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Structural and static prerequisites for the internationalization of small and medium-sized enterprises in the Baltic States

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Abstract

The pace and extent of internationalization of small and medium-sized enterprises (SMEs) is the result of the interaction of various factors and preconditions. This article examines one of these prerequisites – the currently established structure of SMEs in the Baltic States. The relationship between the different components of SMEs or the SMEs structure is the slowly varying parameters of the functioning of the economy. However, as an integral element of the economic system, the SME structure affects its development, including internationalization of business. Based on statistical data, the opportunities for small firms to outsource business activities as a perspective form of internationalization are analyzed. In the Baltic States the preconditions for scale outsourcing in general and information and communication technology (ICT) function outsourcing in particular have been established.

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1. Introduction

At the beginning of the XIX century the Industrial Revolution opened the sphere of production of material goods for the people who wanted to get rich. In the XX century the growth of the population welfare in industrialized countries created favourable conditions for expanding businesses in the service sector. The internationalization of economic relations that takes place against the background of the global expansion of personal computers and the Internet, has increased the attractiveness of entrepreneurial activity in the virtual marketplace. The coexistence of

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real and virtual markets for goods and services has contributed to the changes regarding the representation of the content and purpose of business that had formed in the society over time.

Today's entrepreneurs are able to demonstrate the wonders of adapting to changing market conditions by concentrating their efforts on meeting their own economic interests because these people:

- are not burdened with obligations to shareholders, who expect high dividends on the invested capital
- are sufficiently skilled at adapting to fluctuations of market conditions in real and virtual markets
- strive to implement specific, production programme does not require a significant investment

The term best meeting the criteria of entrepreneurship is “small and medium-sized enterprises” (SMEs), term which includes the businesses of various sizes and types. There is a large variety of the forms of small and medium-sized enterprises – from the traditional trade shops or craft workshop to innovative enterprises scattered across different countries. And, as in the early stages of the business formation, today the evolution of the enterprise using a small amount of factors of production from a tiny family business into a transnational corporation is very feasible.

For the businessmen of 21st century the strong will and developed intuition are not able any more to compensate the lack of knowledge and skills of business management. Ability of businessmen to operate professionally their own business is not only a condition of maintenance internal integrity of the enterprise, but also becomes a decisive factor in competitive struggle. Displacement of accents of activity of the businessman aside decisions of problems of management is substantially caused by qualitative changes of market space. Most obviously new quality of the modern market is shown in expansion of scales of cooperation of corporations and the small enterprises. Market cooperation various on scale of involved resources of the enterprises forces businessmen to think of a finding of „common language” with managers of corporations. Corporate management in its turn is compelled to adapt its organizational structure and methods of work to the features of market functioning of small business. Finally both independently operating businessmen and corporations do it with the purpose of creation and strengthening the competitive advantages of their business.

In general terms, in the scientific literature the expansion of SMEs across the boundaries of national markets is usually interpreted as the internationalization of business. The pace and extent of internationalization of SMEs is the result of the interaction of various factors and assumptions. In this article the authors have attempted to study one of these prerequisites – the structure of SMEs. The relationship among the different components of SMEs or the structure of SMEs is a slowly changing functional economic parameter. However, being an integral element of the economic system, the structure of SMEs influences its development, including also the internationalization of business.

The aim of this paper is to explore and describe structural and static prerequisites for the internationalization of SMEs with the emphasis on the Baltic States in comparison with the EU. The object of the research is the structure of SMEs in the context of exit out beyond the borders of the national economy, using outsourcing. In the paper the authors examine the current structure of the Baltic SMEs and try to justify the opportunities for small business to use outsourcing as a form of the internationalization of business activities. During the research the following challenges are addressed: to study and assess the structure of SMEs in 3 Baltic States; to get the theoretical and methodological background for the internationalization process; to explore the outsourcing as a perspective form of internationalization of SMEs; to base expectations of the service business outsourcing in the Baltic countries; to compare the opportunities of the Baltic States SMEs to outsource ICT function. The structure of the article has been made in accordance with the challenges. In the research, the authors have used bibliographic and teleological methods for gathering the scientific research, statistic methods – for empirical research performance and interpretation of the results. In Section 2 of the article, based on statistical data, the state analysis of the SMEs structure in the Baltic countries is given. Section 3 provides some methodological statements of the internationalization. Section 4 analyzes outsourcing as a perspective form of internationalization of SMEs. The main conclusions are given at the end of the paper.

2. The structure of SMEs in the Baltic countries

SMEs form the backbone of the EU economy accounting for 99.8% of non-financial enterprises in 2012, which equates to 20.7 million businesses. The overwhelming majority (92.2%) are micro-enterprises, defined as those with fewer than ten employees. Some 6.5% of SMEs in the EU are classified as small enterprises (employing between 10 and 49 people) and 1.1% are medium-sized (50–249 employees). Large businesses, with more than 250 employees, account for just 0.2% of the enterprises in the EU's non-financial sector. In employment terms, SMEs provided an estimated 67.4% of jobs in the non-financial business economy in 2012, almost identical to 2011 (67.4%) but up from 66.9% in 2010. (EU SMEs in 2012)

SMEs play a dominant position in the Baltic economies as well. Thus, large companies, with more than 250 employees, account for just 0.2% of enterprises in the Baltic States non-financial sector – see Table 1.

Table 1. Structure of the enterprises and persons employed in the non-financial business economy by size class of employment, 2010, % of total (total business economy; repair of computers, personal and household goods; except financial and insurance activities). (Eurostat, 2010)

		Total	From 0 to 9 persons	From 10 to 19 persons	From 20 to 49 persons	From 50 to 249 persons	250 persons employed or more
Estonia	number of enterprises	100.0	88.9	5.5	3.5	1.9	0.2
	persons employed	100.0	29.1	25.0		24.5	21.4
Latvia	number of enterprises	100.0	89.2	5.7	3.3	1.6	0.2
	persons employed	100.0	29.1	11.4	14.6	22.9	22.0
Lithuania	number of enterprises	100.0	89.0	5.6	3.4	1.8	0.2
	persons employed	100.0	25.0	11.0	14.9	24.6	24.5

Based on the information in Table 1 the SME structure in the Baltic States can be characterized as follows:

Firstly, in the Baltic States there is a very significant share of microenterprises – 89% in 2010. They absorb 25–29% of the persons employed in the non-financial sector in the Baltic States. This fact confirms the validity of the theoretical conclusions about the importance of entrepreneurship in solving employment problems. It is important to note that the micro-enterprises subgroup includes self-employed persons. According to the European Union, the self-employed are defined as persons who are the sole owners, or joint owners, of the unincorporated enterprises in which they work, excluding those unincorporated enterprises that are classified as quasi-corporations. The self-employed persons are classified here if they are simultaneously not engaged in a paid employment which constitutes their principal activity: in the latter case they are classified under employees.

The self-employed persons also include the following categories:

- unpaid family workers, including those working in unincorporated enterprises engaged wholly or partly in market production;
- outworkers whose income is a function of the value of the outputs from some process of production for which they are responsible, however much or little work was put in;
- workers engaged in production undertaken entirely for their own final consumption or own capital formation, either individually or collectively (European System of Accounts, 1996).

The self-employed persons accounted for 15.2% of total EU employment in 2012. 28.3% of the self-employed persons in the EU have employed staff. The highest proportion of the self-employed persons was recorded in Greece (31.9%), Italy (23.4%), Portugal (21.1%) and Romania (20.1%). The lowest proportion was registered in Estonia (8.3%), Luxembourg (8.4%), Denmark (8.9%) and Lithuania (9.7%) (Teichgraber, 2013). The outsider position of Estonia and Lithuania in the list indicates that the economies of these countries do not fully exploit the opportunities of involving the self-employed persons in market relations. Self-employment is attractive due to the opportunity to work at home and there is no need for a special room or office. Another advantage for being self-employed is the freedom in determining one's own work schedule, work productivity and customer base.

Secondly, small enterprises play a special role in the structure of SMEs. However, in the Baltic States the share of small enterprises in 2010 did not exceed 9% and the employed persons – 25–26% of the employees in the non-

financial business economy (see Table 1). In addition, in certain areas of the non-financial business economy of the EU there is a considerable number of persons employed in small businesses. Thus, in 2010, in the EU-27 the workers of small manufacturing enterprises accounted for 34% of the total number of employees in this direction of the non-financial business economy (see Table 2).

Table 2. The proportion of the employees of small enterprises, 2010,% in the total number of employees by the directions (Eurostat, 2010)

	EU-27	Estonia	Latvia	Lithuania
Manufacturing	34.0	24.8	26.3	23.4
Construction	27.7	31.4	32.5	30.2
Wholesale and retail trade; repair of motor vehicles and motorcycles	21.3	24.9	27.8	26.8
Transport & storage	17.5	24.1	21.3	26.2
Information & communication	16.9	20.1	20.9	25.4
Administrative & support services	13.5	17.1	23.9	15.2

Employment level in the small manufacturing enterprises in the Baltic States accounting for 23–26% is relatively low compared to the European average. In this context, it can be assumed that:

- the Baltic countries do not pay sufficient attention to supporting small manufacturing enterprises not only in comparison with the leading EU countries, but also the EU Member States as a whole;
- in industrialized countries small manufacturing enterprises are usually located in small towns. The regional dispersal of such small enterprises facilitates creation of jobs in the province and relieves tension in the urban labour market. In the Baltic States, particularly in Latvia, the emphasis on supporting small manufacturing enterprises in the regions would contribute to solving the problems of agglomeration in metropolitan regions;
- the internationalization of business should promote employment in the small manufacturing enterprises of the Baltic States. This, first of all concerns the creation of the preconditions for exporting the manufactured products to the EU market.

The relevance of business internationalization is even more obvious for the small service enterprises of the Baltic States. For example, in 2010 information and communication business activity in the EU-27 as well as in the Baltic States created relatively few jobs for small enterprises. In the EU-27 the share of the employees of small enterprises in the total workforce of this sector accounted only for 16.9%, in the Baltic States – 20–25%. From the point of view of large-scale virtualization of the global market space the condition of employment in the field of information and communication technologies should be evaluated very sceptically. Moreover, statistics here includes such modern business activity as computer programming consultancy and related activities. In Latvia only 1 457 people provided this type of services in small enterprises compared to 2 968 in Slovenia. The situation in the field of research and development causes even more concern: only 158 employees were engaged in the business of providing research services in small enterprises. It is obvious that the state of the business activity in the service sector is to a greater extent determined by the limitations of the local market than in the production of material goods. However, the internationalization of knowledge-intensive service enterprises is able to cardinaly change the situation.

3. Methodological survey of the internationalization

The traditional view that SMEs, especially small businesses, form the supply of goods and services primarily for the local markets still has many supporters among both researchers and the business community. Moreover, the expansion of SMEs into the global market space or the internationalization of business is considered to be a quite random and slow process. Among other things, the reasons for this should be sought in the quality of theoretical research on the process of SME internationalization.

Regarding the international dimension, several authors have proposed varied definitions of internationalization. A selection of definitions is proposed by Ruzzier, Hisrich, & Antoncic internationalization is a synonym for the geographical expansion of economic activities over a national country's border. The term started to be used when

the phenomenon gradually replaced imperialism as the dominant organization principle framing cross-border interaction between market economies starting in the 1920s. The economic internationalization process accelerated in the post-second-world-war era and appeared unrivalled until the early 1970s when a new phenomenon of globalization started to emerge. The existing research has focused on the internationalization of SMEs mainly from the point of view of the international activities of a firm or operations by applying product operation and market analyses or network analyses (Ruzzier, Hisrich, & Antoncic, 2006).

However, internationalization is more complicated than a simple process of market selection: the level of internationalization does not necessarily steadily increase. Firms can retrench or „de-internationalize” (Benito & Welch, 1997), they can internationalize rapidly after a long period of domestic focus (Bell, McNaughton, Young, & Crick 2003), and there may be several episodes of internationalization that eventually emerge as a long-term pathway of internationalization (Jones & Coviello, 2005). However, internationalization is more complicated than a simple process of market selection: the level of internationalization does not necessarily steadily increase. Firms can retrench or „de-internationalize”, they can internationalize rapidly after a long period of domestic focus, and there may be several episodes of internationalization that eventually emerge as a long-term pathway of internationalization (Kuivalainen, Sundqvist & Saarenketo, 2012).

The internationalization of SMEs has been studied from a variety of perspectives. Theories and models have been proposed to explain the international involvement of the firm including the economic theory, process or stage models, innovation-related models (I-models) pre-export and export-start models, network theory and international entrepreneurship theory. The economic theories have studied the internationalization of multinational enterprises (MNEs). These theories are mainly the product life cycle theory (Mejri & Umemoto, 2010).

Prior research on SME internationalization has discussed three major internationalization patterns: gradual internationalization as proposed by the Uppsala model radical internationalization as proposed by past research on born globals and new international ventures and radical but late internationalization as evidenced by the so-called born-again global firms. Describing gradual internationalization patterns, the Uppsala model has been applied both in the MNE and the SME context. The Uppsala model describes internationalization as a self-reinforced and incremental learning process in which firms gradually acquire knowledge about foreign markets and increase their commitment towards those markets. The emerging body of the born global research has shown that firms can become international shortly after or even from their inception. Observing the phenomenon of rapid revolutionary and dedicated internationalization the born global research challenges the assumption of gradual internationalization from both conceptual and empirical standpoints. The born-again global firms differ from born globals in the following respects: born-again globals start internationalizing much later, are well established in their home markets and have developed tangible resources that they can use for their international expansion (Olejnik & Swoboda, 2012).

The Uppsala Model, developed by the Swedish researchers. They consider that the internationalization process is an evolutionary and sequential one, which develops as the firm becomes more and more involved on the international market. According to the approach of the Swedish theorists, firms enter foreign markets in a gradual way, in accordance to the level of knowledge and the information accumulated about the estimation market. Firms gain knowledge and experience from their activity on the internal market, and, at a certain point, turn to external markets. The external markets have different degrees of attractiveness, in accordance to the geographical and cultural proximity to the home country. The Uppsala Model considers that the firms starts the approach of the international markets with the usage of the traditional export methods to countries closer from the perspective of geographical and cultural proximity, gradually developing complex ways to operate, at firm level, at destination country level, and towards geographical and cultural more distant countries. There can be distinguished four such methods for market penetration: irregular export, export through an agent, subsidiary and production. (Blomstermo & Sharma, 2003)

Entrepreneurs who have made the decision to enlarge the expansion to foreign markets by the algorithm of the Uppsala model must take into account the fact that its implementation may require substantial investment and the implementation period may be longer than planned. In other words, the owners of SMEs should be patient. Consequently, the Uppsala model of internationalization is focused primarily on the management of large enterprises. The models of the radical internationalization are, however, sufficiently adapted to the activity of SMEs

as well as correctly interpret scholars' ideas about the applicability of the Shumpeter's concept about the entrepreneur-innovator to a modern economy. Namely the emphasis on innovation is a characteristic feature of the entrepreneurs who opt for radical internationalization.

However, not all entrepreneurs who have ventured to carry out activities outside the national market space are innovators. Many SMEs, including knowledge-intensive ones, successfully compete in the global market without being innovative. The point is that the changes in the forms and methods of cooperation of enterprises that take place during the transition from the machine dominance in the production to a knowledge-based economy have become a real catalyst for the expansion of SMEs across the local market boundaries. This first of all concerns outsourcing as a form of co-operation between enterprises with different volumes of the used factors of production.

4. Outsourcing as a perspective form of internationalization of SMEs

In the broader interpretation outsourcing can be explained as the use of external resources – investment of outside resources. It is, in fact, the issue about placing the enterprise-customer orders with enterprises-contractors or outsourcers. Companies resort to outsourced services when engaging in an activity independently is either difficult or uneconomical. In addition, if the contractor is the company of another country the term 'offshoring' is used.

There are three criteria outlined in literature according to which it is possible to distinguish outsourcing from simple or even full transfer of non-core competencies to specialized enterprises – performers. The first criterion – the transferred competence is an indispensable part of a technological cycle, instead of arise from time to time by virtue of necessity. And the most important – supports the basic business of the company. The second criterion – this competence is closely linked with to other organizational processes and consequently constant interaction between customer and outsourcer is vital. Proceeding from this the third criterion is formulated – performance of this competence assumes adaptation of forms and methods of outsourcer's work to the requirements of the customer.

In practice outsourcing it is submitted by the following basic forms:

1. Use of services of the outside enterprises for performance of own tasks (industrial, financial, commercial, etc.).
2. Refusal from own business – process and purchase of services for realization of this process at other enterprises and the organizations.
3. Remote (with the help the Internet) use of results of work of foreign programmers.

Encyclopedia of Small Business affirms, that the companies which decide to use outsourcing, are guided exclusively by the solving problems of business profitability. The basic advantages of outsourcing, according to the given criterion, the authors of Encyclopedia of Small Business see in the following:

Cost savings. Many businesses embrace outsourcing as a way to realize cost savings or better cost control over the outsourced function. Companies usually outsource to a vendor that specializes in a given function and performs that function more efficiently than the company could, simply by virtue of transaction volume.

Staffing levels. Another common reason for outsourcing is to achieve headcount reductions or minimize the fluctuations in staffing that may occur due to changes in demand for a product or service. Companies also outsource in order to reduce the workload on their employees (freeing them to take on additional moneymaking projects for the business), or to provide more development opportunities for their employees by freeing them from tedious tasks.

Focus. Some companies outsource in order to eliminate distractions and force themselves to concentrate on their core competencies. This can be a particularly attractive benefit for start – up firms. Outsourcing can free the entrepreneur from tedious and time – consuming tasks, such as payroll, so that he or she can concentrate on the marketing and sales so activities that are most essential to the firm's long – term growth and prosperity.

Morale. This an often – overlooked but still notable benefit that can sometimes be gained by initiating an outsourcing relationship.

Flexibility. Still others outsource to achieve greater financial flexibility, since the sale of assets that formerly supported an outsourced function can improve a company's cash flow.

Knowledge. Some experts tout outsourcing of computer programming and other information technology functions as a way to gain access to new technology and outside expertise. This may be of particular benefit to small businesses, which may not be able to afford to hire computer experts or develop the in – house expertise to maintain

high – level technology. When such tasks are outsourced, the small business gains access to new technology that can help it complete with larger companies.

Accountability. Outsourcing is predicated on the understanding – shared by business and vendor alike – that such arrangements require quality service in exchange for payment.

The modern enterprises successfully cooperating with the large enterprises do it, as a rule in the form of outsourcing. Outsourcing was initially distributed regarding the services of consulting and auditor firms. Over recent years, in connection with prompt development of personal computers, the Internet and mobile communications and their penetration into all spheres of life software outsourcing has been introduced and becomes more and more claimed.

International sourcing of business functions is a common feature as the European Union's businesses increasingly globalize their production processes. To find out more about this phenomenon a new survey gathered data on the international organization and sourcing of business functions in 15 European countries. The survey results presented in this article cover nearly 40 000 businesses each with more than 100 persons employed. The survey identified several types of functions that support the core business function of an enterprise. These are distribution and logistics, marketing and sales, administration and management, Information and Communications Technology or ICT services, R&D and engineering (Eurostat, 2012).

When using, for example, software outsourcing the outsourcer takes over the service functions of the enterprise-customer information system through consultation and administration, creation of software products and provision of other services. As a result, the companies that have entered into the outsourcing contract will acquire the opportunity to use a number of competences in software services at higher profits (utility) for their own business. How does it work?

Firstly, the enterprise-customer enters into the outsourcing contract with the outsourcer for which software maintenance is the core business. Consequently, the enterprise-customer saves on the costs of servicing their business because it acquires qualitative services provided by highly skilled professionals using the latest advances in the field of software development.

Secondly, the enterprise-customer receives high quality services because outsourcing contracts are usually signed with companies that have accumulated knowledge in the field of software.

Thirdly, the enterprise-customer pays for the performed work usually in stages allowing its owners to optimize their cash flow.

Entrepreneurs in the Baltic States are still very passive in using the benefits of outsourcing for expanding the scale of their internationalization. This thesis is illustrated by the situation in the field of ICT (see Table 3).

Table 3. Sourcing status the Baltic States ICT services enterprises, 2011 (number of enterprises; %) (ICT services: IT-services and telecommunication. IT services consist of hardware and software consultancy, customized software data processing and database services, maintenance and repair, web-hosting, other computer related and information services. Packaged software and hardware excluded) (Eurostat, 2013)

			Total	Including		
				function is sourced domestically	function is sourced internationally	function is not sourced
ICT services	Estonia	number	514	26	11	477
		%	100.0	5.1	2.1	92.8
	Latvia	number	600	135	11	454
		%	100.0	22.5	1.8	75.7
	Lithuania	number	945	6	3	936
		%	100.0	0.6	0.3	99.1

In 2011 the largest activity in the use of outsourcing was demonstrated by Latvian ICT service enterprises, 24.3% of which practiced outsourcing. However, for the most part they did it domestically. In 2011 only 2% of the Baltic States ICT service enterprises implemented their ICT functions internationally.

Completeness of information is the most important barrier to the internationalization of SMEs. This thesis is supported by the results of the survey of SMEs in the Baltic States in the framework of the Ballard project. The Ballard project aims to open up the markets around Central Baltic Sea Region for digital services by developing a

network of Living Labs to support SMEs in their internationalization efforts. With a help of an on-line survey and interviews the Ballard project approached all together 106 SMEs. This includes 39 SMEs from Estonia, 26 from Latvia, 24 from Finland and 17 from Sweden. The respondents mostly collaborate with partners from the domestic market. Finding relevant market information is the greatest barrier to international collaboration in product development. 40% of all respondents find this an "extreme barrier" or a "serious barrier". The Estonian and Latvian SMEs in particular deem finding relevant market information the most serious barrier: 41% of Estonian and 43% of Latvian respondents rated it as a "serious barrier" or an "extreme barrier" (Central Baltic Living Labs for Digital Service, 2011).

In the Baltic States the preconditions have formed for enlarging the scale of outsourcing in general and the ICT function outsourcing in particular as the economies of the Baltic States are characterized by:

- education institutions that fully satisfies the demand for programmers in the local labour markets
- the relative competitiveness of salaries for the professionals engaged in ICT function outsourcing
- developed ICT infrastructure
- legislative framework that meets international standards in the copyright protection and confidentiality issues
- the location of the Baltic States entrepreneurs in the common cultural and historical space of Europe

Outsourcing can be seen not only as one of the trends of business internationalization, but also as a means for strengthening a company's market position. In this case, it must be assumed that the effect is achieved by the use of outsourcing in the enterprise-customer as a result of the reorganization of its organizational structure and qualitative changes in the management. The new market conditions, formed when a company outsources its services, force its employees to acquire the relevant skills. The capacity expansion includes the acquisition of knowledge, gaining experience and acquiring skills that is, the formation of the company management competencies for meeting the requirements of outsourcing.

Conclusions

In the Baltic States there are a fairly large number of micro-enterprises. The statistics on the structure of the micro-enterprises also includes the self-employed persons. In the Baltic States economies, especially in Estonia and Lithuania, the opportunities to involve self-employed persons in market relations are not fully utilized.

In the Baltic States, particularly in Latvia, the emphasis on supporting regional small manufacturing enterprises would facilitate addressing the agglomeration problems of the regions around the capitals.

Economic policy designers in the Baltic States should pay particular attention to small enterprises providing services. The condition of entrepreneurship activity in the field of services is to a greater extent than in the production of material goods determined by the limitations of the domestic market. Consequently, the internationalization of knowledge-intensive service enterprises might change the situation.

Many small and medium-sized enterprises, including the knowledge-intensive ones, successfully compete in the global market using outsourcing as the form of cooperation as. Entrepreneurs in the Baltic States are still quite passive in using the advantages of outsourcing for expanding their scale of internationalization.

In the Baltic States the preconditions have developed for enlarging outsourcing in general and the ICT function outsourcing in particular. Outsourcing should not be seen only as one of the trends of business internationalization, but also as a means of strengthening the market position of the company.

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