulation, although it is a positive percentage. The Soviet background of Estonia should also be remembered as important, they were part of the Soviet Union for some time and were occupied by Russia and the extent of "Russification" in a legal sense may show itself within taxation interpretation. One of the features of Russian law is its declaratory nature that means it is merely stating something, but it maybe different in practice. Added to which Soviet law was often inconsistent with dubious judicial independence (Dickinson, 2004, p. 21). Consequently, it further begs the question how consistent in reality is the taxation interpretation in Estonia?

Unofficial taxation costs for an SME

Additionally, an SME manager should also be aware of any additional costs that the firm may have to pay and it is worth reiterating the point made in the introduction of this paper, that the level of corruption with the Soviet tax system was very high. Assessing unofficial costs (through corruption) is quite difficult to do precisely and to obtain the most optimum assessment a combining of both quantitative and qualitative methods is the most helpful. The World Bank Survey (2009) using a quantitative method, concluded that the percentage of SME's who expected to give gifts to tax inspectors was zero. This is a quick and considerable decline from 2005 when it was 12.9 percent. Additionally, in 2005 overall the percentage cost of sales for unofficial costs was only 0.17, so it was clearly a very low cost. Another interesting conclusion however from the same 2009 survey was that, 1.6 percent of firms expected to pay informal payments to public officials (to get things done) very low, but still something.

So how much of that then would possibly take place within the taxation regulation environment in Estonia? I would suggest virtually none at all within the present system, due to the way Estonia has organised its tax agency. The World Development Report (2005, p. 111) makes the point that "One way of minimising unofficial costs is preventing and/restricting direct contact between tax officials and taxpayers by automating and computerising procedures". As well as indicating that another useful step is to organise the tax agency along functional lines (such as auditing, tax payer assistance, and tax returns processing) rather than by tax type. The reason is that if it is organised in such a way it makes it harder for officials to develop relationships with taxpayers.

Certainly the advances in electronic tax submission and registration will have helped Estonia. It appears on viewing the web site (Estonian Tax and Customs Board *Loc cit*) that it is to a large extent organised on functional lines, with little possibility of personal contact with an official in relation to individual taxes. Consequently, the recent electronic changes appear to have helped to reduce any possibility of unofficial costs in the taxation system.

In two recent interviews (qualitative research method), I further raised some of the issues referred to including unofficial costs, and the reality of both taxation compliance and regulation in Estonia for SME's. Interview (1) with Riitta Kondelin, entrepreneur and owner of MarCon Holding Ltd, Tallinn, took place in July 2011. Riitta Kondelin is a Finnish entrepreneur and has been running an SME in Estonia since 2002[9]. This SME

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was chosen as part of the empirical research because it was felt it represented a typical small foreign manufacturing business, which had been operating in the capital city of Estonia for a number of years. Interview (2) took place in January 2012 and involved both Sami Tuominen specialist partner in taxation, Helsinki Finland and Egon Talur Senior Associate, taxation, Tallinn, Estonia, from law firm Borenius[10]. This law firm was chosen as part of the empirical research because it had several years experience of giving taxation advice to foreign SMEs operating in Estonia. Both interviews had input from non-Estonians, which it was felt was important to help with impartiality and overall validity of the research. Additionally, they had both been operating in Estonia for a number of years and consequently were able to comment with credibility on changes that may have occurred over a period of time.

I asked all the interviewees the following questions:

Ideal tax regulation should be clear, consistently interpreted and not subject to frequent change. What is your opinion on those points, as to how it has been in Estonia over the last few years for foreign SME's, such as Finnish ones?

Would you say that the tax regulation is completely as it is written or are there any unofficial costs that have to be paid?

There have been recent, changes due to electronic developments in Estonia, which have affected the compliance work (registration, payment procedure, documentation requirements etc). What is your opinion on the changes and do you think they have they had any effect on taxation compliance by SMEs?

I also asked for them own further opinion/comments on the present tax regulation in Estonia and how it is progressing from a Finnish (or other foreign) business perspective.

Interview (1)

In my opinion, the tax regulation in Estonia covering SMEs, is very clear and has been generally consistent over the years I have been operating a business there. It has for me always as it has been written whatever the tax involved. From the start and my first taxation registration experience it has been good and I have never been asked for an unofficial payment. It has progressed very well over the years in the same direction and the recent electronic changes have simplified the procedure even more. These electronic changes are very good making things easier and are a more efficient way of paying taxes. For me this is very important as my time is important and I can spend it on other business matters. Although I would say that these electronic changes put the taxation compliance on a different level from my early years in Estonia. It is now quicker and simpler to pay my taxes, I can give yearly balances electronically, my VAT, salary and other tax payments go immediately and I can see that. It's very transparent, being even possible to see if other businesses have paid their taxes. I think because of these electronic developments and their effectiveness it encourages greater tax compliance by SMEs, operating in Estonia. It is also I would say impossible to ask for an unofficial payment during this tax compliance process.

Interview (2)

Essentially, the tax regulations should be simple and easy to understand and this is what the state has tried to follow for the last 10 years or so. But the fact is that the regulations have quite different quality in terms of clarity and predictability in interpretation, depending on the time

relevant regulation had been adopted. Overall, the essential interpretation of regulations an entrepreneur needs to know and follow in everyday business is rather consistent and predictable, although there are also many areas or specific issues that the taxpayers need to overcome where relevant administrative or court practice is not sufficiently clear and predictable. To increase predictability and certainty, a few years ago Estonia introduced binding preliminary rulings that taxpayers may apply for but there are also some practical downsides. The number of explanations and notes on how to interpret certain regulations has also increased constantly over the past years, although these are not binding. But at least the taxpayers can find out a trend in interpretation or tax authorities' point of view on a certain issue and if needed, request for binding ruling in its case. Overall it can be said that Estonian legal environment with respect to taxes is rather clear and consistent in what concerns everyday business activities. There may be some additional unofficial time delays or legal costs of the same nature to identify a tax treatment of some activities that are not part of businesses' everyday activities.

With regard to compliance work these changes (electronic filing, registration, payments and electronic documentation) make the procedures a lot easier for most of the taxpayers. It is quite easy to declare taxes, pay taxes and provide electronic documents for electronic auditing. It gives quite a degree of flexibility to accountants and managers of small firms to submit their tax forms 24 hours a day and seven days a week, and there is no need to consider a postal delivery time or to deliver these in person. It means one can submit all their forms online without having to consider the opening hours of tax offices. Current system also allows automatic submission of tax forms in certain accounting programs, the file structures of such electronically submitted files have been disclosed to public so all software developers can use this as the basis to develop their accounting software. Basically, small and medium size enterprises may find it easy to submit their annual reports electronically by filling out the electronic forms provided or uploading a file in a specific format if the accounting software allows them to. Basically the file structure has been set up and software developers are able to write the software needed to create such a file and it can be uploaded to the electronic system. However, there are some obstacles mainly for foreign taxpayers and Estonian legal entities with no actual presence in Estonia. The main issue is the usability of the electronic systems and translation of relevant pages into foreign languages and electronic access for most foreign people without Estonian ID-card. If a taxpayer has a bank account in Estonian banks with electronic authentication and access, the system can be accessed also through the banks' electronic channels and tax authorities may provide access to the electronic system.

It is difficult to foresee any developments or trends as the economy is still recovering from the losses from previous years' recession and the government has taken up somewhat an attitude of wait-and-see. It is planned to decrease the flat income tax rate for legal entities and individuals from currently 21-20 percent from 2015. In any case it is very difficult to foresee the future developments of taxation in Estonia. One may assume that consistency and predictability in tax authorities' behavior is increasing every year and the court practice will bring additional clarity in disputable matters. Also, it is known that the electronic filing systems of tax authorities and also Commercial Register are also being developed and improved to make complying with Estonian regulations as easy as possible also via electronic means and channels.

When comparing interview (1) with the World Bank Survey and my own comments on the functional nature of the Estonian Tax and Customs web site, it is possible to obtain a more complete picture, on the ease of tax compliance as well as unofficial payments. Interview (1), confirms the extent of unofficial payments as being non-existent within the taxation regulation. In fact as she points out in her own words, that under the new electronic system it would be "impossible". Interview (2) comments on possible unofficial legal costs to identify a tax treatment of some activities that are not part of

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businesses' everyday activities. However, that is referring to extra tax treatment and as such does not imply any form of corruption within the system. Consequently, the research indicates strongly that although the percent cost of sales for unofficial costs was very small at 0.17 for SMEs in the World Bank Survey, clearly none of that is now within taxation regulation environment.

Additionally, within both interviews it is emphasised that the electronic changes have considerably enhanced the ease and speed of compliance for SME's, bringing a high level of flexibility for an organization and its management. Although a small amount of caution must be added to this, in that using the electronic system is more difficult for an SME which is not present in Estonia (which is more likely to be a foreign one) and does not have an Estonian ID card, as indicated by interview (2). It was no obstacle for the foreign SME in interview (1) but she was present in Estonia. This is certainly something an SME manager should be aware of and that the alternative use of Estonian banks electronic channels is a possibility.

With regard to clarity, consistency of interpretation and frequency of change. Interview (1) indicates that all three have been present for her as an SME manager, although much more depth of response is given by interview (2). The latter indicates that interpretation of essential regulations has been generally consistent and predictable for SMEs, particularly with ordinary everyday business and that the introduction of binding preliminary rulings has enabled further clarity and consistency of interpretation. An SME manager would be able to find out a trend in interpretation of specific tax regulation which is very helpful for an organization and its everyday business development, preventing a wait and see approach. Some of the regulations have been changed in the sense that they have been amended but although this is change, it has been necessary to keep up with economic developments. Consequently, it does not appear from the overall perspective to have had too much of a significantly negative impact on SMEs and to a large extent answers the earlier rhetorical question posed, that in reality the taxation interpretation in Estonia is generally consistent and predictable.

Conclusion

SMEs are so important for Ex-Soviet countries because of the socialist black hole referred to earlier in the paper, and taxation as indicated has an important influence on SME business activity. Overall, it is more than fair to comment that the Estonian taxation regulation not only complies with EU directives but also that the taxation environment and its identified important aspects is very conducive towards SME business activity.

The tax rate is generally low for all the main taxes, which is one of the immediate concerns of an SME manager when either foreign or domestic when considering a taxation environment. In recent years the rate in particular for income tax has been regularly reduced from 26 percent in 2004, 23 percent in 2006 to 21 percent for 2009 (as it currently is) and VAT has been the lowest of the Nordic countries. The only blot on the horizon in this respect (a point made by the empirical research) is that the income tax rate has stayed the same in the last year and is likely to do so for a few years more, until 2015. There has also been a little recent turning of the tide, with the increase of VAT by 2 percent from 2009. But no country can escape totally unscathed from the reality of the impact of the global recession and Estonia is no exception in that respect.

Keeping the regulation clear and simple together with electronic advances have also been an impressive part of the Estonian tax compliance environment in

recent years. Having said that, there are one or two compliance cost differences that an SME manager would be wise to know in an otherwise level playing field. Particularly, that the compliance cost is slightly different between ownership forms for SME's in some tax areas. For example, with the main direct taxes such as income tax as it is collected every month from a limited company compared to every calendar year from the other ownership forms (sole trader and partnership). Furthermore, although there is some extra compliance cost for a limited company (additional submission of annual reports with the income tax) it is the advance payments of tax that have to be made by a natural person which represent the more burdensome compliance aspect. The complexity of taxable value for VAT which perhaps affects SME time and cost compliance is also a minor concern. However, on the other hand looking at the overall compliance picture it is an overwhelmingly positive one that has been produced. The electronic changes have undoubtedly reduced taxation compliance time as well allowing 24 hours accessibility for all SME types and their managers. The other positive result of these electronic changes is that they have also helped in completely minimising any unofficial costs. In fact, given the recent 2009 survey, electronic advances and the empirical research of this paper it is reasonable to conclude that unofficial costs within the taxation regulation system for SME's are in reality non-existent.

Estonia has carried on with the same tax system during the last decade avoiding frequent change and at the same time providing adaptability with the specific detailed regulation, including the introduction of binding rulings. This has been helpful for both clarity and interpretation of the tax regulation. It is fair to conclude that the Estonian taxation environment and its key aspects have been consistently positive for all SME's, enhancing their business activity. Estonia remains a shining example of taxation simplicity and an inviting prospect for an SME manager considering business activity. There is an encouraging flat tax and the VAT is broad based with allowances and exemptions which are clearly written with reference to other parts of the regulation. Estonia provides a detailed, adaptable, stable tax regulation which is undoubtedly helpful for all SMEs, including foreign ones.

When assessing the whole picture the starting point must be considered and given the Soviet tax legacy discussed at the beginning of the paper (no VAT and a lot of tax evasion), it is a remarkable journey. Estonia has come a long way in a short time, carrying the torch for other countries from similar Soviet backgrounds. She provides a tax regulation model for others with similar origins and EU aspirations who want to encourage small business development. Her financial soundness as a country is further evidenced by its admission to the euro club from 2011. Which given the economic criteria for admission and the EU's severe worries over other euro zone countries debts, perhaps speaks for itself. The business reality of its tax regulation environment is that it should give any SME, foreign or otherwise, confidence to embark on entrepreneurial activity within her shores.

Notes

1. The "Socialist black hole", appeared when comparing the size distribution of enterprises in a mature market economy close to equilibrium with the size distribution of enterprises for a Socialist economy in a sector. It showed a significant absence from the Socialist industrial structure of small firms of up to 200 employees. This vacuum was a communist legacy of pre-form state planning which led to large firms and artificially high concentration and which allowed micro-enterprises little scope to expand. Tyson *et al.* (1994) emphasised, "Even in industries for which optimal unit size is small, for example the many service industries, that in

- developed economies consist primarily of small firms providing support to industrial enterprises, small firms are rare in Eastern Europe. The share of manufacturing employment accounted for by small firms is between 1/3 and 2/3 in developed Western economies. In Central and Eastern Europe by contrast the employment share is only about 3 per cent”.
2. A recommendation, is not legally binding in the same way as a directive or a regulation. However, it is how the EU sees certain issues and is therefore important as to how it wants issues to progress. The Commission Recommendation of 1994 concerning the taxation of SME's, was seen as a hopeful guideline for future development of this area by the EU.
 3. See ITA 2004 and ITA 2006 s(1)4. Although in reality limited companies in Estonia pay profits only on distribution of profits unlike a natural person such as a sole trader who pays tax on earned profit.
 4. This is according to the ITA 2004 s4 (3) and ITA 2006 s(1)4, respectively. The exemption is found at s23 of the Income Tax Consolidation Act 2006. The exemption was raised from 16,800 kroons (€1,073) in the 2004 Act to 24,000 kroons (€1,500) in the 2006 Act. However, Roschner (2009) points out. “By the same token the increase in the basic exemption is postponed by one year: In 2009 the basic exemption remains on the level of that of 2008 (27,000 EEK per year); rising to 30,000 EEK in 2010, 33,000 EEK in 2011 and from 2012 onwards the basic exemption will be 36,000 EEK per year”.
 5. 5.9 percent VAT for example on books or medical equipment. There are also exemptions with 0 percent of VAT on taxable supply on exported goods or services or electricity generated by wind and hydro electricity. See also Roschner (2009) who comments that “Resulting from the changes in the Value Added Tax Act, the VAT rate increases from the current 5% to 9% for books, medicinal products, periodicals and accommodation services. The amendments entered into force on 1 January 2009”.
 6. This is made clear by s44 (1). A pre-completed tax return is made available to the sole trader or partner from 15 February of the year after the taxation period either electronically or at the tax centre. If the sole trader or partner uses the pre-completed tax return, then he or she must assess that the information is correct. If it is not then there is more compliance cost for a sole trader or partner who must submit a tax return which has been changed so that it is accurate. Also an extra tax return if there is a lack of information.
 7. Estonian VAT Act 2005 s 37(6). “An invoice may be issued on paper or subject to acceptance by the acquirer of goods or recipient of services by electronic means”. See s37(9) simplified VAT invoice for transport services.
 8. In relation to Income tax. Beginning from the second year of activity, a sole trader is obliged to make advance payments of his/her prospective, income tax obligations three times a year from the quarter following the deadline of filing tax returns (31 March), advance payments, by the 15th day of the third month of each quarter. The amount of one advance payment is a quarter of the sum of the income tax calculated for the previous taxation S 20 of the Taxation Act envisages that a sole trader may register his/her business as temporary or seasonal. In that case, the sole trader has no responsibility for making advance payments of income tax. Nor have advance payments to be made if the activity has been terminated or if the previous year's running was at a loss (Kirsipuu and Teder, 2006).
 9. Riitta Kondolin has managed and owned an SME in Estonia since 2002. She currently runs a small textile manufacturing company in Tallinn, Estonia, employing five workers. For more information see web site: WWW.marconholding.ee or contact riitta@marconholding.ee
 10. Borenus law firm, Yrjönkatu 13A, FI-00120 Helsinki, Finland, available at: www.borenus.com. Specialist taxation partner sami.tuominen@borenus.com and senior law associate egon.talur@borenus.ee

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Further reading

Estonian legal texts, available at: www.legal.text.ee/en/

European Union Treaties and Legislation, available at: www.euro-lex

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SMEs and the business reality of criminality (the case of Estonia)

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Abstract

Purpose – The aim of the paper is to identify key areas of criminality that affects SMEs and assess and link academic literature on criminality in relation to those areas with the empirical research. In effect to explore the business reality of the criminality environment and its significant aspects that have an impact on SME organisations and their managers and assist their decision making. Additionally, to consider the impact of Estonia's Soviet historical background and her EU membership criminal law obligations within such an evaluation.

Design/methodology/approach – This exploratory paper makes use of World, European and domestic surveys and primary criminal and business law sources as well as interviews from a business within the country assessed and a former Estonian police inspector. Together this gives an academic and grass-roots perspective for an assessment of the criminality reality for SMEs.

Findings – The investigation reaffirms the importance of SMEs within former economies from a Soviet background such as Estonia. It also emphasises the correlation between economic growth, business regulation and criminality and identifies the significance and “key” aspects of criminality for an SME. Furthermore, that Estonia's criminal law that affects SMEs is generally as it is written and that Estonia has a positive compliance with EU directives and regulations. It emphasises that overall a very positive progression has been made by Estonia within its criminal law environment which is considered stable and encouraging for SME activity. The recording of crime is relatively low by EU standards and has an effect, albeit small, on the reality for SMEs.

Practical implications – This research demonstrates the reality of the extent of criminality in Estonia and its positive progression in dealing with it. Corruption, a legacy from the Soviet period, is relatively small within the Estonian system as well as protection costs for an SME. There is, however, an acceptance of the existence of organized crime in Estonia although it is an under researched area. Some of the gaps within the World, European and domestic surveys are filled by the interviews although further evaluation is needed from other academics.

Originality/value – The research highlights the importance of the criminal law environment for SMEs within a relatively new EU member state. It provides an original grass-roots perspective on top of an academic assessment providing fuller information on the reality for SME activity. This is helpful for SME's operating or thinking of doing business in Estonia as well as providing indicators for countries from similar Soviet backgrounds as to their criminality reality.

Keywords Organised crime, European Union, Estonia, Bribes, Crime rate, Criminal law, SMEs

Paper type Research paper

Introduction

Estonia is a small but strategically located country in the North East corner of the Baltic Sea area. She is the most northerly and the smallest of the Baltic States, in area, 45,226 km² a population of approximately 1.6 million having borders with Russia to the

The interviews and useful comments on the paper by Riitta Kondelin (Finnish entrepreneur and owner of MarCon Holding Ltd, Tallinn, Estonia) and Jekaterina Tantt (former Estonian police inspector) are gratefully acknowledged.

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east and Latvia to the south. Transport and communication systems are good and due to its favourable geographic location Estonia has good transport connections with other countries. Strategically, from a business development perspective, Estonia is well located, next to the vast market of Russia (150 million population and large mineral resources).

Estonia's significance has also been enhanced in recent years by the accession of Finland and Sweden to the European Union (EU) in 1995 together with the enlargement process and the strengthening of EU co-operation. The changes taking place within the Baltic region politically, economically and legally after the fall of the Soviet Union have been both rapid and profound. Estonia has been part of this change including becoming a new member of the EU. Although small in area size and population, its process of transition from a planned to a market economy is significant as it also located next to the established EU economies of Sweden and Finland as well as the EU's largest newest member Poland.

Consequently, there are good reasons for SME entrepreneurial activity in the Baltic Sea region and particularly, Estonia. However, taking into account in particular the speed of the changes, it is important that any decision to invest or engage in business activity within Estonia is carefully assessed and strategically right. Any manager making such a decision must look closely at the business reality in order to reap the most rewards. Criminality is an important part of that business reality. This paper examines the reality of the criminality environment for SMEs in Estonia, which includes how regulations are worded, relevant EU legislation and applicable exemptions.

The objective of the paper is to give information beneficial for the enhancement of the business environment for SMEs and to assist SME's decision making related to criminality issues, within Estonia. It acknowledges the significance of SMEs and their activity, in particular, economic growth and the correlation with the business regulation and links the significance of criminality and its "key" identified aspects for SME activity. Added to which, recent World and European together with Estonian domestic surveys are evaluated in relation to criminality, which are used as base for assessment of the main issues for SMEs. Within the identified "key" aspects of criminality the crime rate and transaction costs are significant.

The specific applicable crime regulation in Estonia is reviewed and evaluated as well as being related to relevant survey conclusions. It covers crime regulation in terms of how the regulation reads and operates, as well as assessing any unofficial costs through corruption. An interview with an SME owner within Estonia and a former Estonian police officer adds to the empirical evidence. It fills some gaps from the surveys, as to the criminality reality and its "key" aspects for SMEs. This enables a fuller picture to be given helping any SME managerial decision connected to crime issues.

The importance of SME development and the correlation with business regulation

It could be suggested that it is nearly 20 years since the collapse of the Soviet Union and therefore the need for SME development in Estonia is not as great now. However, the development of SME activity needs to be ongoing even if the country is at an advanced stage of transition. Additionally, because of the history of countries like Estonia and the "Socialist black hole", it is more important to maintain SME development. This is because they have no historical SME background to fall back on.

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The “Socialist black hole” appeared when comparing the size distribution of enterprises in a mature market economy close to equilibrium, with the size distribution of enterprises for a socialist economy in a sector. It showed a significant absence from the socialist industrial structure of small firms of up to 200 employees. This vacuum was a communist legacy of pre-form state planning which led to large firms and artificially high concentration and which allowed micro-enterprises little scope to expand (Tyson *et al.*, 1994).

Additionally, academics such as Kirkby and Watson (2003, p. 193) reaffirm the need for SMEs in both developed and transition economies as the engines of growth.

For countries that approach an advanced stage of transition to a market economy (such as Estonia), there is also the need for internationalisation. They comment on the importance of European SMEs becoming more efficient and providing further economic growth. Furthermore, Winięki *et al.* (2004, pp. 94-95) comment on the fact that the size structure in the EU is dominated by small firms, yet there still remain a gap to be filled by future expansion in SMEs. The jump start of SMEs in East-Central Europe was one of the most important developments in post-communist transition. However, the development of SMEs has not yet reached other high growth countries.

The legal environment is a crucial factor in sustaining and developing the SME sector. This was a point mentioned (early in the post-communist transition process to a market economy) by Koves (1992). The same issue was acknowledged at the 31st International Small Business Conference (September 2004) in Warsaw, Poland, by Miroslaw Marek (Chief Executive Officer of the Polish Agency for Enterprise Development):

A series of factors influence the competitiveness of small- and medium-sized enterprises, amongst which one of the most important is the legal environment of business operations, and not only in the sense of creating favourable conditions for economic activity but also of ensuring the stability of valid regulations.

The criminal law of a country comes within that legal environment of business operations and as such, has an impact on SME activity.

Criminality has been identified as having a significant impact on SME activity

Criminality is illegal activity in breach of the criminal law (Sakwa, 2002; Goorha, 2000), indicating that it raises transaction costs for SMEs through bribes and protection money. The higher the level of criminal activity the greater the discouraging effect on SME activity.

The World Development Report (2005, p. 89) assessed the effect of criminality on SMEs and entrepreneurial activity:

Robbery, fraud and other crimes against property and against the person undermine the investment climate. Rampant crime discourages firms from investing and increases the costs of business, whether through the direct loss of goods or the costs of taking precautions such as hiring security guards, building fences, or installing alarm systems. In the extreme, foreign firms will decline to invest, and domestic ones will flee the country for a more peaceful locale.

First the crime rate for robbery, fraud, crimes against property and the person, and second the transaction costs (bribes, protection money) are consequently the key aspects for SMEs.

The deterrent effect of the criminal justice system is something which the government of a country has influence over. The penalties for theft, robbery and other property crimes can influence and alter a thief's cost-benefit decision making. Connected to this are the penalties that are applied consistently, and how effective the overall system is at preventing and deterring crime. Criminal law is only as effective as those that enforce it and the police play an important role. The government can also help with organised crime and its effect on the SME criminality circumstance, by taking some of the profits out of organised crime by reducing the regulation for firms. As the regulation increases firms are less able to comply with the rules, and less likely to ask state agencies to protect them from criminality. As a consequence organised criminals then meet that demand. This is indicated by the World Bank (2005, pp. 90-92).

In order to assess the total reality of criminality impacting SMEs, first the written criminal law in Estonia has to be assessed, and that includes EU criminal law. It also provides an opportunity to consider if Estonia, as a relatively new EU member, has complied with such laws.

EU crime regulation and Estonia

First, the main EU laws are connected to mutual co-operation by the EU member states, in the area of crime and organised crime. The crime directive relating to victim compensation allows a crime victim from another member state of the EU, to claim if the crime took place in Estonia. For example, if a German resident is injured in Tallinn, Estonia has the responsibility of paying the crime victim, and it has to establish an authority or body to be responsible for such payments, under the directive. However, on reading the directive, it only relates to "intentional violent crimes", so it may be interpreted narrowly. However, it is a useful example of EU criminal regulation, which is widening responsibility to the government of each member state.

There are two acts mentioned within the Estonian legislation to cover this directive.

The State Compensation Act is wider than the coverage of the directive because it covers "temporary" residence of aliens, and the "intentional" aspect is specifically stated. It would therefore be wider than the "habitually resident" within the directive. Also, the Victim Support Act identifies the body responsible and administrative procedures for applications. Consequently, the legal wording of the directive has been complied with. Whether that has an influence on crime rates like robbery, and reduces the rate (which has the use of violence within it) by affecting a robber's cost benefit decision making, is very unlikely. This is because he is not under threat of a greater penalty. Of course the police may become more careful and as a consequence prevent more robberies (affecting SME activity) it is a possibility, although I would suggest a remote one.

Mutual recognition of criminal matters (the Treaty of Amsterdam 1999 provisions) decided that within two years, mutual recognition of decisions and enforcements of judgments in criminal matters needed to be implemented within the EU. This could have meant, for Estonia a criminal conviction in Germany for example is recognised in Estonia through judicial enforcement, by assessing previous convictions within the sentencing process. The effect on the important parts of the criminality circumstance could have been that compliance could reduce the crime rate for robbery or property crimes (which would be helpful for SMEs) this is because the sentencing penalties would be greater and consequently deterring offenders. However, the EU has not at the

time of writing got any further, in reality with this, even though it was detailed again at the Treaty of Lisbon in 2007.

In fact Article 61 specified that the EU should “endeavour to ensure” co-operation in the areas of judicial authorities as well as through mutual recognition of judgments in criminal matters and approximation of criminal law. The wording used “endeavour to ensure” although opening the door wider does not ensure implementation of this important area[1]. Consequently, for a new member state like Estonia, its legal obligation to other member states is simply in reality one of co-operation. This cornerstone of the single market (in relation to criminal matters) has still to be put into meaningful directives that member states have to comply with. Consequently, more significant are the agreements for legal co-operation that Estonia has signed in relation to legal matters including criminal issues. There are for example specific separate agreements that it has signed with other member states, such as Poland[2].

The existence of organised crime and the extent of its operations is also an important factor, being part of the other “key” aspect (protection costs), which raises transaction costs for an SME. One significant guideline for EU countries to be aware of is the EU “pact” and its principles. However, the “pact” does not have the same legal authority as treaty provisions or directives, which must be complied with. On the other hand, Estonia (as a member state) has signed the pact and consequently has to try and implement the principles. They are recommendations and part of the spirit of membership. Some of the important principles include co-operation in the development and operation of judicial and enforcement bodies (principle 3), exchange of information in investigations and legal assistance (principle 4). One of the principles specifically targets corruption within the area of organised crime which shows how the EU regards it. However, it is only a statement that a common EU policy against corruption, in all its forms, is important. Consequently, it does not oblige a member state to do something specifically about it (principle 12)[3].

There are, however, European conventions that the EU has signed and as a member state they are legally binding on Estonia. That is extradition, mutual assistance, laundering, search and seize. Also parts of the pact contain directives which must be implemented by Estonia, through its own legislation such as Directive 91 on the “Prevention of Use of the Financial System for Money Laundering”. The Estonian legislation complies with the directive and the up-dated directive for organisations and responsibilities, specifically, providing penalties for breach by relevant organisations, which was something which was emphasised by the directive (Money Laundering and Terrorist Financing Prevention Act 2004 (MLTFP) s5). It also refers it to the Estonian penal code indicating clearly that misdemeanours referred to are subject to the Estonian penal code (MLTFP 2004 S26).

Within the Estonian Criminal Code (ECC) of 2002, s148 of the code provides the penalty for money laundering and the possible sentence is greater for criminal organisations three to ten years. This is encouraging as it shows that Estonia is following the spirit of the pact and trying to deter organised crime. The wording of the criminal law affecting SMEs also shows that Estonia has complied with EU law and the criminal directives through its own legislation. Examples include exchange of information, previous criminal convictions affecting sentencing and mutual co-operation with other member states on criminality.

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Furthermore, there is also the convention on mutual assistance in criminal matters between the member states of the EU, referred to as the “2000 Mutual Assistance Convention”. This is about the exchange of information as to bank accounts, connected to companies or persons who are subject to a criminal investigation. What it means for instance is if the company is registered in Poland and they have opened a bank account as well in Estonia, then information can be requested by Estonia and has to be given by Polish banking authorities.

All these measures could have an effect on the transaction costs for SMEs within the criminality circumstance, in the long term, by possibly reducing them. These companies or persons may not be able to operate as easily, in relation to asking for bribes and/or protection money from SMEs, within the region as a whole. Only time will tell.

Estonian written criminal law

Within the Estonian legislation the important statute is the Estonian penal code (EPC) of 2004. The offences that are important for an SME are theft, robbery, embezzlement, and crimes against property[4]. The Criminal Code (CC) 2002 covers offences against the person (for example, murder). These are specifically covered with the wording. For example, theft is covered within the wording (the statute uses the wording larceny). Within criminal law of significant importance is the clear use of wording to identify the important parts of the crime. Particularly the mens rea and actus reus that is the intention and the act itself. Both are clearly worded as part of the offence that is the “intention of illegal appropriation” (EPC s199 (1)).

It also gives sentences that are a deterrent. Gangs are given a greater sentence as are repeat offences (EPC 2004 s199 (4) and (7)). Where there is “intrusion” there is also given a greater sentence possibility, under the offence of robbery (EPC 2004 s200 (8)). Presumably, this would cover the situation of burglary, in relation to the premises of an SME in Estonia. Although a separate offence of burglary would be better within the statute. Additionally, the wording does not make it clear enough as to what is meant by the term “intrusion”.

In relation to damage to property an alternative sentence of a fine or imprisonment is written; however, there is a lack of detail as to when either will be imposed and what it will depend on (EPC 2004 s203). Also, within some offences Estonian criminal law uses the words “up to three or five years”, without setting the exact lowest minimum sentence (EPC 2004 s199 (1) and (8), and s2003 relating to damage to property). The effect of such wording is that the judiciary has discretion as to the minimum sentence, which they would not have if it was written in the wording of the law. The impact of giving very low sentences is that it will not deter criminal activity within the offences, which have been identified as important for SMEs.

The written law is important for SMEs which are thinking of doing business in Estonia and their decision making because it will affect their perception of the business environment. However, it is the enforcement of such laws by their implementation, whether it is the organised crime or the specific offences which will deter criminal activity. This is the important point, for affecting the crime rate and deterring organised criminals and consequently improving SME activity. Reducing the number of those offences (e.g. for theft/burglary) would have a positive effect on SMEs. As indicated at the start of the evaluation, this is because their costs would be lower (loss of goods and/or

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security costs). Regional co-operation between countries within the Baltic Sea region is also vital to do this effectively.

The latter point has been emphasised clearly by some authors, for example Jaako (2001, p. 2) who states that in Estonia:

The status and condition of the police hamper often effective combat against crime [...]. Estonian law enforcement officials have realised that economic measures against proliferating organised crime are most effective and that the ratifying the Council of Europe's Convention of laundering, search and seizure and confiscation of proceeds of crime. Within the framework of the Baltic Sea Task Force, co-operation with the neighbouring countries has intensified as results have been good [...]. Functioning market economy, democracy, democratic policing are the best long-term solutions. In this respect, the EU accession criteria and the related assistance provides the best results.

Having considered the written criminal law environment in Estonia, what then is the further actual reality of the two "key" factors impacting SMEs, the crime rate and transaction costs.

(1) Crime rate in Estonia

The European Crime and Safety Survey (2007) covered 18 EU countries including the 15 old members plus Poland, Hungary and Estonia. It gives some further assistance in assessing the criminality reality, in Estonia, relevant for SME development[5].

The survey highlighted (European Crime and Safety Survey, 2007, p. 2) that levels of common crime such as burglary, theft, robbery and assaults have decreased significantly in the last ten years throughout the EU countries surveyed. What this shows is that within Estonia (like the other EU countries surveyed) that the crime rate (one of the important parts of the criminality circumstance) is getting lower within these areas. This is a good sign for SMEs as to future development because of such a trend, which goes back to just after Estonian independence. The survey also makes the following comments (European Crime and Safety Survey, 2007, p. 93):

The levels of crime in Estonia have plummeted in recent years but the overall rates are still amongst the highest in the EU. The level of the crime rate has been improving but it can get better.

The countries with the highest numbers of police recorded crimes were Sweden, Finland, the UK and Denmark. According to the survey the level of crime was relatively low in Finland and medium to high in Sweden and high in Estonia. The police recorded crime rate per 100,000 of population in the year 2000 was 10,000 for Finland compared to just fewer than 4,000 for Estonia. Countries with the lowest numbers of police-recorded crimes included Estonia yet with levels of crime significantly above the European average[6].

The important crime rate for SMEs is that relating to theft, robbery and burglary and this is getting lower, so it appears that it is improving. However, to obtain a really accurate picture, the fact that there is such a low number of police recorded crime has to be taken into account. An example of this is in relation to thefts of personal property reported to the police, where Estonia had the lowest percentage of the surveyed 18 EU countries at 28 per cent (European Crime and Safety Survey, 2007). Yet, at the same time, authors such as Zoubir and Lhabitant (2003, p. 63) have been commenting on the criminality situation and the police in Estonia, quite negatively:

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Although Estonia has launched a programme to improve the effectiveness of its police force, the country has a relatively high rate of violent crime and has in fact witnessed a proliferation of street crime, muggings, car vandalism and car thefts have multiplied consistently [...] very few crimes are solved and it is often quite difficult to obtain police assistance.

How much higher in reality is the crime rate than that which is actually recorded by the police? This is a difficult but important question to be assessed.

The figures on the crime rate for these important crimes identified as affecting SME activity (theft, burglary, and criminal damage) can be further assessed from a domestic source (Ministry of Justice Crime Statistics, 2009). All the figures show a declining trend (which would include burglary as part of larceny). The larceny figures for 2005 were 30,005 compared to 20,361 in 2007, robbery were 1,298 in 2005 compared to 837 in 2007 and criminal offences against property in 2005 36,207 compared to 25,811 in 2007. In 2008 criminal damage was assessed as the largest percentage amongst all crimes "Criminal offences against property constituted the biggest percentage among all crimes 55 per cent. At least 472 million kroons of proprietary damage was caused by criminal offences" (Salla *et al.*, 2008, p. 121). This would, perhaps, have some effects on an SME because the firm may consider protecting its property through greater security measures, to prevent such damage. However, the general crime rate is quite constant in Estonia which is an encouraging factor for SME activity. Salla *et al.* (2008, p. 1) comment "the general crime rate can be considered to be stable".

Serious crimes against the person are also crimes that may also come into the decision making process of an SME when deciding to do business in a country. As indicated at the start of the evaluation, although it could be argued that theft and robbery are more significant as they have a more direct effect on an SME's business activity. The serious personal offences of murder or manslaughter are not registered within a country that often, although they are a good indication as to the level of criminality generally within a country. The same author (Salla *et al.*, 2008, p. 128) notes:

In Estonia, manslaughter and murders are registered seldom, but these are good characteristics of the situation of crime in the state. The total number of manslaughter and murder (104) decreased only by six criminal offences as compared to 2007, which is the lowest level since the restoration of independence in Estonia. However, the homicide rate in Estonia is one of the highest in Europe.

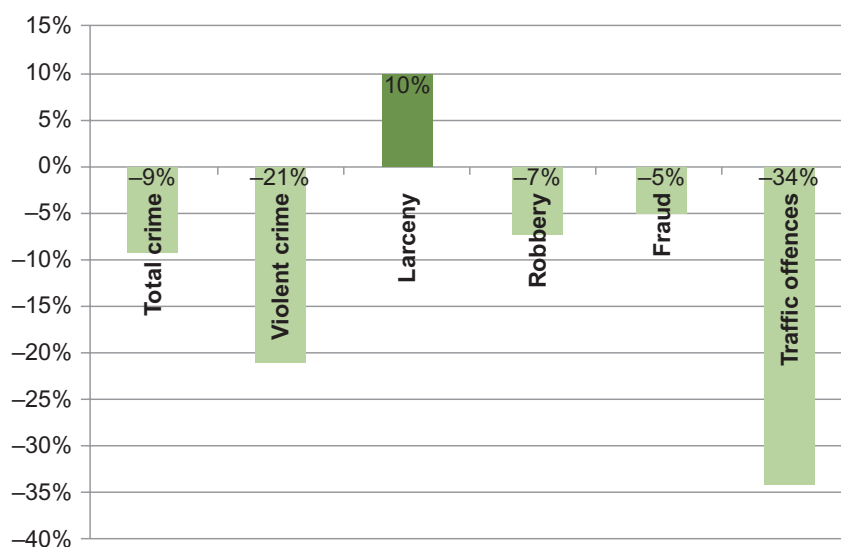
The author puts the situation in perspective in that although 2008 has had the lowest number of murders since 1991 it is still one of the highest in Europe.

Furthermore, the current reality for SMEs can be assessed from a Crime Barometer for 2009 (Ministry of Justice Crime Barometer, 2009).

Crime Barometer 5 June 2009

The Estonian Crime Barometer presents the main figures of crime in a simple and understandable form. The barometer shows the crime trend: the increase or decrease of the number of crimes in comparison with the same period of the previous year. The comparison data are given for the total number of registered crimes and for several of the most common types of crimes (Figure 1).

What the figures show is that the recent trend of total crime in Estonia is that it is getting lower. Additionally crimes that have an effect on the criminality circumstance



	2009	2008	Change	Change %
Total crime	18,727	20,573	-1,846	-9 %
Violent crime	1,713	2,345	-632	-21 %
Larceny	8,889	8,058	831	10 %
Robbery	341	368	-27	-7 %

Notes: Explanations: total crime total number of criminal offences that are registered as crimes by police and other investigative authorities; larceny – penal code s199; robbery – penal code s200

for SMEs such as robbery and violent crimes are also getting lower. The exception is Larceny (theft) which would include burglary. Salla *et al.* (2008, p. 128) comment that in relation to the:

Types of criminal offences the numbers of which increased or decreased the most, the number of thefts increased the most: while 21,685 thefts were registered in 2007, 786 (4%) more (22,471) thefts were registered in 2008.

This is support for the fact that the theft or (larceny as it is referred to within the Estonian criminal law) rate is the exception and is getting higher. However, as indicated earlier in the evaluation, care must be taken with such figures when assessing trends because of the number of crimes which are not registered in Estonia. Although, it perhaps still indicates that the future holds the prospect of a more encouraging criminality environment for SMEs, with lower overall crime in Estonia.

Of course for an SME looking at the crime rate as a deterrent or an encouraging factor, the geographical region within Estonia may provide different rates. The Northern parts of Estonia and in particular the capital Tallinn have the highest crime rates. This would include the crimes identified as the important parts of the criminality circumstance such as theft and criminal damage. Although as discussed this is the official crime rate from registered crimes and a lot of crimes are not reported in Estonia.

Therefore, the reality is that the level of crimes in all areas for SMEs is higher than the figures show. How much higher is difficult to assess exactly. But for an SME looking at the crime rate in Estonia in relation to the offences mentioned, to see the reality certainly involves going further than the crime statistics.

(2) Transaction costs (security/protection costs and bribes)

(a) Security/protection costs. This can be linked to the previous identified key factor the crime rate because the higher it is, or its perception, then the need for security/protection that an SME views as needing becomes higher.

The World Investment Climate Survey (2009) asked the following question of SMEs in Estonia “What are the firms losses as a percentage of total sales that can be attributed to theft, and vandalism against the firm?” The overall answer was 0.9, this compares to 0.5 in 2005 and 0.1 in 2002 with the same surveys.

Consequently, it is a small impact less than 1 euro for every 100 euros sales, according to this survey although the trend is a rising one albeit still a relatively small one. The same survey (2009) also identified that 84.9 per cent of firms pay for security, which is a high figure and which suggests strongly that an SME operating in Estonia needs to pay for some form of security protection. This certainly begs the question why if the crime levels are low, could it be because there is quite a lot of unrecorded crime? If so then the perception of crime levels would be high and the significance of the perception of crime is a point made by Amin (2009, p. 2) who comments “Losses from crime and expenses for security are positively correlated at the firm and country level”.

Additionally, the World Investment Climate Survey (2009) also asked the question as to whether the SMEs “identified crime, theft and disorder as a major constraint?” The question was based on the rating of the obstacle as a potential constraint to current operations of the business. The percentage for 2009 was 8.6 per cent which is similar to the 2002 survey results of 8.2 per cent, which suggests two things that it is at least some kind of constraint to some firms and that it has not changed in a seven-year period. However, a closer look at the figures for small firms (five to 19 employees) reveals the biggest change within the data, that is that in 2002 13.3 per cent identified it as a major constraint compared to 7.2 per cent in 2009. Consequently, there would seem to have been some positive progress related to small firms and how they perceive such a constraint.

Perhaps a fair assessment would be to say, that the business reality, is yes some protection cost, but no not a real constraint on doing business. It looks like there has been an improvement within the last few years with crime being less of an obstacle, particularly for small firms. The fact that it has gone down for small firms is better generally, when looking at SME’s development in Estonia. This is because they do not have the same level of financial reserves to fall back on as medium enterprises. However, a closer look at the percentage figures referred to for the 2002 survey, World Investment Climate Survey (2009) indicate that the percentage cost has gone up (even if only slightly). On evaluation perhaps SMEs see crime as less of a problem, even though there crime costs are slightly higher, perhaps they even may be getting used to it.

Additionally, looking at the European Crime and Safety Survey (2007) together with the World Bank Investment Climate Survey (2009), it is possible to conclude with even

more certainty that SME's losses are slightly greater in practice. This is because they do not all get reported completely to the police in Estonia. Consequently, in answering such a question, the SMEs in Estonia may not record the complete percentage of sales that are attributable to crime.

The World Bank Investment Climate Survey (2009) asked the following question of SMEs. "What are the firms' costs as a percentage of annual sales of providing security (equipment, personnel or professional security service)?" They were 0.36 for small enterprises and 0.90 for medium enterprises and 0.61 for foreign SMEs. It is a low amount but more for medium SMEs which is easier for them to cover, as they normally have more financial reserves than small enterprises. It is also possible that an SME may have protection costs through such payments which are may not be also part of their security costs.

The World Investment Climate Surveys are useful for SMEs as a guide to the level of criminality and a further question relevant for security costs from the survey was about organised crime. "What was the average of firms' costs as a percentage of annual sales of protection payments (e.g. to organised crime to prevent violence)?" The answer was none, however, I think an issue with organised crime is in practice the SMEs may not be giving information about such payments at all. This may be through fear or embarrassment so in practice the corruption may be different and higher transaction costs for SMEs.

Although, Jaako (2001) referred to earlier in the evaluation shows that working with other neighbouring countries and implementing criminal laws in Estonia is having a positive effect against organised crime. This is shown by the protection costs that are low.

The evaluation report (GRECO Estonia, 2001, p. 23) comments "The absence of visible links between corruption in Estonia and organised crime might be an illusion". The report GRECO Estonia (2001, p. 23) expressed concern about the fact that the authorities in Estonia did not seem sufficiently aware of the danger posed by organised crime, in a country that is a natural transit route for smuggling and recommended the checking of the existence of such links.

Not enough is known as to how far such activity stretches in Estonia.

Certainly, comments like these add weight to the possibility that there are payments to organised crime, which is not admitted to by SMEs in Estonia (although probably small amounts). Consequently, it is important for Estonia that it continuously works with neighbouring countries adopting EU laws that deter organised crime.

(b) *Bribes*. Two domestic Estonian surveys provide some help in assessing bribery reality in Estonia.

The first survey (Criminal Policy Department of the Ministry of Justice, Estonia, 2004, p. 1) assessed how corruption was defined, condemned, how far it spread and what was the level of willingness to report corruption in Estonia. This is helpful in assessing the reality of corruption for SMEs particularly as part of the survey was carried out with 503 entrepreneurs. One point made was the reluctance to talk about it (Criminal Policy Department of the Ministry of Justice, Estonia, 2004):

People are generally reluctant to talk about their contact with corruption [...] Respondents sometimes tend to provide the answer that they think is expected of them [...]. People are not ready to provide answers to some sensitive questions as it became evident in trying to find out the exact amounts paid as bribes.

Consequently, in assessing the reality, this reluctance has to be taken into account.

The survey identified the most common situations and officials that SMEs may face bribery issues with Criminal Policy Department of the Ministry of Justice, Estonia (2004, p. 3):

Entrepreneurs have been asked for a bribe more often upon registration or survey of a vehicle – 13%. Imposition of a fine (9%) and application for permits and licences (7%) rank next. Law enforcement authorities (the police, the Security Police, prosecutor's offices, courts, the Border Guard Administration, the Information Board, the Tax and Customs Board) are offered bribe more often as compared with other authorities – 62% and 48%, respectively.

A second domestic survey of 2006 shows that bribery even if only small in cost is still present within the Estonian business environment. Particularly significant figures from the survey are that a quarter of entrepreneurs thought that bribery was a problem. The Criminal Policy Department of the Ministry of Justice, Estonia (2006, p. 62) states:

The number of people who consider that corruption is a problem has grown to 67% of the people of Estonia. Corruption is considered a problem by one fourth of entrepreneurs.

The survey comments further (Criminal Policy Department of the Ministry of Justice, Estonia, 2006) that 27 per cent of entrepreneurs in Estonia do not consider bribery to be any significant obstacle to business, although the entrepreneurs who have come across bribery themselves consider it a serious obstacle to business. Additionally, (Criminal Policy Department of the Ministry of Justice, Estonia, 2006) that bribery is considered a serious problem by the executives of foreign capital companies.

However, for SMEs the cost of bribes is small for those affected, "10 per cent of entrepreneurs have spent over 5,000 Estonian kroons (approximately 319 euros) on bribes" (Criminal Policy Department of the Ministry of Justice, Estonia, 2006, p. 64). Of course that is only one tenth of entrepreneurs and only some of the bribes were asked for by the officials. But it does show SMEs that there will possibly be some extra costs through bribery, although small.

What these figures show for an SME is that the bribery is still present it is a small cost and not that widespread but more of a problem for a foreign SME. However, there is a difference between giving a bribe and being asked for a bribe. An SME which is asked for a bribe will then know that the compliance cost for registration, for example, is greater than is written in law. Other SMEs may try to offer a bribe to an official to quicken the process, this does not mean that the written law is different in practice as the bribe has not been demanded by the official as part of the registration process.

The 2006 survey (Criminal Policy Department of the Ministry of Justice, Estonia, 2006, p. 63) shows that the percentage figure for entrepreneurs that have been asked for a bribe is 15 per cent. However, the survey at Criminal Policy Department of the Ministry of Justice, Estonia (2006, p. 65) makes the comment that only 1 per cent of entrepreneurs who have personally experienced bribery informed enforcement agencies. This supports the assertions referred to in the first survey of 2004. It shows the reluctance of business to give information to authorities and leads to the possibility that it is more widespread than the survey shows.

Additionally the survey helps to show areas in Estonia as well as the type of individual more likely to be involved in corruption. This is useful to know for an SME because if a registration procedure is to take place in one of these areas, then the SME knows that there is a higher possibility of a bribe being asked for by an official.

The 2006 survey makes the comments (Criminal Policy Department of the Ministry of Justice, Estonia, 2006, p. 63). “A bribe has been asked more frequently from men, younger people, non-Estonians and residents of Southern Estonia”. Furthermore, (Criminal Policy Department of the Ministry of Justice, Estonia, 2006, p. 62), “the entrepreneurs of Tallinn find corruption to be more widespread”. So Southern Estonia and Tallinn are the most likely places where an SME will have to deal with corruption through bribes.

This perhaps provides some support for academic comment on the impact of so-called “Russification” within Estonia. Uslaner (2008, p. 22) comments “Ethnic Russians perceive more corruption, are more tolerant of it, and are more likely to be involved in such activities”. Kirch (2001, p. 1) comments on the significance of the Russian migration to Estonia:

The Russian inhabitants, whose massive immigration took place during the Soviet period, live in towns where they form an absolute majority, mainly in the capital Tallinn and the North-eastern Estonian industrial cities such as Narva, resulting in a linguistic and cultural Russification.

If you are an SME doing business with an Estonian official, of Russian ethnic background, then being asked for a bribe is more likely. The other factor is that given the comments by Kirch as to the Russification which has taken place within the region, over generations it will take some considerable time to get rid of the corruption completely.

However, a recent report (Gallup Poll, 2008, p. 1) puts the extent of corruption in perspective. Majorities in each newer EU country surveyed, except Estonia, also say corruption is widespread within businesses in their country. It supports the argument that the perception of business corruption is not widespread in Estonia and is the lowest of the new EU countries. This is supported by academics like (Uslaner, 2008, p. 7), who emphasises the point that it has less bribery than any other transition country which puts the extent of it in a regional context as the lowest.

Empirical aspects

In two recent interviews, using the qualitative research method, I further raised some of the issues referred to and the reality of criminality in Estonia for SMEs. First (interview 1), I interviewed Riitta Kondelin, entrepreneur and owner of MarCon Holding Ltd, Tallinn, on 15 July 2011. Riitta Kondelin is a Finnish entrepreneur and has been running an SME in Estonia since 2002[7]. Second (interview 2), I interviewed Jekaterina Tanttu, a former Estonian police inspector on 5 August 2011[8]. I asked the same questions to both interviewees, and both interviews were “face to face”.

Interview 1 was chosen as part of the empirical research because it was felt it represented a typical small foreign manufacturing business, which had been operating in the capital city of Estonia, Tallinn for a number of years. Interview 2 firm was chosen because the interviewee had experience of operating as a Police Officer in Estonia and as a non-serving officer would be able to give a more unfettered opinion. Both interviewees had been operating in Estonia for at least a few years and consequently were able to comment with credibility on changes that may have occurred over a period of time:

SMEs (for example Finnish ones) are particularly affected by crimes such as burglary, theft, and damage to property. What is your opinion on how effective the criminal regulation (law) system is in Estonia in preventing or deterring such criminality?

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There appears to be from the surveys done, that a low number of crimes are reported to the police, how much higher in reality are crimes such as burglary, theft, and damage to property, which affect SMEs, in your opinion? (Perhaps some indication from the person interviewed as to how much higher, a lot higher, slightly higher or not higher) and why in their opinion are such crimes not reported to the police, by for example Finnish (or other foreign) SMEs?

In Estonia, Do you think in reality is there any unofficial payments which have to be made by a Finnish (or other foreign) SME to any organisation, which perhaps are called other costs? Or do you think no such payments exist at present in Estonia?

Additionally, I asked for both interviewees to give their own further opinion/comments on the present criminal regulation system in Estonia and how it is progressing. As well as any examples of crimes they hadn't reported or any "unofficial protection costs" they may have paid.

Interview 1

The problem, in my experience, as a foreigner of running a business in Estonia is that you can trust no one totally only yourself. The habit and culture of taking from an employer (from the Soviet system) is still very present in Estonia. So financial crime (theft) from within a business is a big problem which I have encountered during my years as an SME owner and I have lost a few thousand euros through it. It is very difficult to prove such crimes by employees particularly as a foreigner consequently I have not gone to the Estonian police to follow them up. I have never suffered any criminal damage to my factory or been the subject of any personal crimes against me in Estonia other than the internal theft specified. I generally have felt reasonably safe going about my everyday business in Estonia. So to that extent I have found that the criminal law system in Estonia is effective. I do pay 40 euros a month to a security firm to protect my property although I was not approached by them for security protection, it came from me. However, in Tallinn it is almost common knowledge that these types of firms were part of the older organized syndicate of years gone by.

Interview 2

Where I worked as a police inspector was in Narva which is a Russian speaking area of Estonia with a population of around 70,000. The main crimes I dealt with were connected to theft, robbery, drugs and assaults. In my opinion during the time I was inspector the level of criminality improved considerably so that during my final year there was far less crime and we had become much more effective. I think the Estonian criminal law system has become even more effective within the last few years. The punishments worked. I think that Estonian people don't like to contact the police, if they can work around the law they will, they don't like to report things to the police, it is the culture. Also, they have an attitude that it is not my problem if they see something, so they don't tell anybody about it. There is from the Soviet past, a kind of attitude that they will not help it will not be taken seriously by the police or that in some way there was consent by the victim. This may mean that there is a slightly higher level of crimes which are not reported. I was relatively well paid as an inspector and I was never offered or received any bribe during my time in Narva. Also I was not aware of any organized crime activity within the criminal activity I was investigating and I think that SMEs don't have to pay any unofficial protection costs. I think the criminal law in Estonia is generally as it is written and operates in practice that way. The only incident I can remember of it possibly not being so was where I was investigating a minor crime which involved a business case (connected to passports) and a well-known business person. It was connected to the signature, and the written law could be interpreted in two different ways and I was ordered by my superior to interpret it so that there was no prosecution. I did feel used in the situation.

First, on the crime rate and effectiveness of the Estonian criminal system (interviewee 1) stated that internal financial crime was the only crime she had suffered during her years in Estonia (although it was large in her estimate) and her opinion on the overall criminal system was that it was effective and she felt reasonably safe in Estonia. Interviewee 2 also stated that the system was effective and had been improving. This backs up, at a grass-roots level, the opinion of academics referred to in the paper such as (Salla), that the general crime rate is stable in Estonia.

Second, with regard to the level of crime in Estonia being higher than that reported (interviewee 1) did not give a direct opinion on that. However, on analysis of her overall reply, she comments on the financial crime within her firm and her reluctance to go to the police because of her being foreign and proving the crime. Certainly, if all foreign SME owners have that perspective it would be one reason, albeit minor, affecting the reporting of crimes. Interviewee 2 stated that she believed it was slightly higher. The reasons for the level of the non-reporting of crime in Estonia can be summarized accordingly from (interviewee 1) that from a foreigners perspective it will not lead to anything (interviewee 2) that it relates to cultural trust of the police.

Third, when comparing (interview 1) with the surveys and academic literature in relation to protection costs, it confirms (Salla's) comments referred to earlier in the paper, on the need for an SME to consider protection costs, although it is very small less than 50 euros a month. Additionally, it reinforces the World Bank Investment Climate Surveys conclusions of it being a very low percentage of costs for an SME. Interviewee 1 also implies the existence of organised syndicates involved in security protection and it being common knowledge within Estonian society. This also supports the academic comment referred to earlier in the paper, of the existence of some level of accepted organised crime in Estonia. Although she indicates that she has never been approached by an organization for protection costs. This would suggest that perhaps an SME, in Tallinn at least, does not necessarily have to pay when asked about organised crime for a security firm to provide protection if they did not want to. Interviewee 2 states that she had not dealings with organized crime when employed as a police inspector although I did observe from the interviewee's body language, an acceptance of its perhaps very limited existence within Estonian society, which would also match the academic comments referred to in the paper concerning organised crime's established existence and that it has a degree of impunity from enforcement authorities. Certainly, it is an area that needs more research to find out exactly how prevalent it is within Estonian business. However, the written criminal law is to all intents and purposes as it is written from a corruption perspective and acceptance of bribes by police officers appears generally unusual.

Conclusion

The crime rate (for robbery, fraud, crimes against property and the person) and the transaction costs (bribes, security/protection money) have been discussed and identified within the paper as the important factors affecting SMEs.

In Estonia the crime rate is however higher in reality than the surveys and statistics show, and there is a possibility of the need for a small protection payment. This is indicated by both the academic literature and the empirical research within the paper (in particular approximately 85 per cent of SMEs take out security protection as indicated by the World Investment Survey, Uslaner, 2008). The logical conclusion must be that the

perception of crimes is high and why, because the amount of crime which has an effect on SMEs is higher than that recorded. However, how much higher is still difficult to exactly gauge although “quite a lot higher” seems to be the most appropriate assessment.

This is also reaffirmed by the qualitative research of the paper (the two interviews undertaken), although the limitations of the empirical research is that it was two different geographical areas (Narva and Tallinn) and only two respondents views, they were nevertheless both in-depth and from an established foreign SME perspective as well as a law enforcement one. The capital city Tallinn has the highest crime rates and entrepreneurs have found bribery more widespread there. But perhaps that is not surprising as it is the capital and most populated city in Estonia.

It is undoubtedly the implementation of the law that will deter criminal activity and lower the crime rate, which is the important part of the circumstance. Particularly because the crime rate is connected to the security costs and by lowering the crime rate you should lower the security costs. Theft and damage to property increases costs for SMEs through a direct loss of goods or through the costs of taking security. It should also reduce the chance of organised crime being involved within the security because there is less opportunity. The involvement of organised crime within the protection costs is very low (if at all) but there is an acknowledged need for more research in Estonia.

Since the turbulent times of the 1990s when Estonia was at some points even close to a “wild west” environment, both the crime rate and transaction costs have improved beyond recognition. Furthermore, Estonia has to a large extent complied with EU regulations, directives and recommendations connected to criminal law, including the signing of pacts against organised crime. Additionally, according to the empirical aspects, the written criminal law is to all intents and purposes as it is written from a corruption perspective and the system is generally effective in providing a safe environment. It is fair to say that both academics and practitioners now consider it a stable criminal environment. Consequently, in reality, an SME will face a stable if somewhat higher crime rate than appears on paper, together with perhaps a low monthly protection cost to a security firm.

The voyage that Estonia has taken in the last 20 years must not be underestimated, stormy waters were obvious to most commentators, but she has sailed quickly through them culminating in a Euro Zone harbour (relatively speaking). To have a stable criminal environment with little meaningful corruption affecting SME business activity is to be commended. Yes, there is something more, greater crime in reality than the crime statistics reveal, a reluctance to contact the police and perhaps wider organised crime activity than appears. But the reality is that it is not going to affect an SME's costs or business investment in any meaningful way.

Notes

1. Article 61 Treaty of Lisbon 2007. “The Union shall endeavour to ensure a high level of security through measures to prevent and combat crime, racism and xenophobia, and through measures for coordination and cooperation between police and judicial authorities and other competent authorities, as well as through the mutual recognition of judgments in criminal matters and, if necessary, through the approximation of criminal law”.
2. Annexe 18 co-operation in the fields of home affairs and justice. (A) “Judicial co-operation in Civil and Commercial matters. (3) 32001R 0044 Council Regulation (EC) no 44/2991 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgements in Civil and Commercial

matters(0)L 12 16.1 2001. (a) The following is added. The agreement between Estonia and Poland on Granting Legal Assistance and Legal Relations on Civil, Labour and Criminal Matters signed at Tallinn on 27 November 1998”.

3. Principle 1 – we affirm our determination to cooperate fully in fighting all kinds of organised crime and other forms of serious crime. Principle 3 – we intend to cooperate in the development and effective operation of central law enforcement and judicial bodies responsible for the fight against organised crime. Principle 12 – we consider that corruption is one of the major threats to our societies, defrauding citizens and private and public institutions alike. We therefore underline the need to develop in common a comprehensive policy against corruption in all its forms.
4. Additionally, the offences of bribery and corruption are also specifically covered and the wording is wide covering, including notaries, county governors and judges. The wording helps SMEs by preventing corrupt notaries. Particularly with company formation, or land notarisation. An example might be bribes by county governors for land acquisition applications, where their approval is required. See CC 2002 s164 and the Anti-Corruption Act 2003 s1.
5. The subjects of the survey were residents of 16 years of age or older and the survey in Estonia was done in close consultation with, but not under the direct supervision of the consortium. With regard to sampling the surveys done in Estonia used randomly selected persons, drawn from official national registration. These samples were also stratified by local area. The sample size that is the targeted number of actual interviews in most countries was 2000. The samples were divided into a larger national part (with a targeted size of 1,200) and a relatively smaller capital city part (targeted size of 800).
6. The survey goes on to state (European Crime and Safety Survey, 2007, p. 24) that collecting statistics on police recorded crimes has not, as in the USA, been harmonised. In recent years serious efforts have been made by a working group of European criminologists to collect crime statistics using standardised definitions. Although, the authors themselves caution against drawing any conclusions from police recorded crime. Figures about the distribution of actual levels of crime across countries (police statistics) continue to be used for that purpose. The survey compares rankings of EU countries according to victimisation by any crime and numbers of police recorded crimes per 100,000 of the population.
7. Riitta Kondolin has had an SME in Estonia since 2002. She currently runs a small textile manufacturing company in Tallinn, Estonia, employing five workers. For more information see www.marconholding.ee or contact riitta@marconholding.ee
8. Jekaterina Tanttü was a serving Estonian Police Officer in Narva, East Estonia from 1999 to 2003. She is currently resident in Finland working for a women’s multicultural centre.

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Further reading

Estonian legal texts, available at: www.legal.text.ee/en/
 European Union Treaties and Legislation, available at: www.euro-lex

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