

**Baltic Development Forum**  
*The leading high-level network  
for decision-makers from business,  
politics, academia and media  
in the Baltic Sea region*

# REPORT

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## COMPETING IN THE SINGLE MARKET

*Towards Effective Policies for Innovation  
and Enterprise Development in  
the Baltic Sea Countries*

*Baltic Development Forum  
is a non-profit organisation.  
Its mission is to  
advance the growth potential  
of the Baltic Sea region  
through the forging of new partnerships  
between leaders from business,  
national and local government,  
academia and media.*

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# **COMPETING IN THE SINGLE MARKET**

## **Towards Effective Policies for Innovation and Enterprise Development in the Baltic Sea Countries**

**September 2003**  
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**About the International Organisation for Knowledge Economy and Enterprise Development (IKED)**

IKED is an independent, international organization focusing on the emerging issues of the knowledge-based economy.

IKED strives to be the link between the primary actors forming the knowledge-based economy: government, industry and academia – facilitating international networks and policy-making forums; leading projects and forming recommendations to turn policies into action.

In addition to mobilizing and enhancing Nordic expertise, IKED engages in activities that support the successful integration of an expanded European Union, and is an active partner supporting structural policy reforms in various countries worldwide. IKED addresses the driving forces and consequences of new technologies, including information and communications technology (ICT), the rapidly changing innovation processes, and the conditions required for dynamic enterprise development. Focusing on the crosscutting horizontal policy dimension of these issues, IKED is a venue for addressing the broader economic and social implications relevant to the ascent of the knowledge economy. IKED further develops programs that involve prime policy makers, government agencies, private sector associations, NGOs, research institutes and other relevant stakeholders.



## PREFACE

During the fifth annual Baltic Development Forum summit in Riga on 5-7 October 2003, the Baltic Development Forum and the International Organisation for Knowledge Economy and Enterprise Development (IKED) will initiate the first official discussions between politicians, business executives and leading academics on how to establish common initiatives and policy solutions for strengthening innovation systems and the overall competitiveness in the Baltic Sea region.

Over the past decade, the countries of the Baltic Sea region have increasingly developed shared priorities and interests, and have supported innovation and enterprise development through many reform initiatives.

It is widely acknowledged that small and medium-sized enterprises (SMEs) play an important role in promoting innovation and competitiveness in Europe. Thus, the SME sector is very important for the economic growth in the ten Baltic Sea countries. Given this baseline and coupled with the region's close traditional cultural ties, the countries of the Baltic Sea region have much to gain from cooperation on fostering favorable conditions for SMEs and improving the SME's ability to compete in the EU's Single Market.

The Baltic Sea countries need to establish common initiatives and policy solutions for strengthening their innovation systems and overall competitiveness.

The main focus of the discussions at the summit in Riga will be on the specific challenges of SMEs in Estonia, Latvia, Lithuania and Poland, and how a strengthened cooperation with their Nordic neighbors can be of mutual benefit to the Baltic Sea region as a whole.

We look forward to the conference discussion and invite everyone to join us now and in the future.

**Uffe Ellemann-Jensen**  
Chairman, Baltic Development Forum

**Thomas Andersson**  
President, IKED

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## **INTRODUCTION: NORDIC-BALTIC COOPERATION ON INNOVATION AND ENTERPRISE DEVELOPMENT**

The Baltic Sea countries are currently in the process of completing the transition to a fully functioning market economy, and in particular, of preparing their economies for accession to the European Union. One of the central questions raised in this context is how well their national innovation systems will adjust to the consequences of joining the European Single Market. There are, in fact, widespread concerns that the Small and Medium sized Enterprises (SMEs) will not be able to capture the opportunities nor to cope with the new challenges arising with their integration into the European Union.

A dynamic and competitive SME sector is pivotal for future economic growth and employment in most countries. The presence of structural weaknesses or obstacles preventing SMEs from competing effectively in the Single Market would significantly increase the transition costs and result in a lower pace of economic development in the Baltic Sea countries than might otherwise be possible. These issues are greatly relevant for other transition economies as well.

The ability and capacity of individuals, companies, and institutions, to innovate will play a vital role in ensuring the competitiveness and well-being of the Baltic Sea countries during their next development phase. By strengthening their innovation systems, these countries can significantly improve the ability of SMEs to compete internationally, thus making a vital contribution to ensuring a successful transition of their economies to the Single Market. The Baltic Sea countries are presently striving to ensure the framework conditions and implement policies that will strengthen national innovation systems.

The Nordic countries are widely regarded as world leaders as far as innovation and technology policies are concerned. They generally rank highly both in terms of investing in and making use of new technology. At the same time, however, the Nordic countries are currently facing a number of structural challenges – an ageing population, a high incidence of sick leave among the working population, fragmented labor markets, high reliance on increasing mobile tax bases for sustaining large public sectors, and problems with integrating the significant number of foreign-born inhabitants into the workforce – which pose serious potential threats to the stability and viability of their social welfare systems and economic development in the coming decades. In addition, on average, the Nordic countries, with the exception of Finland, appear to receive relatively low returns on their investments in R&D in terms of economic growth and job creation.

Both the Baltic and the Nordic countries are looking to innovation policy as pivotal for tackling the structural challenges facing their economies. In addition to their common search for innovation policy solutions and close traditional cultural links, the Baltic and Nordic countries share many other priorities and interests: they are striving for sustainable economic development around the Baltic and North Seas, they are generally small, open economies (with the exception of Poland which has a large domestic market), they have close commercial ties with each other, and tend to have a well-educated labor force.

Furthermore, there are numerous indications, firstly, of complementarities and synergy potentials of the economic strengths of the countries bordering the Baltic Sea, and, secondly, of linkages between these countries' innovation systems. In light of these factors, and, given the end of the East-West division of Europe, there is now a historic opportunity to lay the framework conditions that will enable the Baltic Sea region to become an economically strong, highly integrated and dynamic region, characterized and connected by regional specialization processes, cross-border clusters and public-private partnerships, and large foreign direct investment flows.

Summing up, these two areas within the Baltic Sea region stand to benefit significantly from exchanging policy views and experiences regarding innovation and enterprise development,



and from discussing and agreeing on common initiatives and policy solutions for strengthening their innovation systems and the overall competitiveness of the Nordic and Baltic Sea countries. Furthermore, such cooperation will strengthen the regional economic integration of the Nordic/Baltic Sea area and enable continuous synergy effects between these two regions.

### **BOX 1: The Baltic Programme**

The International Organisation for Knowledge Economy and Enterprise Development (IKED) is currently carrying out a multi-country programme entitled “Competing in the Single Market – the Impact of EU Membership on SMEs in the Baltic countries and Poland (Baltic Programme)”. Building on the work on SME development carried out so far, the Baltic Programme addresses the specific policy challenges for ensuring the development of dynamic, innovative and internationally competitive SMEs once these countries have become members of the EU.

In this context, IKED has put together a working group, consisting of high-level policymakers and experts from Estonia, Latvia, Lithuania, and Poland (henceforth referred to as the B4), from the Nordic countries, and from relevant international organisations. On June 16-17, 2003 in Riga, Latvia, the working group met to address the theme of “**Designing policies for innovation and enterprise development**”. (see Appendix I: Meeting Agenda, and Appendix II: List of Participants)

The purpose of the meeting was to establish a common framework on the challenges facing the Baltic Sea countries seeking to formulate appropriate policy responses to the opportunities and challenges coming, firstly, from the arising knowledge-based economy, and, secondly, from joining the EU’s Common Market. In particular, the workshop touched upon policy solutions for enabling the development of an internationally competitive SME sector, and its importance for assuring their future competitiveness and well-being of these countries.

As a complementary activity within the Baltic Programme, IKED and the Baltic Development Forum have organized a panel comprised of politicians, business executives and scientists that will discuss the establishment of common initiatives and policy solutions for strengthening innovation systems and the overall competitiveness in the Baltic Sea region at **The Baltic Development Forum Summit** in Riga, October 5-7, 2003.





## BALTIC SMEs – AGENTS OF FUTURE GROWTH

### The Background and Importance of SMEs in Transitional Economies

*“The Small and Medium Enterprise (SME) sector carries great hopes and great burdens in the evolution of all of the transitional economies. It is difficult to imagine either rising overall living standards or social peace without sustained and healthy growth of this sector.”*  
(McIntyre (2002), p.2)

In the early stages of transition, one of the main catalysts of macroeconomic transformation was the re-structuring of the large, originally state-owned, enterprises, generally with high levels of foreign involvement, either through direct ownership, joint ventures or foreign know-how (Scase (2000), p.iv). Although to varying degrees, overall the transition economies have increasingly become dependent on large foreign-owned corporations for exports, business R&D, product, process and organizational innovation, capital investments, job creation, and economic growth.

As transition progresses, however, the importance of small and medium enterprises (SMEs) as instruments and guarantors of economic renewal and vitality is rising. Generally, SMEs will play a key role for the economic and social fabric of the transition countries (European Commission (2002e and 2003c), McIntyre (2002 and 2003)). Despite some early reforms by the post-communist countries in the early 1990s (European Commission (2002e)), there are still significant structural barriers to SME development in the transition economies, as pointed out by the European Commission in its 2003 *Implementation Report on the European Charter for Small Enterprises in the candidate countries* :

*Small enterprises in the candidate countries remain to a large extent underdeveloped. New enterprises are mainly created in the traditional service sectors and there are only few innovative companies. The life cycle of companies is shorter than in the EU and the methods of the economic transition towards an open economy have not always been favorable to new and small enterprises.*

European Commission (2003c, p.18)

One of the principal challenges for the former socialist countries will be to enable the development of a critical mass of dynamic, innovative, and internationally active and competitive SMEs which can gradually moderate these countries' economic dependence on large foreign-owned corporations.

### Innovation and SMEs

In recent years, policymakers in the Baltic Sea countries have increasingly realized the key role of innovation – and innovation policy – for competitiveness, economic development and growth.<sup>1</sup> Similarly, there is a widespread consensus among decision-makers that SMEs are important both for job creation and GDP growth (see European Commission (2003c)). However, the link between innovation and SMEs, and the relevance of that link for national competitiveness, appears to be less clear. How important is innovation for the development of

<sup>1</sup> What constitutes innovation is a complex matter, and measuring and comparing innovation is a subject area still very much under development. Traditional perspectives have viewed innovation as closely related to science and technology. In practice, however, innovation can take many forms, including commercialization of science and technology as well as the development and implementation of new ideas more generally, as in the form of organizational change or inventing new ways of doing things. Innovation is thus the key not only to economic progress, but also to identifying new solutions to pressing social issues, such as an ageing population or environmental degradation.



competitive SMEs, and how important are SMEs for stimulating innovation within the national context? What is the role of SMEs in the national innovation system? What is the connection/difference between innovation policy and SME policies and how should they be coordinated?

SMEs provide an important and unique breeding ground for innovation and thus for national competitiveness. Given the right framework conditions, SMEs can serve as incubators to new ideas, exercising their ability to act quickly and flexibly, taking advantage of the full range of national resources (irrespective of geographical location), and engaging in experimentation more easily than big, established firms. In many of the transition economies, SMEs can and should play a key role in moderating their countries' current economic dependence on a handful of large multinational companies. As pointed out by the OECD,

[t]he SME sector can provide a large share of the flexibility increasingly required in OECD economies. Dynamic rates of business turnover facilitate the fundamental restructuring required to shift resources towards growing areas and away from declining areas, and to adjust the structure of production to meet market needs. At firm level, many smaller enterprises are inherently more flexible than larger firms, as they are less likely to be 'locked in' to existing plant, technologies or organisations structures. (OECD (2002), pp.11-12)

At the same time, however, SMEs tend to lack the financial resources, the technological or management know-how, and the networks that would enable them to invest, or otherwise be actively involved in, substantial R&D activities (either in-house or in collaboration with research institutions or networks). Furthermore, small firms tend to lack the resources to invest in organisational change warranted by market developments (ibid.).

***Small and Medium Sized Enterprises form the backbone of the European economy. They are key to entrepreneurial spirit and innovation in the EU and thus crucial to ensure EU competitiveness. A proper definition of which enterprises are SMEs makes it easier to identify their needs and to develop efficient policies to compensate for the specific problems linked to their small size. This is vital for the competitiveness of an enlarged European Union, its growth and employment.***

Erkki Liikanen, Enterprise Commissioner for the EU, 8 May 2003, Brussels

Overall, it should be recognized that both SMEs and Large Scale Enterprises (LSEs) have important roles to play in a nation's growth and competitiveness. In particular, the presence of successful and dynamic LSEs is one prerequisite for stimulating and enabling innovative SMEs (McIntyre (2003), p.5). When seeking to design and implement effective policies for innovation and enterprise development, policymakers must take into consideration the different key competencies of and challenges for LSEs, on the one hand, and SMEs, on the other hand. At the same time, policymakers must be aware of the importance of synergistic relationships between LSEs and SMEs as a precondition for economic growth and competitiveness.

In the following sections, we take a closer look at the economic importance of SMEs as well as indicators of their ability/tendency to innovate.

### **SMEs and SME policies in the B4 countries**

The European Commission defines SMEs as enterprises which:

have fewer than 250 employees;

have either an annual turnover not exceeding 40 million, or an annual balance sheet total not exceeding 43 million;  
conform to independence criterion (75% or more of capital and voting rights are owned by enterprises fulfilling SME criteria).

**Table 1: Comparable SME Statistics**

	SMEs Share of GDP (% of total)	SMEs Share of Labour Force (% of total)	SMEs Share of Total # of Enterprises (% of total)
Denmark	56	70	99.3
Finland	49	58	99.8
Norway	n.a.	69	98
Sweden	56	63	99.8
Estonia	52	55	98.9
Latvia	63	70	81.2
Lithuania	32	32	99.5
Poland	49	65	99.8

Sources: For EU member countries and Poland, data gathered from OECD (2002a) and Eurostat (2002b); for Estonia, Latvia and Lithuania, data gathered from UNECE (2003); data primarily from 2000-2001

As has been pointed out, SMEs play an important role for employment and economic growth in the Baltic Sea countries. Overall, there is a slightly higher percentage of labor employed in SMEs in candidate countries (72%) than in the Europe-19 (66%), with the largest difference concentrated in micro enterprises, i.e. enterprises employing less than 10 people (European Commission (2002e)). In the four countries currently participating in the Baltic Programme (see Box 1), Estonia, Latvia, Lithuania and Poland (henceforth referred to as the B4), SMEs also account for a larger portion of GDP, compared to member countries. In the B4, with the exception of Lithuania, SMEs account for the majority of GDP, the national labor force, and the total number of enterprises (see table 1).

Since the early 1990s, the B4, as well as many other candidate countries, have experienced dramatic increases in the share of both employment and GDP accounted for by SMEs (World Bank (2002), pp.39-41). This development is partially due to the shift of production from formerly state-owned enterprises, many of which were dismantled in the 1990s (European Commission (2002e), p.26). In the early stages, many SMEs in the transition economies were created from the break-up of large, state-owned enterprises and mass privatization, while others were conversions from the unofficial sector. While the rapid rise in the economic significance of SMEs, therefore, “does not in itself point at a healthy development of the SME-sector” (ibid.), it underlines the importance of ensuring conditions which are conducive to the development of dynamic, competitive, and innovative SMEs.

According the European Commission (2002e), after the fall of the Berlin Wall, SME development in post-communist countries rapidly became one of the principal economic reform issues. The institutional structure supporting SMEs has developed quite rapidly over the past few years. As summarized in Table 2, all countries have an established governmental authority, multiple business support organizations, and several ongoing policy initiatives supporting the continued development progress for SMEs.

**Table 2: Summary of National Institutional Structure Supporting SME Development in the Baltic States**

	Governmental Authority	Business Support Institutions	Supporting Measures
Estonia	Enterprise Division, Economic Development Department within the Ministry of Economic Affairs	<ul style="list-style-type: none"> <li>- 16 Regional Business Development Centers</li> <li>- Enterprise Estonia - financial and intermediary institution</li> <li>- Credit and Export Guarantee Fund</li> <li>- Tartu Science Park, Tallinn Technical University Innovation Centre, and 4 business incubators</li> <li>- Foundation Estonian Accreditation Centre</li> <li>- Estonian Centre for Standardization</li> <li>- Department of Legal Metrology of the Technical Inspectorate</li> <li>- SME Advisory Council (advisory body within the Ministry of Economic Affairs and Communication)</li> </ul>	"Enterprising Estonia - National Policy for the Development of Small and Medium-sized Enterprises in Estonia in 2002-2006" is concentrated on the following priority fields: <ul style="list-style-type: none"> <li>- the development of human resources</li> <li>- improved access to finance</li> <li>- the development of the business support infrastructure</li> <li>- improved access to business information</li> <li>- reduction of administrative barriers</li> </ul> The main instruments are: <ul style="list-style-type: none"> <li>- support for advisory services and business training</li> <li>- start-up grants</li> <li>- support for development of business infrastructure</li> <li>- support for retraining and further training</li> <li>- SME credit and Leasing Guarantees</li> </ul>
Latvia	Ministry of Economy	<ul style="list-style-type: none"> <li>- Latvian Development Agency</li> <li>- Euro Info Correspondence Centre</li> <li>- Latvian Technology Park (LTP)</li> <li>- Latvian Technology Centre (LTC)</li> <li>- Business Innovation Centre of Latvian Electronic Industry (LEBIC)</li> <li>- Latvian Association for Quality</li> <li>- Mortgage and Land Bank of Latvia</li> </ul>	<ul style="list-style-type: none"> <li>- Company Income Tax law stipulates tax exemption for SMEs in the amount of 20% of the calculated income tax with gradual reductions of this amount over time until income tax rate reaches 15%</li> <li>- The Value Added Tax law permits SMEs to register a taxable person regardless of the transaction size, allowing SMEs to deduct value-added taxes</li> <li>- In 2000, the Mortgage and Land Bank of Latvia (MLBL) started the first phase of an SME credit programme, providing loans to 255 clients for the total amount of EUR 12.05 million. In July 2001, MLB started phase 2 of the programme, offering lower interest rates and easier pledge requirements. This phase also targets new groups of enterprises. In total terms, 375 loans totalling EUR 17.1 million have been granted during the first two phases of the programme. The average loan amount was EUR 48 thousand, with an average interest rate of 8.5%...allowing for the creation of 912 new jobs.</li> </ul>
Lithuania	<ul style="list-style-type: none"> <li>- The Lithuanian Development Agency for Small and Medium Enterprises (SMEDA) - a public institution, the only founder of which is the Ministry of Economy</li> <li>- Science and Technology Commission, chaired by the Prime Minister, 2002</li> <li>- Innovation and Technology Division at the Ministry of Economy, 2003</li> </ul>	<ul style="list-style-type: none"> <li>- 6 business advisory centres</li> <li>- 13 business information centres</li> <li>- 2 Euro info centres</li> <li>- 7 business incubators</li> <li>- 6 techno parks</li> <li>- State Food and Veterinary Service</li> <li>- State Non-consumable Products Inspectorate under the Ministry of Economy</li> <li>- INVEGA (CSC Investment and Business Guarantees) - risk financing experts</li> <li>- 4 funds of financial support</li> <li>- Lithuanian Economic Development Agency</li> <li>- Lithuanian Association of Chambers of Commerce, Industry and Crafts</li> <li>- Lithuanian Export and Import Insurance</li> <li>- Lithuanian Industrialists' Confederation</li> <li>- Lithuanian Business Employers Confederation</li> <li>- Lithuanian Innovation Centre</li> </ul>	<ul style="list-style-type: none"> <li>- EU Phare Competitiveness Programme for Innovation in Business (2003+)</li> <li>- EU Phare Economic and Social Cohesion funds and grant schemes for innovation projects</li> <li>- Bilateral initiatives with Germany and Denmark</li> <li>- Innovation Relay Centre networked to 68 other European IRCs started in 2000, focusing on high-tech sectors and offering support services to enterprises</li> <li>- Innovation Assistance Network (supported by EU Phare ESC) establishing "twinning partnerships" with Germany and Scotland, developing a national innovation support network, and encouraging innovation projects</li> </ul>
Poland	Department of Craft, Small and Medium Enterprises within the Ministry of Economy	<ul style="list-style-type: none"> <li>- The Polish Agency for Enterprise Development (PAED)</li> <li>- The National SME Services Network (KSU)</li> <li>- Regional Financing Institutions (RFIs)</li> </ul>	<ul style="list-style-type: none"> <li>- Founders of smaller enterprises may choose a simplified form of taxation</li> <li>- Entrepreneurs operating in most areas of business may choose to pay the lump-sum tax on registered income</li> <li>- The tax system includes an exemption from VAT for entrepreneurs whose annual turnover does not exceed the equivalent of EUR 10 thousand</li> <li>- Companies who apply for credits may also apply to the Bank Gospodarstwa Krajowego (a state bank) for guarantees for these credits. This applies only to companies who have a basic credit record.</li> <li>- The Polish Agency for Enterprise Development is furthermore involved in the implementation of major programmes financed out of EU funds.</li> </ul>

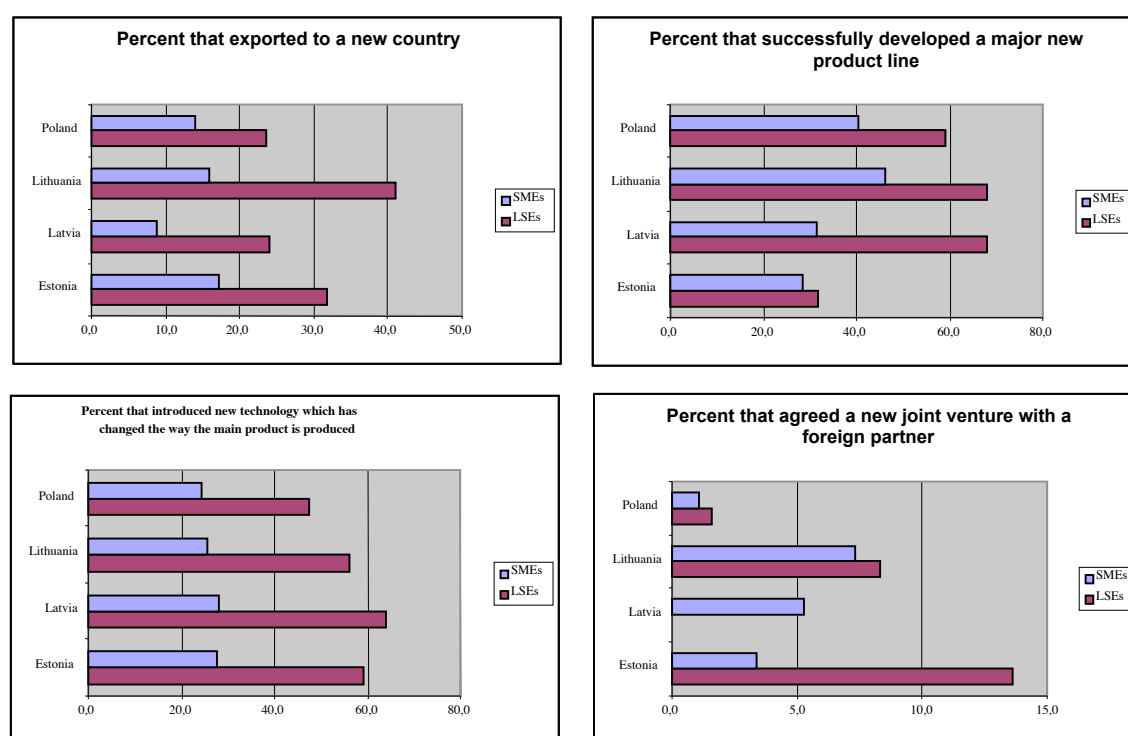
Sources: UNECE report on SMEs in Countries in Transition, 2003; individual country input from Workshop on *Designing Policies for Innovation and Enterprise Development* June 16/17 2003 in Riga; European Commission (2002h): National reports on the implementation of European Charter for Small Enterprises from Estonia, Latvia, Lithuania, Poland (September 2002)

## Challenges

The previous sections established the significant and growing importance of SMEs for economic growth, innovation and competitiveness in the B4, both in theory – through their role as agents of economic renewal and innovation –, and in practice – due to their large and growing share in employment and GDP. Currently, however, a number of challenges are threatening the development of a critical mass of innovative SMEs, and thus a dynamic SME sector, in these countries.

Of perhaps most concern for the longer-term vitality of SMEs is the fact that most active SMEs are principally engaged as small traders or retailers making thin margins on standard products. Candidate Countries still do not have the kind of advanced services sector common in the EU. Furthermore, very few SMEs are seriously engaged in manufacturing activity involving innovative capital investment and new technology (European Commission (2002e, p.26).

**Table 3: BEEPS survey responses on enterprise performance (dates “since 1998)**



According to a recent survey by the World Bank and European Bank for Reconstruction and Development (EBRD), SMEs in the B4 are not performing as well as LSEs in a number of areas: exports to new countries, new product development, new technology/production processes, and new joint ventures with foreign partners (see table 4).<sup>2</sup> This finding mirrors the evidence from studies of existing EU Member States, which reveal that the share of companies introducing new products, processes or technologies tends to be lower for small

<sup>2</sup> The Business Environment and Enterprise Performance Survey (BEEPS), developed jointly by the World Bank and the European Bank for Reconstruction and Development is a survey of managers and owners of firms across the countries of Eastern Europe, the former Soviet Union, and Turkey designed to generate comparative measurements of the quality of governance, the investment climate and the competitive environment, which can then be related to different characteristics of the firm and to firm performance. The results of the survey can be accessed at <http://info.worldbank.org/governance/beeps2002/>.

enterprises than for large firms in most Western European countries. However, there is some evidence that the gap between SMEs and LSE, when it comes to innovativeness, is larger in the B4, and in the candidate countries in general. In particular, the candidate countries appear to lack the technology-oriented segment of SMEs that exist in more advanced EU countries.

In this context, a recent study on innovation in SMEs in Poland, carried out by the Polish Agency for Enterprise Development (PAED), found that R&D cooperation of SMEs, including cooperation with universities, institutes and innovation centres, was very low when compared with EU countries (Zolnierski (2003)). Similarly, survey results presented in an Estonian survey on innovation, pointed out a large gap between smaller and larger enterprises. In all categories (strategic, management, organizational, marketing and product appearance), large enterprises were more successful in implementing significant change. The successful innovators were more likely to have foreign capital and involvement, providing them with more opportunities to carry out every kind of change to raise the competitiveness of the company (Kurik et. al, 2002). The evaluation of innovation policy in six candidate countries commissioned and published by the European Commission in 2001, found that "... despite expectations that large enterprises would be replaced by new innovation-oriented SMEs, large firms continue to undertake the majority of innovation activities..." (European Commission (2001a), p.78). Overall, the data suggests that innovation activities in the candidate countries are more concentrated in large firms than in EEA countries (European Commission (2001a)).

In their survey of SMEs in Europe, including the candidate countries, from 2002, the European Commission identified a number of barriers to SME development in the candidate countries:

*The limited access to finance seems to be one of the serious barriers to economic growth and prosperity. One reason is that the small enterprises are not considered to be a priority for the banking sector as they are perceived to be high risk. Another reason is that small enterprises in the candidate countries have yet to develop an entrepreneurial spirit and still lack the means to know their needs and opportunities, in particular in terms of management or support services. In the area of administrative simplification progress has been made but further efforts are still needed to increase the efficiency of the public administration at all levels.*

European Commission (2003c, p.18)

It is apparent from all the data that SMEs require support through policies designed to meet their specific needs.

These observations are confirmed by the indices for the measurement for competitive advantage and cluster development compiled by the World Economic Forum (in Table 4 below). The comparatively low competitive advantage index for the B4 reflects the fact that these countries have not been able to develop, market, and/or sell products and processes unique to their individual countries, but rather have been competitive based on low cost production.

The state of each nation's cluster development is quite varied. Clusters, and particularly innovative clusters, are a key instrument for strengthening the innovative capacity and the competitiveness of SMEs:

*By increasing SMEs' access to technology, capital, product markets, among other things, strategic alliances and other partnerships, as well as networks and clusters enable SMEs to combine their generally inherent flexibility and ability to adapt quickly with the advantages of scale and scope generally only available to large corporations.*

(OECD (2002a), p.21.)

The low ranking for the B4 indicates considerable room for improvement when it comes to strengthening cluster initiatives in these countries.



**Table 4: Competitive Advantage and Cluster Development rankings**

	Nature of Competitive Advantage (rank amongst 80 countries) <sup>1</sup>	State of Cluster Development (rank amongst 80 countries) <sup>2</sup>
Denmark	8	22
Finland	7	4
Norway	22	15
Sweden	10	9
Estonia	61	74
Latvia	56	56
Lithuania	48	34
Poland	53	42

<sup>1</sup> From The Global Competitiveness Report, where top ranking represents competitiveness of country's companies in international markets primarily from unique products and processes, and bottom ranking represents competitiveness from low cost or local natural resources

<sup>2</sup> From Global Competitiveness Report, where top ranking represents that clusters are common and deep in the country, and bottom ranking represents that clusters are limited and shallow

Strengthening innovative cluster initiatives is not just a matter of promoting networking or ICT. Rather, successful clusters tend to involve close cooperation between business, academia and government, and an element of knowledge creation and application which is highly collaborative and inter-linked. Other factors which play an important role in successful clusters are industry-science relationships, inter-firm collaboration, public/private partnerships, and globalisation.

The B4 have much to gain by encouraging cooperation and cluster development, and thus by supporting SMEs in their striving to achieve the required level of quality, business savvy and scale in order to compete on the wider European playing field.

In view of the upcoming integration into the EU's Single Market, one of the key questions for policymakers is how well prepared their SMEs are to operate internationally. Do SMEs have the managerial competences, the access to technology as well as banking and other financial services that are necessary to recognize and seize opportunities beyond their local or national borders? The challenge for governments, and this applies particularly to transition countries preparing to join the Single Market, is "to create a facilitating and supportive environment for SME development, ... that enables SMEs to exploit the potential benefits and/or cope with any additional costs or threats from increasing internationalisation forces, while avoiding becoming protective" (OECD (2001b), p.219.)

***"Enterprise policy is a key area that will play a major role in setting the conditions for this objective (of the EU becoming the most competitive and dynamic knowledge-driven economy in the world) to be met. In particular, the promotion of small and medium-sized enterprises (SMEs) is thought to be fundamental in fostering an environment that encourages economic growth and job opportunities."***

(Eurostat Statistics in focus (2002), *Enterprises in Europe – does size matter?*)

Turning to the specific challenges for policymakers striving to promote SME development in the B4 countries, a number of areas where there is still considerable room for improvement can be identified<sup>3</sup>:

- **Insufficient access to start-capital and long-term investment sources**  
Start-up companies have neither collateral nor a credit history, and lack experience in completing loan applications. Financing for high-risk projects is generally inaccessible, or is so limited that only a few, select business projects receive financing.
- **Lack of cooperation between businesses, research institutions and state agencies, and lack of cross-border SME partnerships**  
Although many of the Baltic Sea countries have the basic components needed to develop SMEs, they all (except for Poland) lack the size and scale in order to compete independently. In order to succeed, the individual actors need to cooperate more closely, and seek networking partners beyond national borders.
- **Entrepreneurship not seen as a key competence**  
Many of the B4 countries still treat entrepreneurship as a topic for vocational education, rather than a key component of the basic education curriculum. More efforts need to be made to promote and entrepreneurial culture.
- **Insufficient access to new technology**  
Even though internet penetration, telephone and cellular access has increased significantly in all Baltic Sea countries over the past years, there is still a gap in access to new technology when compared with the EU average and particularly with the Nordic countries.
- **Fragmentation and poor availability of business information and business services**  
All of the Baltic Sea countries have initiated a number of activities to support businesses (business development and innovation centers, advisory and information offices, business incubators and technology parks). However, the general view from SMEs is that there is still a need for strengthened skills in international market entry, marketing and promotion.
- **Insufficiently competitive business environment (competing on cheap products)**  
The basic math and science education is viewed as a major asset in all the Baltic Sea countries, but the benefit of this has not yet been seen on a national level. These countries are still competing on low labor costs/cheap products rather than their ability to design and sell unique products, processes or applications of their own.

### Summary

This section has established that SMEs play a significant and growing role for the economies of the B4. Furthermore, SMEs are of crucial importance, as agents of economic renewal and innovation, for securing the future competitiveness of the transition economies. Recent evidence shows that there is a clear need to strengthen competitiveness and innovation in the B4 general, but particularly in the SME sector. One of the key challenges of policymakers in transition economies is to design and implement policies that will promote the ability and willingness of a critical mass of SMEs to engage in innovative activities.

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<sup>3</sup> Sources for this summary list include UNECE report on SMEs in Countries in Transition, 2003; European Commission Report on the Implementation of the European Charter for Small Enterprises in the Candidate Countries for Accession to the European Union; and individual country input from Workshop on Designing Policies for Innovation and Enterprise Development June 16/17 2003 in Riga.



## **BALTIC AND NORDIC COUNTRIES – SIMILARITIES AND DIFFERENCES**

As mentioned in the introduction, the Baltic and Nordic countries share a number of common interests, strengths and challenges. At the same time, there are also some noteworthy differences in factors regarding and affecting innovation and enterprise development.

As regards similarities, both country groups tend to be characterized by small domestic markets (with the exception of Poland), and, consequently, dependency on external markets for selling their goods and services, particularly when it comes to high-tech or highly specialised products (see table 5).

**Table 5: Size and export orientation**

	Population (million inhabitants)	Exports as a share of GDP (2001)
<b>Denmark</b>	5,4	30,8%
<b>Estonia</b>	1,4	60,5%
<b>Finland</b>	5,2	32,7%
<b>Latvia</b>	2,4	25,8%
<b>Lithuania</b>	3,5	38,1%
<b>Norway</b>	4,5	34,2%
<b>Poland</b>	38,6	20,5%
<b>Sweden</b>	8,9	36,0%

Source: World Economic Forum (2003).

Secondly, while SMEs are widely regarded to be the backbone of the economy in these countries – and the motor for growth and employment – they are not the drivers of innovation. In this context, it should be noted that the term innovation is used here to describe new commercially relevant products, services, processes and organisational forms. Thus, similar to the findings for the B4 presented in the previous chapter, recent studies identified a shortage of innovative SMEs as one of the main weaknesses of the Finnish innovation system (Georghiou et.al (2003), European Commission (2001b)). This is interesting given the fact that Finland is generally regarded to be a highly effective and well-functioning system.

Another factor identified by policymakers both from the Nordic and Baltic Sea Countries was the perception of a ‘dual nature’ or ‘polarisation’ of innovation and economic development. Thus policymakers regarded their countries to be characterised, on the one hand, by metropolitan areas (Stockholm, Helsinki, Tallinn, Riga, etc.) and large, and in the case of the Baltic Sea countries frequently foreign-owned, companies, both of which are internationally at the forefront in terms of innovation and economic development. On the other hand, policymakers were faced with rural areas with very low levels of growth, employment and economic development. Nordic and Baltic policymakers argued that these perceived disparities when it comes to regional economic growth and innovation placed unique demands on policy-makers seeking to design national policies for innovation and enterprise development. However, it should be pointed out here that, compared to other EU Member States, including the New Member States, the countries in question display rather small regional disparities when it comes to unemployment or GDP per capita (see European Commission (2003c)).

Turning to the differences between the Nordic countries on the one hand and the Baltic States and Poland on the other, one of the most notable discrepancies, from an innovation system perspective, is the level of expenditure on R&D. As can be seen in Table 6, the Nordic countries tend to invest a considerably higher share of GDP in R&D than the EU average, while the Baltic Sea countries tend to invest far less, both in terms of private and public expenditure on R&D.

**Table 6: Expenditure on R&D (as a percentage of GDP)**

	public	business	total	data from
<b>Sweden</b>	0,94	2,84	<b>3,78</b>	1999
<b>Finland</b>	0,98	2,68	<b>3,66</b>	2001
<b>Denmark</b>	0,75	1,32	<b>2,07</b>	2000
<b>Norway</b>	0,75	0,95	<b>1,70</b>	1999
<b>Lithuania</b>	0,53	0,70	<b>1,23</b>	2000
<b>Poland</b>	0,45	0,25	<b>0,70</b>	2000
<b>Estonia</b>	0,53	0,15	<b>0,68</b>	2000
<b>Latvia</b>	0,29	0,20	<b>0,49</b>	2000
<b>EU</b>	0,67	1,28	<b>1,95</b>	2001

Source: European Innovation Scoreboard 2002

Perhaps even more important than R&D, from the point of view of economic growth is the fact that, according to the available indicators, there is a considerable gap between the Nordic and the Baltic economies when it comes to innovation or innovativeness. As countries develop economically, and given equal access to global markets as well as the rapid pace of technological change and the trend towards shorter product life cycles, the ability to innovate becomes an increasingly critical determinant of international competitiveness. As stated by Porter and Stern, in advanced nations today, competitive advantage "...must come from the ability to create and then commercialize new products and processes, shifting the technology frontier as fast as their rivals can catch up" (Porter and Stern (2003), p.1).

According to the indicators for innovation established so far, the Nordic countries generally emerge as top performers in most categories. Table 7 shows a number of indicators which illustrate the Nordic countries' leading positions both when it comes to investing in and making use of new technology. Nordic countries top the international tables for investing, patenting, and publishing R&D. In addition, they are the most advanced countries in the world in terms of ICT penetration, investment and usage. According to the European Innovation Scoreboard, the Nordic countries are ahead of other European countries, and the United States, when it comes to internet access, investment in R&D, ICT expenditure, and patenting activity, among other things (European Commission (2002a)).

In contrast to the Nordic countries, which top most international rankings for innovation, science and technology indicators, the B4 tend to find themselves far below the EU and OECD averages, when it comes to innovation and innovativeness. Table 8 (Innovation and Competitiveness rankings) compares the Baltic and Nordic countries according to several aggregated indices for measuring national innovative and competitive ability.

**Table 7: the Nordic countries in international comparison (selected indicators and countries)<sup>1</sup>**

	Mobile phone subscriptions per inhabitants 2001	PCs per 100 inhabitants 2001	Internet hosts 1000 inhabitants 2001	Internet users per 1000 inhabitants 2001	R&D exp. % of GDP 1999	Researchers per 10 000 in the labor force 1999	Patent appls. with EPO per million inhabitants 1998	Exp. on univ. educ. per student 1998 (PPP \$)
<b>Denmark</b>	74	43	105	447	2,09	64	139	9562
<b>Finland</b>	78	42	171	430	3,22	99	216	7327
<b>Iceland</b>	82	42	<b>190</b>	<b>679</b>	2,33	<b>101</b>	70	..
<b>Norway</b>	<b>83</b>	51	67	596	1,7	78	70	10 9184
<b>Sweden</b>	77	<b>56</b>	83	516	<b>3,78</b>	91	<b>226</b>	<b>13 224</b>
<b>United States</b>	44	<b>62</b>	<b>371</b>	500	2,66	815	97	<b>18 493</b>
<b>France</b>	61	34	13	264	2,19	61	111	7005
<b>Italy</b>	70	19	12	276	1,04	28	56	62954
<b>Germany</b>	68	34	29	364	2,44	64	<b>233</b>	94665
<b>OECD</b>	64	32	66	319	2,21	62	82	11 464
<b>EU</b>	75	33	54	317	1,86	53	115	..

<sup>1</sup> Countries with the highest number or percentage of a given indicator (either among the Nordic countries or internationally) are marked in bold.

Source: International Telecommunication Union (ITU) 2002; OECD, MSTI database 2001; OECD (2001).

**Table 8: Innovation and Competitiveness rankings**

	Innovation Subindex <sup>1</sup> (out of 80 countries)	Innovative Capacity Index <sup>2</sup> (out of 73 countries)	Growth Competitiveness Index <sup>3</sup> (out of 80 countries)	Microeconomic Competitiveness Index <sup>3</sup> (out of 80 countries)
<b>Finland</b>	3	3	2	2
<b>Sweden</b>	4	7	5	6
<b>Norway</b>	12	19	9	21
<b>Denmark</b>	13	12	10	8
<b>Latvia</b>	26	44	44	45
<b>Estonia</b>	28	29	26	30
<b>Poland</b>	29	35	51	46
<b>Lithuania</b>	33	31	36	40

<sup>1</sup> World Economic Forum (2003)

<sup>2</sup> Porter and Stern (2002-2003)

<sup>3</sup> Global Competitiveness Report (2002-2003)

The B4 rank considerably lower than the Nordic countries, both in the innovation subindex, which seeks to explain the elements of innovation that are linked to economic growth, and in the innovative capacity index which seeks to capture the underlying factors that contribute to innovation (Cornelius et.al. (2003), p.8). The B4 also rank comparatively low in the growth competitiveness index, which is based on three categories that are found to drive economic growth in the medium and long term (technology, public institutions, and the macroeconomic environment), and the microeconomic competitiveness index examines the underlying conditions defining the sustainable level of productivity in each of the 80 countries.

Confirming the impression derived from the above indicators, the Business Environment and Enterprise Performance Survey (BEEPS) mentioned in the previous chapter indicates that the level of innovation in enterprises in the Baltic States and Poland is relatively low.

Summing up, there appears to be a significant gap between the Nordic countries, on the one hand, and the B4, on the other hand, when it comes to the ability to innovate. However, it would be hasty to conclude from these observations that the Baltic Sea countries are 'hopelessly' behind in the striving towards innovation and competitiveness. Several indicators for innovation, science and technology have shown a dramatic improvement for the B4 countries (see table 9). Furthermore, since they came out of the severe economic crises that afflicted most candidate countries in the early 1990s, the Baltic economies have experienced average economic growth rates that are significantly than those of the Nordic countries, the EU or the OECD, for that matter (see table 10).

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<sup>4</sup> The Business Environment and Enterprise Performance Survey (BEEPS), developed jointly by the World Bank and the European Bank for Reconstruction and Development is a survey of managers and owners of firms across the countries of Eastern Europe, the former Soviet Union, and Turkey designed to generate comparative measurements of the quality of governance, the investment climate and the competitive environment, which can then be related to different characteristics of the firm and to firm performance. The results of the survey can be accessed at <http://info.worldbank.org/governance/beeps2002/>.

**Table 9: Innovation in the Nordic and Baltic Sea Countries (selected innovation, science and technology indicators)**

	pop. with tertiary education 2001	empl. in med./hi-tech manuf. (% of tot. workforce) 2001	EPO patents per million inhabitants 2000	home internet access (% of households) 2001	ICT exp. (% of GDP) 2000 or 2001	PCs per 100 inhabitants 2001	internet hosts per 1000 inhabitants (Jan 2002)	internet users per 1000 inhabitants (2001)	mobile phone subscription per 100 inhabitants 2001
<b>Denmark</b>	26,5	7,0	177	58,6	7,4	43	105	447	74
<b>Finland</b>	32,5	7,4	283	50,2	6,7	42	171	430	78
<b>Norway</b>	33,8	4,2	306	58,2	5,7	51	67	596	83
<b>Sweden</b>	29,7	7,9	306	60,7	9,9	56	83	516	77
<b>Estonia</b>	29,4	4,8	7	9,8	9,6	18	37	301	46
<b>Lithuania</b>	45,0	3,2	1	3,0	5,9	15	11	72	28
<b>Latvia</b>	18,2	1,7	3	2,0	7,9	7	9	68	25
<b>Poland</b>	11,7	7,5	2	8,0	5,9	9	12	98	26

Sources: International Telecommunication Union (ITU) 2002; OECD, MSTI database 2001; OECD (2001), European Innovation Scoreboard 2002, Eurostat (2002).

In addition to the high average GDP growth in recent years, there are a number of indications that the B4 are making rapid progress increasing the use of and investment in ICT. Compared with the much slower rate of change in selected indicators for ICT development (see table 11) in the European Union countries, including the Nordic countries, one of the salient features of the B4 is a clear trend towards reducing the innovation gap and the rapid progress towards a knowledge economy.

**Table 10: GDP Growth 1995-2003 in the Nordic and Baltic Sea countries (at constant prices)**

	1995	1996	1997	1998	1999	2000	2001	2002	2003 <sup>1</sup>	1995-2003 (average)	2000-2003 (average)
EU-15	2.4	1.6	2.5	2.9	2.8	3.5	1.6	1.0	1.2	<b>2.2</b>	<b>1.8</b>
Estonia	4.3	3.9	9.8	4.6	-0.6	7.3	6.5	6.0	4.9	<b>5.2</b>	<b>6.2</b>
Latvia	-1.7	3.7	8.4	4.8	2.8	6.8	7.9	6.1	5.5	<b>4.9</b>	<b>6.6</b>
Lithuania	6.2	4.7	7.0	7.3	-1.8	4.0	6.5	6.7	4.5	<b>5.0</b>	<b>5.4</b>
Poland	7.0	6.0	6.8	4.8	4.1	15.8	1.0	1.6	2.5	<b>5.5</b>	<b>5.2</b>
Denmark	2.8	2.5	3.0	2.5	2.6	2.9	1.4	1.6	1.5	<b>2.3</b>	<b>1.9</b>
Finland	4.1	3.9	6.4	4.9	3.4	5.5	0.6	1.6	2.2	<b>3.6</b>	<b>2.5</b>
Norway	4.4	5.3	5.2	2.6	2.1	2.4	1.4	1.5 <sup>1</sup>	2.2	<b>2.8</b>	<b>1.5</b>
Sweden	4.0	1.3	2.4	3.6	4.6	4.4	1.1	1.9	1.4	<b>2.7</b>	<b>2.2</b>

<sup>1</sup>: forecast.

Source: Eurostat.

However, this general picture of rapid progress towards an innovative and knowledge-based economy is clearly marred by the fact that the B4 have still failed to increase significantly their comparatively low expenditure on R&D (measured as a percentage of GDP).

**Table 11: Indicators of the Baltic Sea countries ‘catching up’ (%)**

	Number of PCs (growth 2001/2000)	Number of internet hosts (growth 2001/2000)	Number of internet hosts (growth 2002/2001)	IT exp. (growth 2001/2000)	mobile phone subscriptions (growth 2001/2000)
<b>Estonia</b>	13.6	41.4	22.9	8.3	16.9
<b>Lithuania</b>	8.3	25.0	86.6	9.6	77.9
<b>Latvia</b>	5.9	5.1	27.9	8.5	63.7
<b>Poland</b>	23.6	103.4	24.0	10.2	49.0
<b>Total CC</b>	13.1	38.2	33.4	-4.5	42.1
<b>EU-15</b>	8.5	19.5	27.0	4.0	14.9

Source: Eurostat (2002).

While the indicators presented here offer a useful tool for assessing and comparing innovative capacity, it is important to point out that there is still considerable room for improving these instruments. The difficulty of comparing innovation performance and capacity across countries, and the lack of reliable and comparable data – particularly in the candidate countries –, as well as the need to ensure greater transparency in the collection and aggregation of data, significantly restricts the ability to formulate appropriate policy responses. Thus the European Commission remarked:

*A ... major issue for policy-makers is the lack of available reliable and internationally comparable survey data on innovation performance. Few firm conclusions can be reached either in terms of internal patterns of innovation or how countries are performing in comparison to their neighbours and future partners in the EU. In the absence of reliable data, policy decisions are more likely to be influenced by pressure groups and political considerations than by well-identified needs of enterprises.*

(European Commission (2001a,

p.78)

### **BOX 2: Nordic and Baltic countries – similarities and differences**

#### *Similarities*

- Small domestic markets and export orientation
- SMEs considered the backbone of the economy but are not the drivers of innovation (innovation takes place elsewhere)
- Perceived polarisation / dual nature of innovation and economic development within the countries

#### *Differences*

- Expenditure on R&D: much higher in Nordic countries than in the Baltic countries
- Innovativeness: Nordic countries rank very highly internationally, and much higher than Baltic countries, in terms of their ability to innovate.

## NETWORKING ECONOMIES – THE CASE FOR STRENGTHENING BALTIC/NORDIC COOPERATION

Aside from these common characteristics pointed out in the previous chapter, there are several indications of increasing economic interaction and integration between the Baltic and Nordic countries. One such sign is the rapid increase in foreign direct investment (FDI) by the Nordic countries particularly in Estonia, Latvia and Lithuania (see table 12).

In 2002, the Nordic countries were the main foreign director investor countries in Latvia, Lithuania and Estonia, accounting for between 31% and 71% of total FDI stocks in these countries. In the case of Poland, which attracts large FDI from France, Germany and the United States, Sweden was nevertheless the seventh largest foreign director investor in 2001 with 2.3 bn US\$. Together the four Nordic countries together accounted for 4.2 bn US\$ or 7.5% of total FDI stocks.

**Table 12: Foreign Direct Investment in the Baltic Sea countries, selected statistics**

	largest investor countries, end 2002		inward stock % of GDP, 2000	inward stock (bn US\$), 2001
	Country	% of total		
<b>Latvia</b>			<b>29.5</b>	<b>2.3</b>
	<i>Germany</i>	12.8		
	<i>Sweden</i>	12.4		
	<i>Denmark</i>	10.8		
	<i>Finland</i>	7.2		
<b>Lithuania</b>	<i>United States</i>	7.0	<b>20.6</b>	<b>2.7</b>
	<i>Denmark</i>	17.2		
	<i>Sweden</i>	15.3		
	<i>Estonia</i>	11.7		
	<i>Germany</i>	9.6		
<b>Estonia</b>	<i>United States</i>	8.7	<b>53.2</b>	<b>3.4</b>
	<i>Sweden</i>	40.9		
	<i>Finland</i>	26.9		
	<i>United States</i>	8.1		
	<i>Netherlands</i>	4.0		
<b>Poland</b>	<i>Norway</i>	3.3	<b>21.7</b>	<b>34.2</b>
	<i>France</i> <sup>1</sup>	18.0		
	<i>United States</i> <sup>1</sup>	13.7		
	<i>Germany</i> <sup>1</sup>	12.6		
	<i>Netherlands</i> <sup>1</sup>	8.1		
	<i>Italy</i> <sup>1</sup>	6.2		

<sup>1</sup> Figures are for 2001.

Source: Statistics Lithuania (2003) and UNCTAD (2003).

Whereas there is a big gap between the Nordic and the B4 when it comes to ability to innovate, one could argue that these two country groups are much closer when it comes to the level of maturity of innovation policy in their national contexts. In the past years, governments in both the Nordic countries and the Baltic States and Poland, have worked actively to design or improve national policies for innovation and enterprise development.

Thus, the Norwegian and Swedish governments are currently in the process of formulating national innovation strategies, while Finland and Estonia have recently evaluated their national innovation policies and/or national innovation systems (Georghiou et.al. (2003), Reid (2003)).<sup>5</sup>

Overall, similar to the Nordic countries and in contrast with a number of other candidate countries, innovation policy, and its importance for competitiveness and economic development is not a new concept in the B4 (for an overview over innovation policies in the candidate countries see European Commission (2001a), (2001c), (2001d) and (2003b), and Reid (2003)).

When it comes to designing and implementing effective policies for innovation and enterprise development in the B4 and the Nordic, there are a number of key policy issues common to both country groups:

- 1) **The role of policy-making – the possibilities and the limitations.** Policy-making plays a fundamental role in affecting/determining basic conditions for enterprise development and innovation, investment climate, etc., and thus, in enabling long-term economic growth and competitiveness. At the same time, however, policymakers should not overestimate the ability of policies to ‘create’ economic growth or innovation. As observed by Kuhlmann, one of the fundamental pitfalls when it comes to devising sound policies for innovation and enterprise development is the fact that economists tend to ignore political realities, while policymakers tend to overestimate the ability of public policies to stimulate the innovation system (Kuhlmann in European Commission (2003a), p.40). Policymakers seeking to design policies that will contribute to long-term economic growth and competitiveness need therefore to be highly aware of both the significant possibilities of policy-making but also of its limitations. This dichotomy is particularly important in countries with a strong faith in the ability of the government to intervene in markets, or with a long tradition of economic ‘dirigisme’ or planning, where there is a bias towards overestimating the ability of policies to steer economic development.
- 2) **The organization of policy-making.** Effective innovation enterprise policies require a horizontal and cross-sectoral approach to, and coordination of, policy-making. However, while national conditions for innovation and enterprise development are influenced by a broad spectrum of factors, - ranging from education, interest rates, incentive structures, to social structures and cultural aspects -, the institutions charged with designing and governing innovation policies tend to be narrow and vertical in their thematic focus. As a result, overall policy design is often characterized by fragmentation, overlap and rivalries or competition for resources and decision-making powers and competences. As stated by the European Commission, in most candidate countries, “The formulation and delivery is hindered by a lack of appropriate procedures, and by conflict between the various lobbies participating in the policy-making process” (European Commission (2002c)). The experiences with innovation policy in both the Nordic and the Baltic Sea countries presented and discussed at the workshop, indicate that there is a need to coordinate, evaluate, and possibly phase out some of, the numerous initiatives, and organizations, directed at promoting or facilitating innovation and SME development.
- 3) **Evaluation of policy-making.** Directly linked to the organization of policy-making is the importance of establishing procedures and strategies for evaluating and monitoring innovation and enterprise policies. Whereas most European countries have implemented a number of policies aimed at promoting innovation and enterprise development, many countries have no strategies or mechanisms for systematically assessing the effectiveness and usefulness of these policies. Evaluation should be included as an integral part of innovation policy design. Good recent examples of evaluations of national innovation policies and/or innovation systems can be found in Estonia, Sweden and Finland.

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<sup>5</sup> For evaluations of the Swedish and Norwegian innovation systems, see Andersson et.al. (2002) and (2003).



- 4) **Understanding the role of the public sector in and the importance of competition for innovation.** European economies tend to distinguish themselves from other economies and regions by the fact that relatively large sectors, usually but not only the public sector, are sheltered from competition. The size of the public sector in Europe increases its role in innovation-diffusion, “both as a user of technology and as a provider of skills, infrastructure and services” (Fagerberg in European Commission (2003a), p.19). In addition, however, it underlines the importance of the public sector’s capacity to understand and, when appropriate, adjust policy to changes in technology, organisational structures, nature and forms of innovation (networks, etc.), business strategies and practices, ways of doing business, consumer patterns and demands, etc. Thus, the ascent of the knowledge economy and a well-functioning innovation system put new and high demands on the ability of all actors, incl. academia and the public sector, to learn, absorb, adapt and innovate.
- 5) **The focus of policy-making:** As innovation policy matures in the Baltic and Nordic countries, there is a realization that policy initiatives have a tendency to focus on / or to be directed at research performers, ‘the top 10%’ of companies, not the bulk of enterprises. This is particularly the case for SMEs. In addition, when it comes to measuring, as well as designing and implementing policies for promoting innovation, there also appears to be a bias in favour of technological innovation as opposed to other forms of innovation (process or organisational innovation, for example). Future policies need to include measures targeted at encouraging or facilitating innovation in ‘traditional’ (as opposed to hi-tech or knowledge-intensive) enterprises and sectors.
- 6) **The instruments of policy-making:** In designing policies for strengthening innovation and enterprise development, there is a tendency in many European countries to focus on policy measures which fall within the realm of the ministry officially in charge of innovation policy, generally either the Ministry of Industry/Economy or the Ministry of Research/Education. Thus, measures aimed at promoting innovation and enterprise development tend to be focused on providing startup assistance to SMEs, creating institutions for promoting industry-academic linkages, networking, commercialisation of R&D, etc. While these are important tools for strengthening national innovation systems, they tend to be overemphasized in policy-making at the expense of other equally important areas, such as opportunities or possibilities (in terms of access to venture capital, for example), capacities, and incentives for innovation and enterprise development.

In light of the combination of the common interests, challenges and innovation policy issues, both the Baltic and Nordic countries stand to benefit significantly from exchanging policy views and experiences and for discussing and agreeing on common initiatives and policy solutions for strengthening their innovation systems and overall competitiveness. Furthermore, such cooperation will strengthen the regional economic integration of the Nordic/Baltic Sea area and create important synergy effects between these two regions.

In order for Nordic-Baltic cooperation on innovation, enterprise development and competitiveness to be effective and policy-relevant, discussions on and processes for strengthen innovation systems in the Baltic and Nordic countries should involve all relevant actors and stakeholders. In particular, they should include representatives from policymaking, academia and the business sector (according to the triple helix model). In addition, they should be based on a systemic, cross-sectoral or horizontal policy perspective and involve top level decision-makers.

**Box 2: Innovation and enterprise development: cooperation between Baltic and Nordic countries****Multilateral initiatives:**

- *Baltic Development Forum: summit organizer and networking forum for the Baltic Sea region created in 1999 ([www.bdforum.org](http://www.bdforum.org))*
- *Council of Baltic Sea States (CBSS) ([www.cbss.st](http://www.cbss.st)): an overall regional forum for intergovernmental co-operation among the Baltic Sea States (created in 1992); examples of initiatives within the framework of the CBSS:*
  - *Business Advisory Council ([www.tt.fi/bac/](http://www.tt.fi/bac/))*
  - *SME information site ‘Baltic Market’ [www.balticmarket.org](http://www.balticmarket.org)): information site for doing business in the region.*
  - *Baltic Sea Chambers of Commerce Association ([www.bcca.ws](http://www.bcca.ws))*

**Bilateral initiatives<sup>1</sup>:**

- *Latvian Chamber of Commerce and Industry and Latvian Development Agency are working with Denmark’s SME Association on “Fostering export ability in Latvia and Lithuania”*
- *Finnish experts (incl. TEKES) involved in the development of a national technology agency in Estonia as well as the development of an Estonian business development centre.*
- *Four Swedish government agencies are working with Latvian authorities to facilitate Latvia’s adaptation to becoming an EU Member State (twinning).*
- *Agency co-operation between Sweden and Estonia and Sweden and Poland on promoting the participation of SMEs in international R&D and business cooperation*

<sup>1</sup>European Commission (2002f).

There are currently a number of different forums for regional cooperation between the Baltic and Nordic countries which could serve as appropriate arenas for effectively addressing issues related to innovation, competitiveness and enterprise development between these two regions, such as the Council of Baltic Sea States and the Baltic Development Forum, which brings together Heads of States and Ministers to discuss key issues and challenges for the economic and social development of the Baltic Sea region (see also Box 2).



## CONCLUSIONS

The Baltic Sea countries have undergone, and are still in the process of undergoing the transition from planned economies to functioning and thriving market economies. The B4 have made substantial and impressive progress in this process, by implementing a number far-reaching structural reforms and establishing the institutions necessary for the development of functioning markets. The progress is reflected in significant and rapid increases in the use of ICT with some countries – which initially started out a dramatically lower level – rapidly approaching the levels of some of the existing EU Member States. It is also reflected in the high average GDP which particularly Estonia, Latvia, Lithuania, and Poland have experienced since 1995, and in the ability of these countries to attract substantial foreign direct investment.

Policymakers in the B4 are increasingly recognizing the importance of innovation policy for competitiveness and economic development. Similarly, the importance of a dynamic SME sector, for economic growth and job creation, is widely acknowledged. In the past years, the governments in these countries have worked actively to design or improve national policies for innovation and enterprise development.

Nonetheless, a number of important policy challenges remain with regard to enabling the development of a critical mass of innovative SMEs which are able to contribute to ensuring the competitiveness and vitality of the B4 economies in the Single Market in the long term.

Given a number of common challenges and interests, there is a case for strengthening Nordic/Baltic cooperation on innovation and enterprise development.

**BOX 2: Conclusions from IKED working group meeting (Riga, June 16-17, 2003)**

Based on the conclusions from the workshop, the following priorities for designing policies for innovation and enterprise development in Estonia, Latvia, Lithuania and Poland (B4 countries) were identified:

- 1) **Improving the coordination, organization and evaluation of policies.** In recent years a number of strategies and policies aimed at strengthening innovation and promoting SME development have been implemented in the B4 countries. As a result, some countries are currently experiencing an overlap, fragmentation and even competition of policy measures and institutions claiming to be in charge of innovation and/or SME policy. In order to ensure efficient and effective policy-making, the Working Group emphasizes the need for a horizontal, systemic approach to innovation and enterprise development. Governments should therefore continuously strive to ensure the coordination and improve the organization of innovation and SME policies. Furthermore, the Working Group recommends that evaluation and monitoring should be included as integral parts of innovation policy design.
- 2) **Strengthening innovative, entrepreneurial, absorptive and managerial capacities in the private sector, academia and the public sector.** The knowledge economy puts new and high demands on the ability of all actors to adjust and respond to changes in technology, organisational structures, nature and forms of innovation, business strategies and practices, ways of doing business, consumer patterns and demands, etc. A functioning innovation system therefore requires that all actors, - private sector, academia and the public sector -, have the skills and organizational and institutional structures necessary to learn, absorb, adapt and innovate. Particular areas in this context that should be addressed include venture capital (markets and policies), cluster policies, as well as human capital and entrepreneurship issues.
- 3) **Raising the general awareness of innovation policy and of its importance for economic growth and competitiveness.** As pointed out in a recent evaluation of innovation policy in the candidate countries, “innovation, in its broadest sense, remains a poorly understood, and even accepted, concept” (European Commission 2001a), p.158)). The Working Group agreed that there is a need to increase and improve the general awareness and understanding of innovation and innovation policy, and of its importance for economic growth and competitiveness. Increased awareness and understanding is vital for ensuring the coordination and the effectiveness of policies.
- 4) **Improving methods and data for measuring and comparing innovation performance.** The Working Group pointed out that, in order to ensure the design of effective and resource-efficient innovation policies, there is a need to improve data and methods for assessing and comparing innovation performance and capacity.

**Based on the insights gained during the workshop, the Working Group identified the following topics as possible themes for future workshops:**

- 1) Venture capital: markets, policies, experiences
- 2) EU Structural Funds: How to use EU Structural Funds to strengthen innovation, competitiveness and convergence?
- 3) Possibilities for Baltic cooperation on issues relating to innovation, knowledge economy and enterprise development
- 4) Cluster policies: models, best practices, directions for future policy design
- 5) Human capital issues (training, education, lifelong learning)
- 6) Innovation policy: awareness issues
- 7) Entrepreneurship
- 8) (Innovation in ‘non-market’ sectors?)

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## APPENDIX I

Agenda for Working Group Meeting, on *Designing policies for innovation and enterprise development*, June 16-17, 2003 in Riga

### PROGRAMME

**DAY 1: IDENTIFYING THE POLICY CHALLENGE – ESTABLISHING A COMMON FRAMEWORK**

**9:00-9:30 Registration of participants**

**9:30-10:00 Welcome address:**  
**Mr. Juris Lujans**, Minister of Economics of the Republic of Latvia  
**Mr. Juris Kanels**, Chairman of the Board, LDA  
**Mr. Arthur Bayhan**, Director, IKED  
**Mr. Kristian Birk**, Head of Division, Danish Agency for Housing and Enterprise (EBST)

**10:00-11:15 SME development in the Baltic States and Poland**

**CHAIR:** Arthur Bayhan, Director, IKED

Poland: Dr. Elzbieta Raciniewska, Expert, Ministry of Economy, Labour and Social Policy

Estonia: Pirko Konsa, Head of Enterprise Division, Ministry of Economy

Latvia: Andrejs Buharins, Director of Department of Entrepreneurship, Ministry of Economy

### DISCUSSION

**11:15-11:30 Contact break**

**11:30-12:30 Knowledge intensive SMEs and cluster development in the Baltic States and Poland**

**CHAIR:** Matti Pietarinen, Deputy Director General, Ministry of Industry and Trade, Finland

Dr. Kastytis Gecas, Director, Lithuanian Innovation Centre: “Promoting innovative SMEs in Lithuania”

Dr. Janis Stabulnieks: “National Innovation Programme – instruments for promoting high-tech business development in Latvia”

Jan Maier, Inno-Group: Building Innovative Competence Clusters

*Comments: (Possible comments by Raimonds Aleksejenko, Director of Industry Department, Ministry of Economy, Enn Metsar, Estonian Ministry of Economic Affairs and Communications, Aleksander Zolnierski, PAED)*

### DISCUSSION

**12:30-14:00 Lunch**

**14:00-15:30 Lessons/experiences/examples from other countries**

**CHAIR:** Kristian Birk, Head of Division, EBST

**SPEAKERS:**



Matti Pietarinen, Deputy Director-General, Ministry of Industry and Trade, Finland: “Innovation policy and SME development in Finland: characteristics, insights, developments”

Suzanne Håkansson, Deputy Director, Ministry of Industry, Employment and Communications, Sweden

Tomas Aronsson, Swedish Agency for Innovation Systems (VINNOVA)

Martin Hedman, IDC Coordinator, Sweden: “Industrial Development Centres – experiences and insights from a Swedish concept”

**15:30-16:00**      **Contact break**

**16:00-17:30**      **Identifying the policy challenge: what are the main issues facing Baltic and Polish SMEs in connection with the accession to the EU?**

**CHAIR:** Prof. Dr.oec. Uldis Osis, Member of the National Economic Council of Latvia

**SPEAKERS:**

Aisling Quirke, Innovation Policy Unit, DG Enterprise, European Commission

Charles Kovacs, Vice Chairman, Business and Industry Advisory Committee to the OECD (BIAC), Committee on Non-Member Economies

Nils Gabrielsson, Inno-Group: “Obstacles/challenges for the development of innovative and competitive enterprises in the new member countries”

**DISCUSSION**

**17:30-18:00**      **DAY 1: Wrap-up and conclusions by Mr. Charles Kovacs**

**19:00-21:00**      **Dinner Reception hosted by the Ministry of Economy of Latvia / Latvian Development Agency (Conference Centre of Reval Hotel Latvia, Hall Delta, 26<sup>th</sup> floor)**

**DAY 2:            POLICY SOLUTIONS**

**9:30-10:30**      **Innovation policy and SME development in the Baltic States and Poland: challenges, approaches, ways forward**

**CHAIR:** Charles Kovacs, Vice Chairman, Business and Industry Advisory Committee to the OECD (BIAC), Committee on Non-Member Economies

**SPEAKERS:**

Maria Vagliasindi, Chief Economist’s Office, EBRD, “Innovation Policy Challenges”

Daewon Choi, UNECE: “Industrial Clusters and Knowledge Clusters: Linkages”

Al Watkins, World Bank: “Creating commercially oriented national innovation systems and linkages between university research programs and private enterprises: experiences/ insights from the World Bank Knowledge Assessment Exercises”

Loreta Kriinauskienė, Managing Director, Alliance “Window to the Future”, Lithuania

**DISCUSSION**

**10:30-11:00**      **Contact break**

**11:00-12:15**      **Concluding discussion: What policy measures are required to ensure a successful integration of Baltic and Polish SMEs into the Single Market?**



**What possibilities/mandates/capabilities do the ministries have to design and implement sound innovation and SME policies? – conclusions and recommendations**

**CHAIR:** DaeWon Choi, Head of Knowledge Economy Programme, UNECE

**SPEAKERS:**

Raimonds Aleksejenko, Director of Industry Department, Latvian Ministry of Economy

Enn Metsar, Technology and Innovation Division, Estonian Ministry of Economic Affairs and Communications

**DISCUSSION**

**12:15-12:30**    **Wrap up and Conclusion by Sylvia Schwaag Serger**

**12:30-14:00**    **Lunch**



## **THE IMPACT OF EU MEMBERSHIP ON SMEs IN THE BALTIC COUNTRIES AND POLAND – DESIGNING POLICIES FOR INNOVATION AND ENTERPRISE DEVELOPMENT**

### **Background:**

Ten new countries are set to become members of the European Union in 2004. One of the central questions raised in this context is what will be the impact of joining the EU's internal market on small and medium-sized enterprises (SMEs) in the new member states. As a consequence of their integration with the European Union, considerable new opportunities can be anticipated for the SME-sector in these countries. On the other hand, competition in their home markets will intensify, bringing pressures and transition costs. A dynamic and competitive SME sector is pivotal for future economic growth and employment in these countries. What special measures are warranted by policy makers to improve prospects for SMEs to capture the new opportunities while handling the costs of the EU-accession.

IKED, in close cooperation with the Danish Agency for Housing and Enterprise (Erhvervs- og Boligstyrelsen), the Centre for Economic and Business Research (FORA) in Copenhagen, Denmark, and the governments of the three Baltic countries and Poland, is currently carrying out a multi-country programme that will focus on the impact of integration on Baltic and Polish SMEs into the European Union's Single Market. Building on the work on SME development carried out so far, the Baltic Programme addresses the specific policy challenges of ensuring the development of dynamic, innovative and internationally competitive SMEs once these countries have become members of the EU.

IKED is currently putting together a working group, consisting of high-level policymakers and experts from the Baltic States and Poland, as well as from the Nordic countries, including the representatives from countries who have undergone a comparable transition process in connection with their accession to the EU. In addition, qualified representatives from the European Commission will also be invited to participate.

The purpose of the working group is twofold: In the first instance, it will give experts and policy-makers from the Baltic countries and Poland the opportunity to exchange views and experiences with their counterparts in countries, which faced similar opportunities and challenges when they became members of the EU. In the second instance, it will bring together experts, policy-makers and business representatives from the countries in question to discuss, and agree on, specific policy proposals for improving SME competitiveness.

Based on the conclusions reached at the meeting of the working group in June 2002, policy recommendations for SME development in the Baltic States and Poland will be presented at the Baltic Development Forum Summit in Riga in October 2003.

## APPENDIX II

Participants in the IKED Working Group Meeting on June 16-17, 2003 in Riga

### **Latvia:**

- *G.Freimanis*, Deputy State Secretary, Ministry of Finance
- *R.Aleksejenko*, Director of Industry Department, Ministry of Economics
- *A.Buh\_rins*, Director of Entrepreneurship Department, Ministry of Economics
- *U.Osis*, Member of the National Economy Council
- *J.Stabulnieks*, Director, Latvian Technology Centre
- *V.Avoti\_*, Head of Engineering Cluster, Latvian Development Agency
- *J.D\_klavs*, Chairman of SME Commission, Latvian Chamber of Commerce and Industry
- *I.\_teinbuka*, Public Utilities Commission, Chair, (e-mail:

### **Estonia:**

- Pirko Konsa, Head of Division, Enterprise Division, Ministry of Economic Affairs and Communications
- Enn Metsar, Technology and Innovation Division, Ministry of Economic Affairs and Communications
- Alar Kolk, Member of Management Board, Enterprise Estonia Foundation,
- Üleri Alamets, Director of Regional Development Agency, Enterprise Estonia Foundation

### **Poland:**

- Aleksander Zolnierski, Specialist in the Analysis and Programming Section, Polish Agency for Enterprise Development (PAED)
- Dr. Elzbieta Raciniewska, Chief Expert, Ministry of Economy,
- Przemyslaw Kulawczuk, Expert, SME sector development support, Polish Chamber of Commerce

### **Lithuania:**

- Dr. Kastytis Gecas, Lithuanian Innovation Centre
- Loreta Kri\_inauskien\_, Managing Director, Allianace "Window to the Future"

### **Finland:**

- Matti Pietarinen, Deputy Director-General, Head of Division, Industrial Policy Division, Ministry of Trade and Industry

### **Sweden:**

- Suzanne Håkansson, Deputy Director, Ministry of Industry, Employment and Communications
- Thomas Aronsson, VINNOVA
- Martin Hedman, IUC Coordinator, University of Linköping

### **Denmark:**

- Kristian Birk, Head of Division, Danish Agency for Housing and Enterprise Development (EBST)
- Ejnar Andersen, Head of Section, Danish Agency for Housing and Enterprise Development (EBST)
- Ms. Heide Ehlert-Jürgensen, Confederation of Danish Industries

### **Norway:**

- (Jostein Djupvik, Senior Adviser, Ministry of Trade and Industry)

### **Hungary:**

- Charles Kovacs, Vice Chairman, Business and Industry Advisory Committee to the OECD (BIAC), Committee on Non-Member Economies

### **European Commission:**

- Aisling Quirke (TBC), Innovation Policy Unit, DG Enterprise, European Commission
- European Bank for Reconstruction and Development (EBRD):**
- Maria Vagliasindi, Chief Economist's Office, European Bank for Reconstruction and Development
- United Nations Economic Commission for Europe:**
- Dae Won Choi, Head of Knowledge Economy Programme, United Nations Economic Commission for Europe
- World Bank:**
- Al Watkins
  - Toms Baumanis
- Inno-Group:**
- Jan Maier
  - Nils Gabrielsson
- Baltic Development Forum:**
- Niels Vinther, Analyst
- IKED:**
- Arthur Bayhan, Director
  - Sylvia Schwaag Serger, Senior Programme Officer

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<sup>6</sup> <http://www.unece.org/indust/sme/smepubli.pdf>