

Development of the Financial Sector Infrastructure in an EU Candidate Country (The Case of Estonia)

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Document Version
Final published version

Publication date:
2004

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Citation for published version (APA):
Vensel, V. (2004). *Development of the Financial Sector Infrastructure in an EU Candidate Country (The Case of Estonia)*. LEFIC. Center for Law, Economics and Financial Institutions. LEFIC Working Paper No. 4

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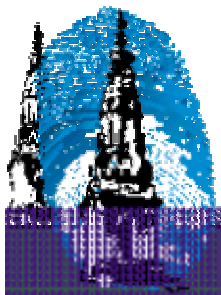
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LEFIC WORKING PAPER 2004-04

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Development of the Financial Sector Infrastructure in an EU Candidate Country (The Case of Estonia)

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Revised May 4, 2004

Abstract

In the 1990s, most of the Central and Eastern European countries (CEECs) went through radical liberalization and adopted large-scale economic and political reform programs. These programs included almost complete price, trade and capital movement liberalization, macroeconomic stabilization, currency reform, and small-scale and large-scale privatization. What is the role of the development of a legal and institutional infrastructure along with these radical changes in society and the economy? The first part of this paper is based on the results of an interview study of entrepreneurs and managers in Estonia undertaken in 1998 and in Estonia, Russia, Finland and Sweden in 2000 in order to obtain their view of the behavior of government agencies, lawmaking procedures and the operation of law enforcement mechanisms.

The second part of this paper presents summary results from interview surveys of Estonian manufacturing firms undertaken from 1994-2000. The surveys were designed to quantitatively measure the state of and changes in the Estonian business environment, focusing on the key aspects of financial contractual relationships of Estonian manufacturing firms as well as regulation and dispute resolution mechanisms. Among the observations it is noted that government regulations do not seriously affect business decisions regarding the operation, expansion or closing down of Estonian manufacturing firms. A second observation is that the Estonian court system is perceived as inadequate for resolving a substantial number of disputes and conflicts among economic agents although legislation exists. Most firms rely on mechanisms of self-enforcement when possible.

Journal of Economic Literature Classification numbers: K42, K49, G18, G30

Keywords: business environment, corporate financial relationships, enterprise restructuring, corruption, law making procedures, law enforcement.

Acknowledgement: This research was undertaken with support from the Estonian Science Foundation Program (Project 5185). Clas Wihlborg's participation was supported by the Johnson Foundation through the SNS Europe project Vello Vensel wishes to express his thanks to Tatjana Põlajeva for carrying out field studies in other countries.

1. Introduction

After the collapse of the Soviet Union, many of the former Soviet bloc countries began programs to reform their economic and political environments. One of the most successful of the Central and Eastern European countries (CEECs) has been Estonia. In little more than a decade it has affected almost complete price, trade and capital movement liberalization, macroeconomic stabilization, currency reform and small- and large-scale privatization. Among the newly admitted countries to the European Union it is a model of free market reform. That Estonia has managed to make such headway in the face of a legal and institutional infrastructure calcified by years of Soviet central planning, makes the accomplishment even more remarkable, even from an Estonian perspective.

This paper attempts to provide a glimpse of the role legal and institutional infrastructure plays when paired with radical changes in society and the economy. By direct interviews with Estonian entrepreneurs and managers, we provide a case study of financial market development in a transition economy. The focus is on two dimensions: 1) the quality of legal and state institutions that hold special importance for the financial sector and 2) the financing choices of firms and the constraints put upon them in financial markets by this existent infrastructure.

Before presenting the Estonian case study itself, it can be helpful to review what has been written and said about the economic aspects of a transition process. Thus, Section 2 takes a look at some of the factors influencing the success of transition, as identified within the framework of the New Institutional Economics.

Section 3 of this paper presents results from a special interview study of Estonian entrepreneurs and managers undertaken in 1998 and 2000. A questionnaire similar to the one used by Borner and Weder (1995) was used. Taking results from the survey with 128 respondents in 1998 and 142 respondents in 2000, we attempt to give a general picture of the behavior of government agencies, legislative procedures and law enforcement mechanisms. The Estonian results are then compared with results of a similar survey administered in Russia (132 respondents,) Finland (65 respondents) and Sweden (63 respondents) in 2000. Respondents for these countries were top managers from various industries with firms located mainly in large towns.

Section 4 presents a number of results from an Estonian interview study of manufacturing firms, undertaken on a yearly basis from 1994-2000 (for more details, see Vensel and Wihlborg 2001). The study was designed to capture and quantitatively measure the state of and changes in the Estonian business environment, focusing on the study of financial contractual relationships of Estonian manufacturing firms (the market environment aspect), but also including issues related to regulation mechanisms, dispute resolution mechanisms etc. (the non-market aspect). The main focus of this paper is on the most important factors influencing firms' financing and investment decisions. Between fifty and seventy firms responded to questionnaires during each interview round.

2. The Transition Process

There are several obstacles hindering the transformation of a formerly centrally-planned economy such as Estonia's into a well-functioning market economy. Underdevelopment of the legal system seems to be one of the most important limits to economic growth in

transitional countries. The most relevant issues in the underdevelopment of legal infrastructure include: 1) the incompleteness of major areas of law, 2) the lack of independence and specialization in the judiciary and, 3) the absence of mechanisms necessary for the court to enforce its decisions. Recent studies in developing and transition countries indicate that public sector corruption, which has ramifications within the legal system, is another major obstacle to the growth process of a developing country.

Yet despite the presence of these and other obstacles, Estonia has made good headway in overhauling its business environment. Among the reforms it has carried out are the following:

- privatization and restructuring of formerly state-owned enterprises in all industries
- development of the private sector in order to establish a competitive business environment, replacing planned allocation of resources and concentrated production
- restructuring of the financial sector, especially the development of a private commercial banking system, and the development of the financial markets
- liberalization of prices, capital movements, and international trade regime
- monetary reform and the introduction of a stable convertible domestic currency
- defining the new role of government, development of budgetary discipline, introduction of market-oriented fiscal instruments and social security programs, etc.

- **At present**, more than ten years' experience of transition to a market economy in CEECs exists.¹ According to Gomulka (2000, pp.18-19), policymakers have learned a number of lessons from the transition process with respect to requirements for a successful reform process:

- 1) The rapid creation of institutional, legal, microeconomic and macroeconomic conditions are essential for the development and growth of a new private sector, both domestic and foreign.
- 2) New private sector development requires measures to increase competition, such as liberalizing prices, permitting SOEs (State Owned Enterprises) to sell capital assets, imposing hard budget constraints on SOEs, encouraging foreign direct investment (FDI) and lowering entry barriers for new businesses.
- 3) Inflation rates need not need to be very low, but they must not exceed 40% annually and should converge with the average level in the EU.
- 4) A disinflation policy should involve all the key macroeconomic components: fiscal (tight fiscal policy), monetary (the cost of disinflation is lower if monetary authorities are politically independent, the extreme solution being currency board arrangements (CBAs), exchange rate policy; and wages and benefits policy where applicable
- 5) An independent central bank (CB) and a solid regulatory framework for financial institutions are essential as is a stable macroeconomic environment.
- 6) Since external credibility is vital to attract FDI and eliminate capital flight, the exchange rate should be competitive, but the choice of exchange rate regime is not crucial. The exchange rate should ensure that international reserves are high relative to imports and foreign debt, especially short-term debt

¹ Descriptions and broad analyses of the transition process can be found in, for example, Dillon and Wykoff, 2002; Golodko, 2002; Tumpel-Gugerelli et al., 2002, Mitra and Selowsky, 2002; Campos and Corricelli, 2002; and Orłowski, 2001 and Wypłoz, 1999.

- 7) Fiscal policy should aim to meet the Maastricht budget deficit and public debt limits, and to keep taxes low relative to GDP. Public spending should favor education and infrastructure at the expense of social transfers, defense, and subsidies
- 8) A high rate of structural unemployment requires changes in the labor code in order to increase labor market flexibility and active participation by the government in education and training
- 9) Most former SOEs, especially large ones, have suffered from “the British Leyland/Rover syndrome”-- i.e. the accumulation of structural problems of such magnitude that they are not amenable to significant “strategic” restructuring and growth (financial, managerial, and other constraints and poor positive incentives)

There is of course substantial interdependence among these requirements but we focus here on those explained by points 1, 2 and 5 -- points which primarily refer to financial market developments. Here, what is needed already in the earliest phases of transition is referred to by Kornai (1993) as financial discipline: “Financial discipline, as I see it, means the enforcement of four simple rules: 1) buyers: pay for the goods you buy; 2) debtors: abide by your loan contract; pay back your debt; 3) taxpayers: pay your taxes; 4) enterprises: cover your costs out of your revenues” (op. cit., 1993, p. 315).

Looking at the subject of corporate governance arrangements, Winkler (2000) emphasizes the key role they play in overall performance of a transition economy. Citing the Macedonian experience, he argues that when a country’s macroeconomic policy changes dramatically while the market infrastructure stays more or less the same, serious corporate governance problems arise. He also concludes that “[m]ost bank owners still regard their institutions as instruments for meeting their own liquidity requirements, so that they still deserve to be regarded as “market-distorting” rather than “market-supporting institutions” (op. cit., p. 280).

On the basis of the Bulgarian experience, Peev (2000) focuses on the particular features of so-called “crony capitalism” as a major hindrance. He points out that crony capitalism tends to thrive when institutional constraints (property rights, governance structures, market institutions) are undeveloped; there is a post-socialist rent-seeking culture; and quasi-state officials, quasi-owners, and quasi-managers have a short-term perspectives. (see Peev, 2000, p.349).

Examining the Russian experience, Buitter (2000) argues that insecure property rights and widespread predation, including rent seeking, lobbying, influence-seeking, theft, involuntary and unrequited transfer of property rights, extortion, as well as threats and actual violence against personal property, have depressed capital formation in all its dimensions: private, public, physical, human and environmental (see op. cit., pp. 603-604). Even international financial institutions are unable to make a significant contribution to the emergence and development of civil society in Russia and other transition economies; they can make only limited, albeit important, contributions to the governments’ reform programs.

In this paper the New Institutional Economics (NIE) definition of a “firm” is used; a firm is “a network of relational contracts between individuals ... with the purpose of efficiently organizing production” (Furubotn and Richter, 1998, p. 272). According to the NIE approach, three fundamental types of institutions, the market, the firm, and the state, have to be looked at in interaction. In other words, the tight links between the macroeconomy and the corporate sector are recognized. These links are two-way: (1) macroeconomic developments can affect the health of the corporate sector, especially if firms have to do business in an environment

that does not promote sound corporate governance and firms are highly leveraged; (2) the corporate sector can affect the macroeconomy through various channels and the prolonged period needed for corporate restructuring can significantly impair economic growth. Several researchers use an institutional approach to explain why the transition process is so complex and why it comes in so many shapes and forms (Moers, 2002; Van der Mortel, 2002).

There are three distinct aspects of poor economic governance in transition: First, excessive government intervention and discretion (regulation of private entities, adoption of preferential schemes) as well as trade restrictions, price controls, directed credits, tax exemptions, etc. can provide opportunities for eliciting bribes and/or kickbacks; Second, lack of government transparency and accountability as well as poor management hinder the establishment of an efficient civil service that can avoid conflicts of interest, develop an open budgetary process, and establish an efficient tax system; Third, the absence of a stable, rule-based, competitive environment cuts off nourishment for market activities.

While there are many traditionally accepted reasons why some countries lag behind others in the reform process -- to wit: unfavorable starting conditions (more years spent under the communist system; greater distance from the West and the incentive of EU accession; landlocked status, as is the case of Central Asia and the Caucasus; over-industrialization; civil conflicts) -- other reasons are more unconventional. For example, Havrylyshyn and Odling-Smee (2000) suggest that economic reform has been thwarted by rent-seeking vested interests. As they see it, someone always stands to gain if reforms stall halfway through the reform agenda. The stagnation of transition may be due as much to vested interests as to poor initial conditions. Thus, the old party and managerial elite (*nomenklatura*) may well become, ironically, the winners of partial reform: It quickly becomes clear that they can “reap much higher profits by obtaining privileges in a system marked by continuing government interventions than by setting up risky new ventures to restructure old, inefficient industries or starting up new companies” (*op cit*, 8).

Operation of the enforcement mechanism is very important, and if this mechanism does not function well, self-enforcement mechanisms are needed to fill the void. However, as Klein and Murphy point out, “transactors cannot rely entirely on self-enforcement, because the magnitude of the private sanction that can be imposed for non-performance is limited” (1997, 417). The strategy of private enforcement of public rules may sometimes serve emerging market economies well in the short and medium run, but judicial enforcement is surely the ultimate goal of legal reforms. The economic role of the state during the transition process is clearly defined by Frye and Shleifer (1997) and can be characterized by means of three basic models, as shown later in Table 1.

In this paper the development of state and legal institutions of particular importance for financial market development is studied with particular emphasis on Estonia in comparison with Russia and Nordic neighbors. Furthermore, we study how financial market developments have affected the pattern of firm financing.

3. Government Agency Behavior, Law Making Procedures and the Operation of Law Enforcement Mechanisms

In order to get a general picture of the role Estonian infrastructure plays in the development of financial markets, we created a questionnaire designed to probe the experiences of

business heads vis a vis government agencies, the courts and civil servants. The results of these interviews in 1998 and 2000 are presented in Table 2; thereafter, results are discussed.

Similar questions were also posed to an equivalent group in Russia and two Nordic countries -- Sweden and Finland -- and results for the year 2000 compared with those of Estonia. It should be noted that because Russia is so diverse, we broke the Russian results down to four categories: Russia overall, then the separate cities Moscow, Kaliningrad and St. Petersburg.

Table 1. The Economic Role of the State during Transition

Model	Legal Environment	Regulatory Environment
Invisible Hand	Government is not above the law and uses power to supply minimal public goods. Courts enforce contracts.	Government follows the rules. Regulation is minimal. Little corruption.
Helping Hand	Government is above the law but uses power to help some businesses. State officials enforce contracts.	Government aggressively regulates to promote some businesses. Organised corruption.
Grabbing Hand	Government is above the law and uses power to extract rents. The legal system does not work. The mafia replaces the state as enforcer.	Predatory regulations. Disorganised corruption and bribery. Bureaucrats adopt Helping Hand rhetoric

Source: Frye and Shleifer, 1997, p. 355.

3.1 The Behavior of Government Agencies

Our interview subjects were asked over a two year period to evaluate the operation of government agencies, legislative procedures and enforcement mechanisms in terms of the day to day dealings with civil servants and other agents of the government and judicial system. Questions were framed so as to permit respondents to express how rarely or frequently they met up with certain obstacles. For example, the variable “Civil Servants’ Arbitrariness” is a result of the question: Please evaluate to what extent the following statement applies in Estonia: “Laws and regulations are so complicated, unclear and sometimes even contradictory that it is impossible to adhere to them on a regular basis. Therefore, civil servants can always find ways and means of giving you a hard time (long delays, arbitrary decisions etc.). This happens: never (1), rarely (2), sometimes (3), frequently (4), mostly (5), or always (6).”

As can be seen in part 1 of Table 2, “*civil servants’ arbitrariness*” was a major complaint of the 128 respondents, who stated this was something they encountered “frequently”(with an average rating of 3.74 in 1998 and 3.49 in 2000 and a low standard deviation of 0.90 and 0.83 respectively.) In 2000, 56 respondents (39.4%) said that civil servants frequently give them a hard time and 57 respondents (40.1%) answered that this happens sometimes. Neither in 1998 nor in 2000 did one single respondent answer that this never happens. We may conclude that civil servants’ arbitrariness is considered a problem in Estonian society.

All other variables were formulated on the basis of analogous questions. With regard to the variable “*will to insist on rights*”, respondents gave “sometimes” an average rating of 3.23 in 1998 and 3.08 in 2000, (but the standard deviation of 1.57 and 1.46 respectively was high). The majority of the respondents answered that they either “rarely” demonstrated their will to insist on rights (35.9% of respondents in 1998 and 34.5% in 2000) or “sometimes” did so (25.0% and 24.6% respectively). The will to insist on rights in the face of civil servants’

Table 2 Estimates of Government Agency Behavior, Law Making Procedures and Law Enforcement Mechanisms in Estonia

	Year	Never (1)	Rarely (2)	Sometimes (3)	Frequently (4)	Mostly (5)	Always (6)	Mean	SD
1. Government Agency Behavior:									
Civil servants’ arbitrariness	1998	0	7	48	47	23	3	3.74	0.90
	2000	0	15	57	56	13	1	3.49	0.83
Will to insist on rights	1998	9	46	32	9	12	20	3.23	1.57
	2000	13	49	35	18	12	15	3.08	1.46
Civil servants’ misuse of power	1998	8	41	47	26	3	3	2.88	1.03
	2000	19	48	46	21	2	6	2.70	1.17
Knowing a civil servant personally – speeding up procedures	1998	2	4	23	36	41	22	4.38	1.15
	2000	0	9	41	39	25	28	4.16	1.22
Knowing a civil servant personally – influencing his or her decisions	1998	13	22	38	32	19	4	3.27	1.28
	2000	9	33	54	25	17	4	3.14	1.18
2. Law-Making Procedures:									
Predictability of law	1998	3	34	51	28	9	3	3.12	1.03
	2000	9	27	78	26	2	0	2.89	0.82
Information availability	1998	7	39	39	18	24	1	3.13	1.22
	2000	2	29	47	31	29	4	3.48	1.15
Opportunities to voice one’s concerns and opinions	1998	66	38	18	4	2	0	1.73	0.93
	2000	56	41	17	17	11	0	2.20	1.29
Credibility of Government announcements	1998	7	42	48	22	9	0	2.88	0.99
	2000	8	26	63	26	17	2	3.17	1.08
3. Law Enforcement Mechanisms:									
Objectivity of courts	1998	1	26	50	35	15	0	3.30	0.96
	2000	1	20	53	46	19	3	3.50	0.99
Power of money on the decisions	1998	0	7	27	45	41	8	4.13	1.00
	2000	0	16	44	34	40	8	3.86	1.12
Knowing the judge personally	1998	3	38	47	29	7	4	3.09	1.06
	2000	3	31	48	35	18	7	3.39	1.17
Turning to a higher court	1998	1	5	23	13	38	48	4.77	1.28
	2000	0	4	21	26	46	45	4.75	1.14

arbitrariness is thus apparently not high, and respondents seem to be of the opinion that insistence is mostly useless.

Respondents claim that civil servants are able to *misuse their power* “sometimes” (an average estimate of 2.88, with a standard deviation of 1.03 in 1998; 2.70 and 1.17 in 2000). In 2000, 46 respondents (32.4%) answered that civil servants are able to misuse power “sometimes”, 48 respondents (33.8%) that this is “rarely” possible, and 21 respondents (14.8%) that this is “frequently” possible. It is interesting that respondents evaluated civil servants’ arbitrariness as a more relevant problem than the risk of them misusing power. In any case, problems related to civil servants’ misuse of power (for example, in cases of blackmail) are relevant in Estonian society.

The next two variables are connected with cases in which the economic agent knows the civil servant personally. Most of the respondents stated that knowing the civil servant personally speeds up different procedures “frequently”, with an average estimate of 4.38 in 1998 and 4.16 in 2000. This can be dangerous, especially in a small society, as it could generate the basis for widespread cronyism. The variable “*knowing a civil servant personally - influencing his or her decisions*” was evaluated by respondents as being something they took advantage of “sometimes”, with an average rating of 3.27 in 1998 and 3.14 in 2000. It is also quite interesting that knowing the civil servant speeds up a concrete procedure “frequently”, but in most cases influences the decisions of the civil servant only “sometimes”. In any case, knowing civil servants personally affects their decision-making, and may especially speed up the relevant procedures.

Comparative estimates of government agency behavior in Russia as a whole and in Moscow, St. Petersburg and Kaliningrad in particular, as well as in Finland and in Sweden in 2000 are presented in Table 3. Although Estonia is somewhere between Russia and its Western neighbors, it is clearly closest to Russia. For example, while civil servants’ arbitrariness is estimated in Russia and in Estonia as something that is encountered “frequently”, with average rates of 4.17 in Russia in 2000, compared with 3.74 points in Estonia in 1998 and 3.49 in 2000), this phenomenon is estimated as “rarely” encountered in Finland and in Sweden, with average ratings of 2.09 and 2.28 points, respectively. The same quite clear differences exist with regard to the other characteristics of government agency behavior on the list.

3.2 Legislative Procedures

The variables characterizing legislative procedures in Estonia are presented in panel 2 of Table 2. The variable “*predictability of law*” is a result of the question: “As an entrepreneur, do you regularly have to cope with unexpected changes in laws and/or policies which could seriously affect your business? Changes in the law and policies are predictable: never, i.e. changes are completely unpredictable (1), rarely, i.e. they are mostly unpredictable (2), sometimes, i.e. they are frequently unpredictable (3), frequently, i.e. they are fairly predictable (4), mostly, i.e. they are highly predictable (5), or always, i.e. they are completely predictable (6).” Respondents evaluated changes in laws and/or policies as being “sometimes” predictable. The average score was 3.12 in 1998 and 2.89 in 2000. The standard deviations were 1.03 and 0.82). In 2000, 18.3% responded that they were mostly unpredictable. The figures in table 3 indicate that neither Estonia nor Russia are less predictable than Sweden and Finland. The score in Finland is actually the lowest.

Table 3 Estimates of Government Agency Behavior, Legislative Procedures, and Law Enforcement Mechanisms in Different Countries (Scale 1-6)

	Estonia		Russia 2000	Moscow	St. Petersburg	Kaliningrad	Finland 2000	Sweden 2000
	1998	2000						
Government Agency Behavior								
• Civil servants' obstinacy	3.74	3.49	4.17	3.93	4.10	4.33	2.09	2.28
• Will to insist on rights	3.23	3.08	2.73	2.63	2.93	2.64	4.06	4.41
• Civil servants' misuse of power	2.88	2.70	3.21	4.00	2.95	3.00	1.91	2.08
• Knowing a civil servant personally – speeding up the procedure	4.38	4.16	4.39	4.63	4.15	4.44	2.52	2.41
• Knowing a civil servant personally – influencing his/her decision	3.27	3.14	4.45	4.83	3.90	4.64	2.06	2.03
Legislative Procedures								
• Predictability of law	3.12	2.89	3.14	3.23	3.05	3.16	2.34	3.05
• Information availability	3.13	3.48	3.52	3.57	3.07	3.80	4.85	4.44
• Opportunities to voice one's concerns and opinions	1.73	2.20	1.73	1.50	1.85	1.77	4.45	3.65
• Credibility of government announcements	2.88	3.17	2.17	2.53	2.12	2.03	5.11	4.67
Enforcement Mechanisms								
• Objectivity of courts	3.30	3.50	3.27	3.43	2.95	3.41	5.45	4.79
• Influence of money on decisions	4.13	3.86	4.33	4.50	4.15	4.36	1.83	2.16
• Knowing a judge personally	3.09	3.39	3.64	3.63	3.82	3.36	2.02	2.00
• Turning to a higher court	4.77	4.75	3.98	4.43	3.41	4.13	4.91	4.87

According to Estonian respondents, the problem of “*information availability*” arose “sometimes”, with an average estimate of 3.13 in 1998 and 3.48 in 2000. In 2000, 47 respondents (33.1%) answered that information was “sometimes” available, 31 respondents (21.8%) that information was “frequently” available, and 29 respondents (20.4%) were of the opinion that information was “rarely” available. At the two extremes, two respondents were of the opinion that information was “never” available and four respondents that it was “always” available! In general, entrepreneurs do not seem to be able to get the information they wish about new laws or plans to change existing laws and policies.

Respondents were of the opinion that the possibility of “*voicing their concerns and opinions*” indirectly or directly was quite small. The opportunity to do so was clearly evaluated by respondents as rarely available (average estimate 1.73, with a low standard deviation of 0.93 in 1998 and 2.20 in 2000). In 2000, 56 respondents (39.4%) answered that they are never

consulted, and 41 respondents (28.8%) answered that this happens rarely. None of the respondents was of the opinion that they are always consulted.

Government announcements were evaluated by respondents as being “sometimes” credible (average estimate 2.88 in 1998 and 3.17 in 2000). In 2000, 63 respondents (44.4%) were of the opinion that government announcements were “sometimes” credible and 26 respondents (18.3%) that they are either “rarely” or else “frequently” credible. Only two respondents answered that government announcements are “always” credible. Faith in the “*credibility of government announcements*” is thus quite low, which is typical under the conditions of an unstable political and economic environment.

Comparative estimates of legislative procedures are presented in Table 3. The general conclusion is that there are great differences between Russia and the Scandinavian countries, and Estonia is positioned between them, but closer to Russia. For example, while respondents “mostly” had faith in the credibility of government announcements in Finland and in Sweden (with average ratings of 5.11 points and 4.67 points respectively), they “rarely” had faith in them in Russia (average 2.17 points) and only “sometimes” in Estonia (2.88 points in 1998 and 3.17 in 2000). It is quite interesting to mention that the credibility of government announcements was lower in the Russian towns of Kaliningrad (on average 2.03 points) and St. Petersburg (2.12 points) than in the capital Moscow (on average 2.53 points). Only the variable “*Predictability of law*” was estimated similarly in all countries – mainly as sometimes unpredictable.

3.3 Law Enforcement Mechanisms

Variables related to problems with the objectivity and credibility of courts were formulated on the basis of specific questions to respondents (see Tables 2 and 3). The variable “*Objectivity of Courts*” was formulated on the basis of the question: “Imagine that a private conflict is brought into court with the evidence being very clearly in your favor. Are you confident that the assigned judge will enforce the law objectively? Courts can be trusted to enforce the law objectively according to transparent rules: never (1), rarely (2), sometimes (3), frequently (4), mostly (5), or always (6).” Respondents estimated that this happens sometimes, with an average estimate of 3.30. In 2000, 53 respondents (37.3% of respondents) were of the opinion that courts can be trusted to enforce the law objectively sometimes, 46 respondents (32.4%) that this is frequently the case, and 20 respondents (14.1%) that this is rarely so. Thus, in most cases, courts are not trusted and economic agents must resort to self-enforcement mechanisms in the case of disputes.

Respondents evaluated that *money* frequently influences the decisions of courts (average estimate 4.13 in 1998 and 3.86 in 2000). This means that money changing hands influences courts: while outright bribery is one method, the wealthy may also be able to buy better legal services or pay off the other party. In 2000, 23.9% of the respondents were of the opinion that money can change the result of the court case frequently, 31.0% that this is sometimes possible, and 28.1% of the respondents that this is mostly possible. Eight respondents were sure that this happens always. Money thus seems to play an important role in court cases, a statement that is in accordance with widespread public opinion.

Respondents were of the opinion that *knowing the assigned judge personally* can sometimes influence the court procedure and result (average estimates of 3.09 in 1998 and 3.39 were given in 2000). In 2000, 48 respondents (33.8% of respondents) answered that this was true, 35 respondents (24.6%) were of the opinion that this was frequently true, and 31 respondents

(21.8%) that this is rarely the case. Personal relationships thus appear to play an important role in court cases. At least, it is a widespread perception that this is the case.

Respondents evaluated the demonstration of the *will to fight* against unfair court decisions as a commonly occurring event (average estimates 4.77 in 1998 and 4.75 in 2000). In 2000, 31.7% of the respondents were of the opinion that they would appeal to a higher court always and 32.4% that they would do so in most situations. It is quite surprising that although respondents do not trust the objectivity of the courts to any great degree, they are optimistic enough to *appeal to a higher court* in the case of unfair court decisions. A significant number of cases have been appealed, sometimes successfully, at a higher court in Estonia.

Comparative estimates of the characteristics of law enforcement mechanism are presented in Table 3. The general conclusion is the same as that mentioned above: there are significant differences between Russia and Nordic countries, and Estonia lies between them. For example, while respondents in Finland and Sweden said that they had faith in the objectivity of courts most of the time (average estimates 5.45 and 4.79 points, respectively), respondents in Russia and Estonia only sometimes have faith in the objectivity of courts (average estimates 3.27 in Russia, 3.30 in Estonia in 1998 and 3.50 in 2000). The demonstration of the will to resist and to turn to a higher court in the case of unfair court decisions was quite high in all countries and was estimated to occur frequently, even in Russia (average 3.98 points).

3.4 Uncertainties in Government Agency Behavior, Law Making Procedures, and Law Enforcement

In order to gauge whether any positive changes have occurred in Estonia vis a vis the uncertainties in government agency behavior, law making procedures and law enforcement, respondents were asked to assess the level of changes over the last five years. Results were formulated on the basis of the question: “Do you think that during the last five years uncertainties in dealing with government agencies/ in law-making /in law enforcement have increased (1), remained about the same (2), or decreased (3)?” The results are shown in Table 4. Although there was a slight improvement with regard to uncertainties in law-making procedures (average estimate 2.15 in 1998 and 2.30 in 2000) and in law enforcement mechanisms (average estimate 2.06 in 1998 and 2.17 in 2000), standard deviations of these estimates were very high. Thus, we may say that in general, Estonia’s uncertainties remained at about the same level over a five year period.

Comparing the Estonian estimates to different uncertainties in Russia, as well as Finland and Sweden, it was found that the level of uncertainties decreased in the two Nordic countries, but increased in Russia (with the exception of activity in Moscow.) These results are shown in Table 4.

Table 4. Estimates of Uncertainties in Different Countries

Uncertainties...	Estonia		Russia 2000	Moscow	St. Petersburg	Kaliningrad	Finland 2000	Sweden 2000
	1998	2000						
in dealing with agencies	1.96	2.28	1.95	2.17	1.76	1.98	2.11	2.41
In law making	2.15	2.30	1.82	2.03	1.85	1.69	2.55	2.43
In law enforcement	2.06	2.27	1.78	1.83	1.73	1.79	2.38	2.60

4. Financial and Regulatory Constraints on Estonian Firms

In an attempt to form a picture of financial and regulatory constraints on Estonian firms, we interviewed between 50 and 70 managers of firms operating in Tallinn and northern Estonia. Before moving on to gauge managers' impressions about these restraints and their impact on business dealings, we examined the makeup of the firms with regard to their control and ownership structure (Table 5).

The interview studies took place each year beginning in 1994 and ending in 2000. The majority of respondents were drawn from small (an average of 37.2% of the sample) and medium-size (49.6%) domestically owned private (73.8%) joint stock companies (70.4%) or limited liability enterprises (16.5%), which started business on the basis of personal savings (58.1%) after the year 1992 (64.1%), and which operate in the capital of Estonia, Tallinn (49.2%) and in northern Estonia (28.0%). The control and ownership structure of the firms is described in Table 5. Almost all firms had some kind of board of directors (average number on the board: 3.1 members) although some firms were managed by a managing director alone. In most cases, the distribution of voting rights was the same as the distribution of shares, but some of the respondents did not report distribution of voting rights and only one firm reported a distribution of voting rights that differed from the distribution of shares (the advantage going to the managing director and board members). A decrease over time in the share of employees and an increase in the share of board members in the distribution of shares are clearly observable.

In the following we study first, in 4.1, sources of financing and financial contractual relations. Thereafter we turn to Regulatory Constraints in 4.2, Dispute Resolution in 4.3, and finally Business Support Services in sub-section 4.4

Table 5. Distribution of Shares (%)

	1994	1995	1996	1997	1998	1999	2000	Mean
Managing director	21.6	18.4	20.5	15.1	23.9	20.3	17.3	19.6
Board members	17.6	22.3	24.8	30.9	29.7	27.5	41.4	27.7
Employees of the firm	27.5	24.8	21.6	19.5	14.4	11.3	9.8	18.4
Foreign owners	5.9	7.2	5.8	4.5	6.2	6.0	7.9	6.2
Other firms	11.8	12.3	8.4	9.9	14.0	7.7	6.2	10.1
Others (parent firm, previous employees etc)	15.6	15.0	18.9	20.1	11.8	27.2	17.4	18.0

4.1 Sources of Financing and Financial Contractual Relations

In this subsection we turn to a more detailed analyses of sources of financing in the period 1994-2000. We focus on source of finance of latest investments and the role of formal and informal loans.

Financing of Latest Additional Investment: Financing sources for the latest additional investment in 1997-2000 are presented in Table 6. The most important source of funding was retained earnings, which were used in 44.2% of total investments, and in 59.1% of investments in the form of acquisition of land. The share of bank loans, which was quite stable from year to year, was on average 18.5%. Although a number of firms use informal borrowing from relatives, friends and moneylenders, these loans are quite small and the share of such informal loans as additional sources was only 2.5% on average. The share of other financing sources (accumulated depreciation, leasing etc) was on average 19.6% and the share of supplier credit was 7.2%. For total investments there seems to be a trend towards a declining use of retained earning but the alternative source varies from year to year (% of firms indicating choice).

Table 6. Financing Sources of Latest Investment

Financing Source	Land					Buildings				
	1997	1998	1999	2000	Mean	1997	1998	1999	2000	Mean
Retained earnings	75.0	65.5	58.6	37.5	59.1	45.2	44.3	8.7	26.5	31.1
Personal savings	-	21.1	10.0	25.0	14.2	-	0.5	4.6	19.2	6.0
Loan(s) from friends or others	-	-	-	-	-	-	9.2	-	-	2.3
Bank loan	-	2.3	13.4	-	3.9	35.9	28.8	49.0	30.4	36.0
Supplier credit	25.0	11.1	18.0	-	13.5	-	4.3	7.7	-	3.0
Other sources (depreciation etc)	-	-	-	37.5	9.3	18.9	12.9	30.0	24.9	21.6
Total	100	100	100	100	100	100	100	100	100	100
Financing Source	Equipment					Total Investments				
	1997	1998	1999	2000	Mean	1997	1998	1999	2000	Mean
Retained earnings	43.9	41.1	37.2	47.6	42.5	54.7	50.3	34.8	37.1	44.2
Personal savings	7.1	2.0	0.6	5.8	3.9	2.4	7.8	5.2	16.6	8.0
Loan(s) from friends or others	4.2	5.0	4.5	6.7	5.1	1.4	4.7	1.5	2.2	2.5
Bank loan	16.8	18.2	14.5	13.3	15.7	17.6	16.4	25.6	14.5	18.5
Supplier credit	7.8	10.1	0.2	2.0	5.0	10.9	8.5	8.6	0.7	7.2
Other sources (depreciation etc)	20.2	23.6	43.0	24.6	27.8	13.0	12.3	24.3	28.9	19.6
Total	100	100	100	100	100	100	100	100	100	100

Borrowing from Formal Institutions: About half of the interviewed firms reported usage of overdraft facilities, most of them receiving overdrafts from one bank and others from two different banks (see Table 7). Firms that received loans either during the last year or the last five years of the study reported more exact terms and conditions of their loans. While about two-thirds of institutional loans were bank loans, the remaining loans were from non-bank financial institutions (for example, credit unions), government projects and foundations or from parent companies. As a whole, a larger share of firms gained access to loans and leasing contracts towards the end of the period. The size of loans has increased, too. Equipment as well as land and buildings were used as collateral to an increasing extent. Legal procedures seem to have become more important as enforcement mechanisms. We do not observe a trend in the average collateral to loan ratio however. Another indication of a hard budget constraint

imposed by lenders is that the maturity is prolonged to a lesser extent during the last few years.

Table7. Borrowing from Formal Institutions

	1994	1995	1996	1997	1998	1999	2000	Mean
Share of firms (%) using:								
Overdraft facilities	41.9	42.9	45.5	56.3	43.3	45.7	50.0	46.5
Granted loans	33.3	38.7	47.9	55.1	50.7	63.8	54.0	49.1
Leasing contracts	22.2	32.6	47.5	60.0	68.7	61.4	65.4	51.1
Share of bank loans (by number)	76.9	74.3	75.2	74.8	73.3	65.0	84.9	74.9
Average annual interest rate	24.6	18.2	16.7	16.6	12.4	12.1	10.8	15.9
Average amount of loans	?	1.67	3.68	2.12	4.18	3.30	8.12	3.85
Average value of collateral	?	1.22	5.11	5.26	7.30	4.72	7.43	5.17
Collateral/loan ratio	?	0.73	1.39	2.48	1.75	1.43	0.92	1.34
Type of collateral (%):								
Land and buildings	?	28.2	30.6	36.0	56.7	44.8	66.6	43.8
Equipment	?	37.7	42.1	32.0	33.3	51.7	23.8	36.8
Moving assets (stock, cattle etc.)	?	34.1	27.3	32.0	10.0	3.5	9.6	19.4
Penalties in the case of non-payment								
Interest penalties	42.8	37.6	31.4	27.6	29.0	57.6	53.3	39.9
Prolonging maturity	28.6	31.2	37.1	17.2	21.1	6.1	6.7	21.1
Initiating legal procedure	12.6	17.4	14.3	34.5	36.8	27.3	26.7	24.2
Others (interruption of the loan)	16.0	13.8	17.2	20.7	13.1	9.0	13.3	14.8
Share of firms applying for loans, %	36.8	47.2	62.5	51.1	52.2	42.2	35.8	46.8
Share of accepted loan applications	92.9	89.1	76.6	88.0	82.9	89.5	85.0	86.3
Reasons why the firm did not apply:								
High interest rates	37.3	3.9	27.3	7.4	10.8	16.0	6.2	15.6
Avoidance of debt	20.8	19.2	27.3	18.5	10.8	4.0	18.8	17.1
Do not need a loan	16.7	42.3	36.4	40.7	56.7	48.0	21.9	37.5
Complicated procedures	8.4	11.5	9.0	3.8	-	-	9.4	6.0
Insufficient collateral, probably will not be approved for a loan	8.4	23.1	-	29.6	5.5	12.0	28.1	15.2
Other reasons (parent firm is helping, already has a large debt etc.)	8.4	-	-	-	16.2	20.0	15.6	8.6

Informal Borrowing and Lending: As shown in Table 8, 22.4% of the respondents reported the usage of informal borrowing on the average, primarily because fewer formalities were involved and because of more favorable interest rates. Relatives and friends, as well as owners and parent companies, were reported as the main loan sources, while in some cases moneylenders and suppliers/clients were mentioned. Maturity varied from several months to several years, but was in most cases one year. The average annual interest rate decreased in the final years of the study to 7.9% in 2000. Collateral was only required in some cases, equipment being the main collateral. Prolonging the maturity was mostly mentioned in cases of non-payment at maturity.

The trend we can observe with respect to informal borrowing is that informal groups have become increasingly unimportant, and collateral is used to a decreasing extent. Relatives and friends remain the most important source of informal loans.

As can be seen in table 8, firms also lend to employees in particular, and secondly to other firms. We see no clear trend. A sign of decreasing cronyism is that loans to family members and friends have been declining, although the trend is broken in 2000.

Table 8. Informal Borrowing and Lending

Characteristics	1994	1995	1996	1997	1998	1999	2000	Mean
1. Informal Borrowing:								
Share of firms using informal borrowing	18.7	21.2	16.7	24.5	23.9	23.4	28.3	22.4
Main reasons for informal borrowing:								
More favorable interest rates	33.3	41.6	12.5	8.3	37.5	36.4	26.7	28.1
More flexible repayment schedule	16.7	25.0	25.0	58.4	-	-	6.7	18.8
Fewer formalities	33.3	-	25.0	-	31.3	54.5	46.6	27.2
Collateral is not needed	-	16.7	25.0	8.3	12.5	9.1	13.3	12.1
Others (could not obtain a bank loan)	16.7	16.7	12.5	25.0	18.7	-	6.7	13.8
Main loan sources/lenders:								
Relatives and friends	50.0	58.3	37.5	50.0	77.4	36.4	46.6	50.9
Moneylenders	16.7	16.7	25.0	16.7	12.9	18.2	20.0	18.0
Informal groups	-	16.7	25.0	16.7	3.2	-	6.7	9.8
Suppliers or clients	-	8.3	12.5	-	-	18.2	6.7	6.5
Others (individuals, parent company)	33.3	-	-	16.6	6.5	27.2	20.0	14.8
Average annual interest rate	28.4	22.3	19.8	16.3	11.1	8.1	7.9	16.3
Usage of collateral, %	16.7	22.5	37.5	25.0	25.0	9.1	6.7	20.3
2. Informal lending:								
Share of firms granted informal loans	23.0	34.2	29.6	35.8	37.3	31.1	22.7	30.5
Main loan recipients:								
Relatives and friends	14.8	27.8	5.3	3.2	8.0	14.3	20.0	13.3
Suppliers or clients	14.8	-	-	17.4	12.0	14.3	10.0	9.8
Employees	48.2	55.6	73.7	76.7	60.0	57.1	50.0	60.2
Other firms	22.2	16.6	21.0	2.7	20.0	14.3	20.0	16.7
Average annual interest rate	23.5	18.6	15.4	11.3	9.9	8.8	13.0	14.3
Usage of collateral (%)	33.3	28.4	47.4	21.7	38.1	46.1	60.0	39.3
Penalties in the case of non-payment:								
Interest penalties	-	12.5	20.0	16.7	4.0	8.3	-	8.8
Prolonging maturity	75.0	50.0	45.0	48.0	32.0	41.7	66.7	51.2
Initiating legal procedures	-	25.0	20.0	22.4	36.0	41.7	22.2	23.9
Others (use of agents, interruption)	25.0	12.5	15.0	12.9	28.0	8.3	11.1	16.1
Share of firms with the first loan (%)	86.7	75.0	84.2	88.2	72.0	71.4	81.8	79.9
Relationship to the loan recipient:								
Family member	25.0	12.7	12.5	4.3	8.0	7.7	10.0	11.5
Relatives or friends	25.0	22.3	12.5	4.3	20.0	15.4	20.0	17.1
Business relations only	50.0	58.3	75.0	56.5	64.0	69.2	70.0	63.3
Others	-	6.7	-	34.9	8.0	7.7	-	8.1

4.2 Regulatory Constraints

Regulations/Restrictions on Firms' Decisions on Activities: Table 9 lists a number of direct restrictions on financial activities as well as on general activities, licensing arrangements and joint ventures. On a scale of 1 to 5, with 5 the highest degree of relevance, the table shows average estimates of relevance of the various restrictions. The Estonian economic environment appears to be very liberal, without regulations/restrictions on firms' decisions regarding operation. Respondents mentioned domestic finance restrictions, with an average of 1.75 points on the scale between 1994-2000 and equity capital requirements, with an average

of 1.61, as being among the most relevant restrictions regarding decision-making. There is clearly a perception of declining restrictions on earnings repatriation, general activities and foreign loans.

Table 10 focuses on constraints that affect the cutting of production and the closing down of business units. Respondents evaluated the high costs of firing workers as the most important restriction on both the closing down the business and on reducing production, at an average score of around 3 between 1994-2000. There is no discernible trend. Trade union restrictions against firing and government restrictions on selling the enterprise were evaluated as non-relevant restrictions with an average of 1.43 and 1.64 points respectively. In general, all regulations and/or restrictions concerning the operation, expansion or closing down of businesses are relatively similar. This implies that the economic environment in Estonia is perceived as liberal.

Table 9. Average Estimates of the Relevance of Various Regulations/Restrictions Affecting Firms' Decisions on Activities

Regulations/Restrictions	1994	1995	1996	1997	1998	1999	2000	Mean
1. Relevance of Restrictions to Firms' Operating Decisions:								
Domestic finance restrictions	2.2	1.7	1.6	1.98	1.40	1.56	1.83	1.75
Earnings repatriation restrictions	2.0	1.5	1.2	1.40	1.12	1.35	1.25	1.40
Restrictions on activities	1.7	1.5	1.5	1.32	1.31	1.22	1.26	1.26
Capital requirements	1.7	1.5	1.9	1.66	1.43	1.49	1.62	1.61
Exchange restrictions	1.7	1.3	1.2	1.21	1.19	1.23	1.38	1.31
Foreign loan restrictions	1.7	1.9	1.5	1.27	1.19	1.27	1.33	1.45
Restrictions on technology licenses	1.6	1.2	1.3	1.12	1.17	1.19	1.34	1.27
Joint venture restrictions	1.3	1.0	1.0	1.34	1.14	1.13	1.09	1.14
Restrictions on payment of salaries to non-residents	1.2	1.6	1.4	1.29	1.15	1.21	1.09	1.28

Table 10. Restrictions on Reduction in Production and Closing of Business Units

Regulations/Restrictions	1994	1995	1996	1997	1998	1999	2000	Mean
A. Hindrances to Reducing Production:								
High financial costs of firing workers	3.1	3.5	3.5	2.35	2.60	2.93	3.40	3.05
Government restrictions on firing	1.9	1.6	2.0	1.40	1.57	1.81	1.90	1.74
Trade union restrictions on firing	1.4	1.2	1.5	1.29	1.37	1.48	1.51	1.39
B. Relevance of Hindrances in the Case of Closing Down the Business:								
High financial costs of firing workers	3.0	3.3	3.1	2.58	2.74	3.22	3.25	3.03
Legal procedure of liquidation	1.9	2.4	2.1	2.00	2.25	2.32	2.31	2.18
Government restrictions on firing	1.8	2.5	2.7	1.87	1.98	2.07	2.36	2.18
Government restrictions on the sale of enterprise	1.4	2.4	1.6	1.65	1.43	1.39	1.58	1.64
Trade union restrictions on firing	1.3	1.4	1.6	1.38	1.48	1.52	1.60	1.43

4.3. Dispute Resolution Mechanisms

In order to get an idea of how well the Estonian infrastructure is equipped to deal with settling business disputes, we queried managers about the nature of, first, conflicts with clients, suppliers, competitors, government agencies and commercial banks and second, the method of resolution of these conflicts inside and outside courts.

Late Payments and Non-Payments by Clients: A large number of respondents, it was found, have experienced problems with late payments or non-payment in recent years (on average 86.6% and 70.3% respectively in the period 1994-2000); and most of the firms had between 1-5 disputes a year in this period as shown in table 11. The main reasons behind late payment or non-payment were clients' difficulties in making payments, bankruptcies and lack of consideration towards business partners. The duration of business relations with the other party in cases involving late payment or non-payment problems was in general short, approximately 1-3 years (in 2000, for example, it was about 2.3 years on average – not shown). Dispute resolution and enforcement is an important aspect of contractual relations in a market economy. Absence of effective mechanisms creates uncertainty and either market failure or private participants may organize their own mechanisms for resolution and enforcement. Mafia-like organizations may arise. Table 11 shows our respondents' answers to questions about types of disputes with different parties and resolution mechanisms. In about one fourth of cases, it was the first transaction with the other party,. The other party of the dispute was usually another domestic firm (81.1% on average) and only rarely a foreign firm (7.5% of cases), an individual (5.8%), or a governmental institution (5.6% of cases). We can observe that late payment disputes with clients have declined while non-payment related disputes have been increasing.

Disputes with clients were resolved primarily through the use of direct bargaining (in an average of 92.3% of cases in 1994-2000),. The advice or services of a lawyer were not used very often (33.5% of cases). The threat of turning to the police or of taking the case to court was made in an average of 12.6% and 38.3% of cases respectively. Slightly more than one half (an average of 57.0%) of disputes were settled, and respondents expressed satisfaction with the outcome of the dispute settlement in an average of 49.5% of cases. About one half of respondents are still doing business with the other party of the dispute. There is no clear trend in the type of "other party to the dispute" and in the resolution mechanism.

Late or Non-delivery and Deficient Quality of Inputs/Services: Turning to disputes with suppliers in the same table (11), we note that about one third of all firms annually have had problems with late delivery or non-delivery of inputs/services. An average of 46.2% of respondents in the period 1994-2000 experienced deficient quality of inputs/services. The number of times firms have had these problems with suppliers during the years in question fluctuated, but was for the most part between 2-5, but some firms have had such disputes with suppliers ten or even more times (not shown). The other party of the dispute was typically another domestic firm (in an average of 66.6% of cases), but quite often also a foreign firm (in 30.0% of cases). As one would expect for supplier disputes, governmental institutions and individuals were rarely involved.

Table 11. Disputes With Clients and Suppliers (%)

Dispute Characteristics	1994	1995	1996	1997	1998	1999	2000	Mean
A. Disputes With Clients:								
1. Late payment problems (share)	92.1	88.2	87.3	81.3	89.4	85.1	83.0	86.6
2. Non-payment problems (share)	66.7	70.1	68.9	69.1	71.9	71.1	74.0	70.3
3. Other party of the dispute:								
• Other domestic firm	66.7	78.4	87.5	87.5	75.9	84.6	87.0	81.1
• Governmental institution	18.2	5.4	2.5	2.5	3.4	2.6	4.3	5.6
• Foreign firm	15.1	8.1	7.5	7.5	6.9	7.7	-	7.5
• Individual	-	8.1	2.5	2.5	13.8	5.1	8.7	5.8
4. Resolution of disputes:								
• Use of direct bargaining	100	96.2	93.8	80.0	88.1	94.7	93.3	92.3
• Use of private arbitration	-	-	5.0	2.5	3.7	5.3	4.3	3.0
• Threat to turn to the police	6.5	13.2	10.5	12.8	15.8	5.3	23.9	12.6
• Use of a lawyer	32.1	34.2	39.4	21.1	35.6	29.7	42.2	33.5
• Threat to take case to court	41.4	36.7	42.1	27.5	37.0	36.8	46.7	38.3
• Share of settled disputes	63.0	54.3	55.5	50.0	59.3	52.6	64.4	57.0
• Satisfaction with the outcome	51.6	52.2	44.4	43.6	54.2	47.4	53.3	49.5
• Still doing business with the other party	60.6	48.9	38.9	40.7	54.2	36.8	64.3	49.2
B. Disputes with Suppliers:								
1. Late or non-delivery problems	22.2	34.2	46.7	37.5	58.2	25.5	32.7	36.7
2. Deficient quality of inputs	38.7	42.1	58.5	37.5	61.9	38.3	46.2	46.2
3. Other party of the dispute:								
• Other domestic firm	61.5	80.0	73.1	45.5	57.4	73.7	75.0	66.6
• Foreign firm	30.8	10.0	26.9	54.5	36.2	26.3	25.0	30.0
• Individual	7.7	-	-	-	6.4	-	-	2.0
• Governmental institution	-	10.0	-	-	-	-	-	1.4
4. Resolution of disputes:								
• Use of direct bargaining	91.7	86.4	80.8	91.2	91.1	78.9	91.7	87.4
• Use of private arbitration	-	-	11.5	-	6.7	-	-	2.6
• Threat to turn to the police	-	3.2	-	-	2.2	-	-	0.8
• Use of a lawyer	9.1	12.4	11.5	9.1	13.0	5.6	4.2	9.3
• Threat to take case to court	18.2	8.3	11.5	9.1	4.3	-	-	7.3
• Share of settled disputes	61.5	75.6	92.0	82.6	93.3	90.0	91.7	83.8
• Satisfaction with the outcome	46.2	57.2	87.6	73.9	84.4	80.0	73.9	71.9
• Still doing business with other party	69.2	74.2	67.6	80.0	86.7	90.0	91.7	79.9

Only 4.2% of respondents reported in 2000 that it was their first transaction with the other party, and the duration of business relations with the other party was mainly between 1-3 years (not shown). Direct bargaining was the main mean of resolving disputes with suppliers and was used in an average of 87.4% of cases. A lawyer or private arbitrator was used very rarely, as was the threat to take the case to court (used on average in 7.3% of cases). In contrast, self-enforcement mechanisms worked quite well, with most disputes being settled (in an average of 83.3% of cases) and firms being satisfied with the outcome (in 71.9% of cases). The majority of respondents continue to do business with the other party of the dispute. The share of firms continuing to do business after disputes has actually been increasing. This result may be a reflection of the greater credibility of threats to go to court to resolve disputes.

Disputes with Competitors, Governmental Institutions, and Commercial Banks: Panel A of Table 12 shows disputes with competitors. The main causes were perceptions of dumping, unethical competition and breaking of agreements. An average of 14.3% of respondents had disputes with their competitors, sometimes more (for example, 22.6% in 2000). These disputes remained for the most part unsettled, with an average of only 27.5% being resolved.

Table 12. Other Disputes and Their Resolution

Disputes Characteristics	1994	1995	1996	1997	1998	1999	2000	Mean
A. Disputes with Competitors:								
Share of firms having disputes	5.4	12.5	14.9	20.4	13.4	10.6	22.6	14.3
Share of settled disputes	-	33.3	-	30.0	22.2	80.0	27.3	27.5
B. Disputes with Government Agencies:								
Share of firms having disputes	18.9	23.4	18.0	26.5	22.4	14.9	26.4	21.5
Other party:								
• Tax Office	85.7	54.8	28.6	30.8	46.7	57.1	57.1	51.5
• Customs Office	14.3	22.6	28.6	38.4	33.3	-	28.6	23.7
• Others (police, consumer protection agency)	-	22.6	42.8	30.8	20.0	42.9	14.3	24.8
Use of direct bargaining	42.9	58.6	71.4	53.9	53.3	28.6	50.0	51.2
Share of settled disputes	42.9	45.0	42.9	30.8	53.3	71.4	78.6	52.1
Satisfaction with the outcome	14.3	22.5	42.9	15.4	46.7	57.1	58.3	36.7
C. Disputes with Commercial Banks:								
Share of firms having disputes	18.4	16.7	10.9	12.2	20.9	14.9	5.7	14.2
Reason for the dispute:								
• Late transfer of payments	57.1	50.0	60.0	66.6	35.7	28.6	66.7	52.1
• Quality of credit services	42.9	25.0	20.0	16.7	42.9	28.6	-	25.2
• Quality of other banking services	-	25.0	20.0	16.7	21.4	42.8	33.3	22.7
Use of direct bargaining	28.6	48.7	60.0	50.0	78.6	42.9	33.3	48.9
Share of settled disputes	28.6	38.8	60.0	50.0	78.6	42.9	33.3	47.5
Satisfaction with the outcome	14.3	45.2	60.0	50.0	71.4	28.6	-	38.5
Still doing business with other party	14.3	56.7	80.0	83.3	78.6	28.6	66.7	58.3

Disputes with government agencies were caused mainly by different interpretations of laws and other legal acts. The opposing party in most disputes was the Tax Office (in an average 51.5% of disputes), followed by the Customs Office (in 23.7% of cases) and, less frequently, the police and the Customer Protection Agency. Direct bargaining with the governmental institution was used in 51.2% cases of disputes, and about one half of disputes were settled. The majority of firms were dissatisfied with the outcome, with only an average of 36.7% reporting that they were satisfied. However, both the share of settled disputes and the degree of satisfaction with the outcome increased significantly during the final years of the study period. There is no trend, but large fluctuations from year to year indicate that the agencies' experience in the market environment helped relations with firms.

The main reasons for disputes with commercial banks were the late transfer of payments by the bank and the quality of credit services. However, the share of respondents having disputes with commercial banks was not very high, with an average of only 14.2% of respondents

reporting problems. The fluctuations from year to year in this kind of dispute are substantial, while the total seems to be declining during the last few years after a peak in 1998. Less than half the firms (48.9%) used direct bargaining in resolving these disputes. While most of these disputes were not settled and only 38.5% of the respondents reported that they were satisfied with the outcome, the firms are still doing business with the other party. The share of disputes addressed through direct bargaining and the sphere of settled disputes are identical, usually to the firm's satisfaction as well. These figures indicate that the only way to address disputes with banks is through bargaining rather than through courts. It is possible that banks' information advantage in court makes court challenges difficult.

Legislation and Enforcement Mechanisms: In Section 2 it was shown that the Estonian legal system in 2000 was perceived as weaker than the established systems in Finland and Sweden but stronger than the systems in neighboring parts of Russia. According to Table 13, a large share of respondents during the years 1994-2000 found that Estonian legislation was inadequate for the resolution of disputes and conflicts between economic agents for various reasons, including contradictions and weaknesses in certain Estonian legal acts, such as the Business Law and the Bankruptcy Law; the lack of various specific legal acts, for example, regarding debt legislation and regulation of economic agents; the weakness of the court system; and the obstinacy of civil servants. Firms were of the opinion that legal acts should be based on real life and not on an ideal theoretical framework which is impracticable.

Only 42.4% of respondents were satisfied with Estonian legislation, and this percentage seemed to increase from 1996 through 1999, but it fell again in 2000. Less than half the respondents (47.3% on average) were satisfied with the available enforcement mechanisms. The perception of enforcement, like the perception of sufficiency of legislation, improved from 1996 through 1999 but deteriorates in 2000. The decline is small, however. Most of the respondents (66.1%) favored the use of self-enforcement mechanisms, such as, for example, dependence on the mutuality of a business relation, to achieve contractual arrangements with mutual safeguards. This result strengthens our earlier conclusions that the development of the legal framework is not yet satisfactory.

Table 13. Legislation and Enforcement Mechanisms

	1994	1995	1996	1997	1998	1999	2000	Mean
Sufficiency of legislation for resolution disputes and conflicts	37.5	36.7	32.5	45.8	53.8	51.1	39.6	42.4
Satisfaction with enforcement mechanisms	38.5	42.3	31.6	48.7	58.5	59.6	52.9	47.3
Support for use of self-enforcement mechanisms	64.0	68.0	65.8	65.0	69.2	64.4	66.0	66.1

4.4. Business Support Services

Governmental, Educational, and Other Institutions: Finally, we turn to certain functions generally considered important for a country's business environment. Table 14 shows the

main forms of business support services including consulting and legal advice services and business contacts. The following five institutions were indicated by respondents as the most important institutions supporting business during the observed period 1994-2000: training schools (48.9% of respondents reported that they received support from them), commercial banks (41.2%), the Estonian Tax Office (38.3%), the Estonian Commercial Chamber (32.3%), and the Estonian state universities (29.5%). Other institutions mentioned were lawyers' offices, accounting and auditing firms and the Environment Foundation.

**Table 14. Perceptions about Institutions Supporting the Business
(% of firms receiving support)**

<i>Institution</i>	<i>1994</i>	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>	<i>2000</i>	<i>Mean</i>
Training schools	53.8	44.7	39.6	42.9	46.3	44.7	70.2	48.9
Commercial banks	25.6	34.0	43.8	32.7	31.3	42.6	78.7	41.2
Estonian Tax Office	41.0	31.9	29.2	28.6	32.8	39.1	65.2	38.3
Estonian Commercial Chamber	15.4	19.1	31.3	32.6	40.3	36.2	51.1	32.3
Estonian Universities	28.2	40.4	31.3	24.5	22.4	34.0	25.5	29.5
Ministry of Economic Affairs	0	8.5	27.1	14.3	10.4	8.5	10.4	11.3
Estonian Privatization Agency	17.9	14.9	10.4	6.1	7.5	6.4	12.6	10.8
Estonian Labor Office	5.1	4.2	14.6	10.2	7.5	10.6	20.8	10.4
Estonian Export Council	2.5	4.2	16.7	12.2	7.5	6.4	8.5	8.3
Estonian Manufacturers Association	17.7	4.2	6.2	4.1	4.5	4.3	8.5	7.1
Estonian Small Business Association	7.7	8.5	12.5	6.1	4.5	6.4	4.3	7.1
Estonian Central League of Industry	5.1	8.5	12.5	6.1	6.0	4.6	4.3	6.7
Ministry of Foreign Affairs	10.2	6.4	8.3	6.1	7.5	4.3	2.1	6.4
International financial institutions	2.5	6.4	6.2	4.1	6.0	10.6	2.1	5.4

Commercial Banks: The average estimates made by respondents of the quality of different banking services using a five-point scale, with 1 representing poor quality and 5, excellent quality are presented in Table 15. The table is arranged according to the perceived average quality of service. The ranking of different services remains largely unchanged with the exception that “crediting of working capital” has gained quality relatively.

Table 15. Respondents' Average Estimates of the Quality of Banking Services

Banking Service	1994	1995	1996	1997	1998	1999	2000	Mean
Arrangement of domestic payments	4.4	4.4	4.5	4.29	4.27	4.15	4.23	4.32
Arrangement of foreign exchange	3.8	4.4	4.0	4.14	4.11	3.84	3.98	4.04
Speed of banking operations	4.1	4.2	4.2	3.86	4.07	3.89	3.91	4.03
Arrangement of foreign payments	3.6	4.1	4.0	4.11	3.90	3.92	3.71	3.91
Financial consulting	3.8	3.7	3.7	3.28	3.10	3.53	3.31	3.49
Crediting of working capital	2.9	3.0	3.6	3.56	3.23	3.18	3.47	3.28
Crediting of investments	1.9	2.7	3.0	3.39	2.92	3.08	3.31	2.90
Budgeting assistance	2.0	2.6	2.4	2.32	2.22	2.57	2.52	2.38

5. Concluding Remarks

On the basis of the survey results presented and discussed in this paper, a number of conclusions may be drawn with respect to financial sector development and firms' perceptions about the legal and regulatory environment supporting financial transactions:

- Retained earnings and personal savings are used to finance more than 50% of all investments. The share of firms borrowing from banks has increased but remains between 50 and 60%, substantially below levels in Western Europe. The average size of loans has increased substantially.
- Banks are able to enforce loans through legal procedures to an increasing extent.
- Relatives and friends remain the most important source of informal loans.
- Government regulations do not seriously affect Estonian manufacturing firms' decisions in relation to operation, expansion or closing down the business.
- A number of disputes and conflicts exist between economic agents, and Estonian legislation is inadequate for resolving these disputes. Furthermore, enforcement mechanisms do not function well and the majority of respondents relied on self-enforcement mechanisms.
- The quality of banking services has improved and is in general high, but still problematic are issues of budgeting assistance, long-term crediting of investments and short-term crediting of working capital.

The development of the legal and institutional infrastructure in Estonia seems to be lagging relative to the radical changes in the society and success in economic development: Sometimes entrepreneurs and managers are not informed clearly about new laws and plans to change existing laws and policies. In addition, they have few opportunities to voice their concerns and opinions indirectly or directly. The responses also indicate that there was little faith in the credibility of government announcements.

Law enforcement mechanisms and especially the court system are sources of dissatisfaction. Entrepreneurs and managers have little faith in the objectivity of courts and judges, and in most cases economic agents need to resort to self-enforcement mechanisms in various disputes and conflicts. Monetary power is perceived as influencing court decisions to a significant degree and personal relations (knowing the judge) influence court procedures and outcomes quite frequently according to the respondents. Nevertheless, Estonian entrepreneurs and managers are quite optimistic and are willing to appeal decisions deemed unfair to higher courts.

The arbitrary use of power among civil servants' is perceived to be high. There are some signs of "helping-hand" and "grabbing-hand" characteristics of the state in the Estonian legal and regulatory environment. Respondents feel that civil servants frequently find ways and means to give entrepreneurs and managers a hard time; sometimes they are able to gain a position of power and construct a case to blackmail entrepreneurs and managers. Personal relations with a civil servant can speed up relevant procedures and sometimes influence decisions. This phenomenon can be dangerous, especially in a small society, and generate a basis for corruption.

The perception of uncertainty about dealings with government agencies, about law-making rules, and about law enforcement mechanisms have not changed significantly during the last five years. These uncertainties have remained a concern.

A comparison of government agencies' behavior, law making procedures, and operation of the enforcement mechanism in Estonia, Russia, Finland and Sweden indicates that there are major differences among the countries. The legal and institutional environment in Russia is significantly less developed than in Finland and Sweden in particular, but also Estonia has progressed significantly relative to Russia in terms of quality of institutional environment for business. In Russia, and to a lesser degree in Estonia, the influence of bureaucrats' behavior is high, law-making procedures are unclear, and the enforcement mechanism does not function well. Uncertainty in dealing with government agencies, in law-making procedures, and in operation of the law enforcement mechanism decreased significantly during the five years leading up to the end of the study in Finland and Sweden while these sources of uncertainty were perceived as increasingly important in Russia. In Estonia the importance of these uncertainties neither increased nor decreased during the same period.

In spite of the rapid pace of reform and economic growth in Estonia, it appears from these studies of managers' perceptions that there is room for substantial improvement of the legal and the public sector infrastructure supporting transactions between firms and the financial sector.

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