



Global Entrepreneurship Monitor

2005 Latvia Report

Vyacheslav Dombrovsky, Mark Chandler, Kārlis Krēslīņš
with contributions by Olga Rastrigina, Egita Uzulēna, Friederike Welter
Sponsored by TeliaSonera
The TeliaSonera Institute at the Stockholm School of Economics in Riga



TeliaSonera



LATVIAN FACTS
Market and Public Opinion Research



RIGAS EKONOMIKAS AUGSTSKOLA
STOCKHOLM SCHOOL OF ECONOMICS IN RIGA

GLOBAL ENTREPRENEURSHIP MONITOR

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Founding and Cooperating Institutions:

TeliaSonera
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FOREWORD

In 2005 Latvia participated in the Global Entrepreneurship Monitor (GEM) for the first time. GEM is a major international research project aimed at describing and analyzing entrepreneurial processes across a wide range of countries. This volume represents the Latvian country report based on original data collected in Latvia for GEM. The report has been written by researchers at the Stockholm School of Economics in Riga (SSE Riga), the Baltic International Centre for Economic Policy Studies (BICEPS), and the TeliaSonera Institute at the Stockholm School of Economics in Riga. We are convinced that the report will contribute to the knowledge and understanding of the factors influencing entrepreneurial activity in Latvia.

Latvian participation in GEM would not have been possible without the generous support of TeliaSonera through the TeliaSonera Institute at SSE Riga.

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EXECUTIVE SUMMARY

GEM provides policy makers and others interested in entrepreneurship with a level of detailed information about entrepreneurship that was not previously available. Sincere gratitude goes to our sponsor, TeliaSonera, for making this possible.

The level of early-stage entrepreneurial activity in Latvia involves 6.6 % of the adult population. This means that close to 100,000 individuals in Latvia are in the early stage of business creation. Compared with other countries participating in the GEM survey, the level of early-stage entrepreneurship in Latvia can be characterized as somewhat below average. By contrast, early-stage entrepreneurship in Ireland, with the highest levels of entrepreneurship in Europe, stands 50 % higher than in Latvia.

Although this is the first GEM research in Latvia, evidence from a comparable study suggests a dramatic growth in the scope of entrepreneurship in Latvia over the last two years.

The Vidzeme region shows the highest level of early-stage entrepreneurship, followed by Riga, then Latgale, Zemgale, and Kurzeme. Regional disparity in early stage entrepreneurship is substantial, with Vidzeme being twice as entrepreneurial as Kurzeme.

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Most early-stage entrepreneurs in Latvia feature in consumer-oriented services, such as the retail trade. In general, sectoral distribution of entrepreneurship in Latvia is broadly similar to the pattern observed in other European countries.

Entrepreneurship plays an important role in job creation in Latvia. Some 37 to 55 thousand new jobs were created in 2004 and early 2005 by early-stage entrepreneurs.

Compared with other countries, entrepreneurship in Latvia is characterized by high activity rates among the young and very low activity rates for the old. GEM research suggests that in the long run demographic change (i.e. an aging population) can influence the entrepreneurial capacity of the country, because older people are found to be less likely to be entrepreneurs.

As in many other countries, entrepreneurship in Latvia has a strong gender dimension. Only about 40 per cent of all early-stage entrepreneurs are women. Compared with other countries in the GEM project, however, women in Latvia are highly active in entrepreneurship.

Entrepreneurship in Latvia also has a strong ethnic dimension. The Russian-speaking ethnic minority is notably underrepresented among entrepreneurs. An ethnic Russian is only half as likely to be an early-stage entrepreneur as is an ethnic Latvian.

Level of education and amount of work experience are strongly correlated with entrepreneurship. Indeed, entrepreneurs perceive value in acquiring education.

Family background might be a particularly important influence on entrepreneurship in Latvia. Some 35 per cent of early-stage entrepreneurs reported having parents-entrepreneurs, as compared with a mere 13 per cent among non-entrepreneurs. Entrepreneurs in Latvia enjoy a very high level of cultural support from the population and the media. In terms of level of cultural support, Latvia ranks third highest among the EU countries surveyed.

Nearly 42 per cent of business owners planned to expand their business in the next year. About 19 per cent of those who did not plan to expand identified difficulty in obtaining financial resources as the most important barrier to expansion. Overall, however, it does not appear that significant artificial barriers prevent growth of businesses in Latvia.

Corruption remains a significant problem in the Latvian business environment. Nearly 43 per cent of all entrepreneurs thought that public officials are "often" or "very often" bribed to avoid complying with regulations. Moreover, about one-third of all entrepreneurs think that public officials are "often" or "very often" bribed to change the rules of running a business.

Many entrepreneurs in Latvia trust in the ability of the courts to enforce contracts. More than half of all business owners expressed readiness to defend their interest in the courts against either private suppliers or public officials. Most of those who were not willing to use the courts explained that alternative measures for resolving disputes exist, that court proceedings are expensive, and courts are not objective in their decisions. Reservations about objectivity of the courts constituted the main reason for unwillingness to go to court against public officials. The amount of nascent enterprise start-up financing expected in Latvia is quite low, although access to capital is rather limited. The average cost of establishing a start-up enterprise in Latvia in 2005 was € 36,200. However, half the enterprises in Latvia were established with capital below € 9,960. 38 % of all entrepreneurs (both nascent and established business owners) regard own capital as the main source of start-up funding.

The incidence of informal investments in Latvia stands marginally above the average of the GEM EU countries. About 2.7 % of respondents reported that they had provided financing for the creation or expansion of enterprises in Latvia over the last three years. Average informal financing in 2005 stood at €14,840 compared with the EU average of € 38,000 but the typical investment was much lower with 50 % of informal investors investing only about €2,130.

Employment expectations of Latvian entrepreneurs are high enough to be comparable to such extremely entrepreneurial countries as the USA and Germany. Moreover, high-expectation early-stage entrepreneurship in Latvia appeared to be far more frequent than in developed European countries.

The proportion of innovative early-stage entrepreneurs in Latvia is only about a half of the proportion in the middle-income countries or in the high-income countries region. All three innovative characteristics (novelty of product, intensity of competition, and novelty of technologies) are relatively rare among Latvian firms.

Experts see the most significant problem of innovative entrepreneurship in Latvia in the lack of a sound scientific and technological base, as well as poor knowledge transfer from universities and public research organizations to new and growing firms.

Higher education seems to be a favorable factor when employment expectations of early-stage entrepreneurs are formed. A former managerial position appears to be a useful experience for established businesses with growth potential as well as for innovative entrepreneurs. However, gender and income differences seem not to play an important role for entrepreneurial growth potential and innovativeness.

A number of recommendations expressed by experts and entrepreneurs consulted outlined the importance of government policy and government programs. Transparency of legislation, improvement of the taxation system, and increase of support systems as well as provision of state-guaranteed loans were among the most essential issues mentioned by respondents.

Another important factor will be change and improvement of the existing education and training system in order to support innovative and knowledge-intensive businesses. Finally, financial and professional support, market openness, and regional development will also to a great extent foster entrepreneurial activities and development of entrepreneurship in Latvia.

1. INTRODUCTION TO GEM AND WHAT IT DOES

The three main objectives of the Global Entrepreneurship Monitor are:

- To measure differences in the level of entrepreneurial activity between countries.
- To uncover factors determining the levels of entrepreneurial activity.
- To identify policies that may enhance the level of entrepreneurial activity.

In light of these objectives, GEM focuses on the role played by individuals in entrepreneurship. After all, people start new firms, and people determine the entrepreneurial attitude of established firms regardless of size. Clearly, entrepreneurship is a complex phenomenon and can be found in a variety of settings and situations. No single measurement, no matter how precise, can fully capture the entrepreneurial landscape of a country. Thus, GEM provides a comprehensive (though by no means exhaustive) set of measurements aimed at describing several aspects of the entrepreneurial make-up of a country.

GEM investigates different points in the cycle of the entrepreneurial process and the corresponding characteristics of the entrepreneur's actions. An individual who is just starting a venture and trying to make it in a highly competitive market is an entrepreneur, even if lacking high growth aspirations. Another individual may be an established business owner who has been operating for some years but who remains innovative, competitive, and growth-minded. This individual is also an entrepreneur.

Within this context, GEM data collection observes three points in the life-cycle of the entrepreneurial process, by looking at individuals:

- when they commit resources or start a business (nascent entrepreneurs),
- when they own and manage a new business that has paid wages for more than three months but less than 42 months (new business owners), and
- when they own and manage an established business that has been in operation for more than 42 months (established business owners).¹

For GEM, paying wages for more than three months to anybody, including the owner, is considered to be the "birth event" of actual businesses. Businesses that have paid salaries and wages for more than three months and less than 42 months are considered to be new. When considered together, nascent entrepreneurs and new business owners may be viewed as an indicator of

early-stage entrepreneurial activity in a country. Business owners who have paid salaries and wages for more than 42 months are classified as "established business owners." Their businesses have survived the liability of newness.

With respect to the characteristics of business ownership that can be viewed as "entrepreneurial" regardless of the age of the business, broad consensus exists that growth expectations and innovativeness are fundamental properties of entrepreneurship. GEM allows us to look at aspects of innovative propensity, as well as the growth aspirations of businesses.

Finally, the quantity and quality of entrepreneurial activity taking place in a country is a function of the entrepreneurial capacity of that country. Assessing such capacity requires assessment of the characteristics of a country's most important resource: its people. GEM allows us to look at the socio-economic characteristics of people as well as their subjective perceptions and expectations of the entrepreneurial environment.

2. SCOPE OF ENTREPRENEURIAL ACTIVITY IN LATVIA

GEM estimates the level of involvement in early-stage entrepreneurial activity by calculating the sum of nascent entrepreneurs and new business owners.²

- Nascent entrepreneurs are individuals between the ages of 18 and 64 who have taken some action in the past year toward creating a new business. In order to qualify for this category, these individuals must also expect to own a share of the business they are starting. Additionally, the business must not have paid wages or salaries for more than three months.
- Owner-managers of firms are classified as new business owners if they report being active as an owner-manager of a new firm that has paid wages or salaries for more than three months, but less than 42 months.

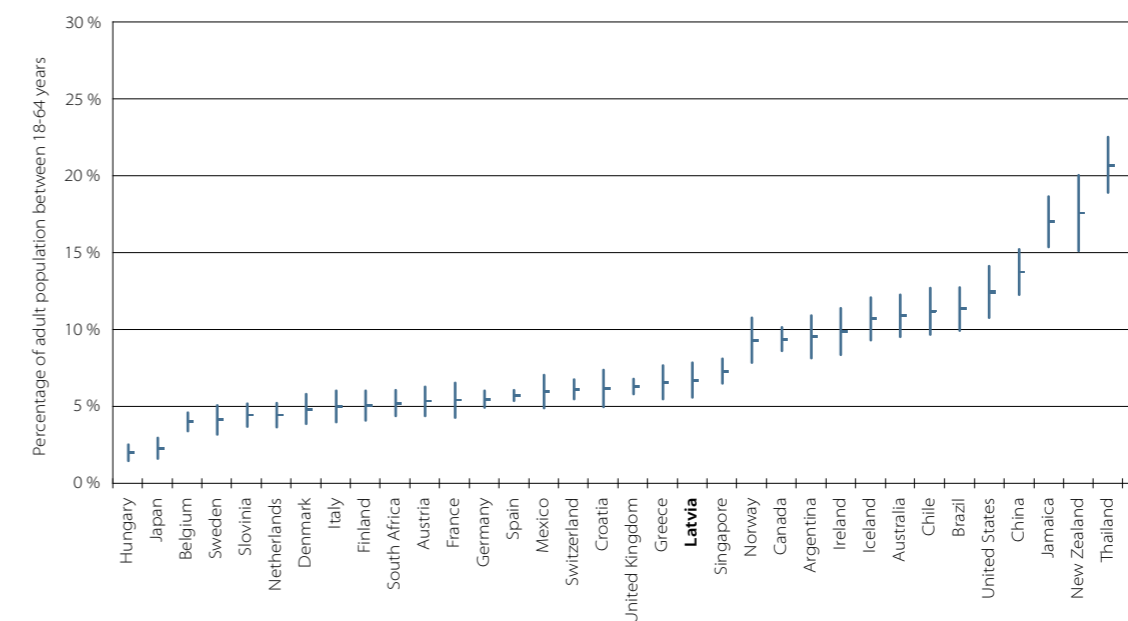
GEM uses the sum of these two measurements to calculate the prevalence rate of early-stage entrepreneurial activity in each country. Figure 1 shows the prevalence of early-stage entrepreneurial activity in the 35 participant countries in 2005.

The level of early-stage entrepreneurial activity in Latvia stands at 6.6%. That is, one in fifteen of the adult population aged between 18 and 65 are either actively planning to start a new busi-

ness or have recently done so. This means that close to 100,000 individuals in Latvia are actively planning to set up a new business and are in the process of doing so, or have set up a new business over the 42 months prior to the GEM adult population survey. Compared with other countries that participated in the GEM survey, the level of early-stage entrepreneurship in Latvia can be characterized as below average. Latvia is not nearly as entrepreneurial as the United States, China, or Ireland, but more entrepreneurial than Sweden, Japan, or Hungary. As shown by the GEM research, Thailand, New Zealand, China, and the United States are among the most entrepreneurial countries in the world, as measured by the index of early-stage entrepreneurial activity. The most entrepreneurial country in Europe is Ireland.

In addition to individuals currently involved in the early stages of a business, many others have also owned and managed a business for a longer time. These individuals are included in the established business owner index, which captures the percentage of individuals in a population owning and managing a company that has paid wages or salaries for more than 42 months. Figure 2 shows the prevalence rates of established business owners across countries in 2005.

Figure 1: Early-Stage Entrepreneurial Activity² by Country 2005



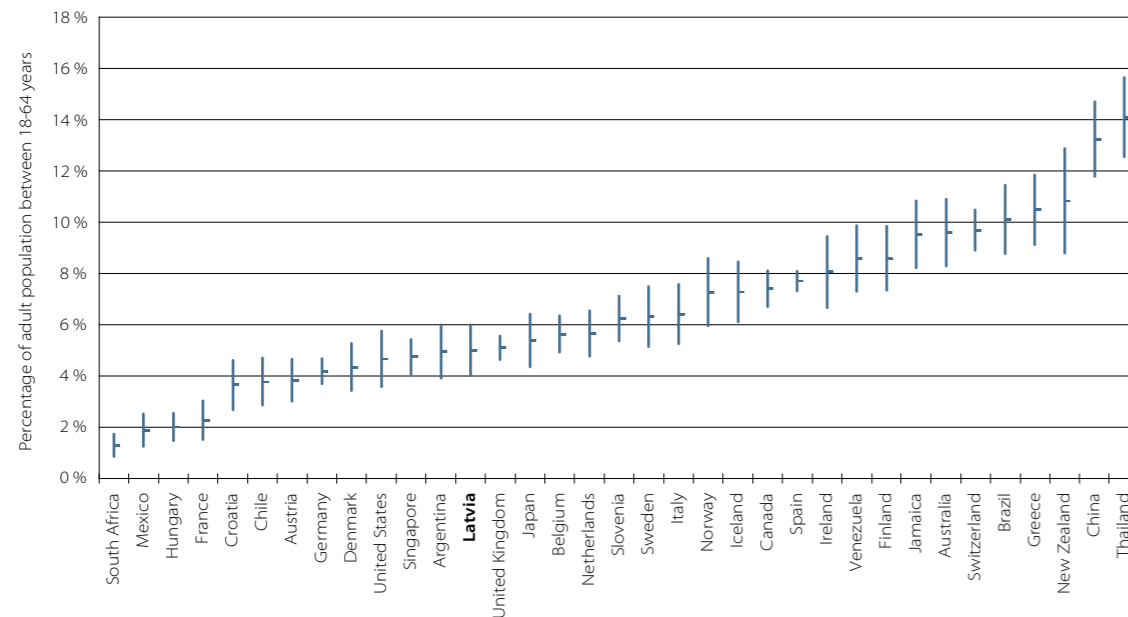
Notes: The vertical bars in the chart display 95% confidence intervals.

² Respondents who qualify as both "nascent entrepreneur" and "new business" are counted only once. See Appendix on details of data collection.

³ Formerly known as the Total Entrepreneurship Index (TEI)

¹ A detailed discussion of the idea and methods behind the initial phase of GEM can be found in Reynolds et al. 2005.

Figure 2: Established Business Ownership by Country 2005



Notes: The vertical bars in the chart display 95 % confidence intervals.

Table 1 provides an overview by country of the different stages of entrepreneurial activity measured by GEM. The early-stage prevalence rate consists of the combined count of nascent entrepreneurs and new business owners, while the overall rate of entrepreneurial activity consists of the count of early-stage plus established entrepreneurs. One would expect that more people plan to set up a business than in fact do so; indeed,

GEM research shows this to be the case. Approximately 60,000 nascent entrepreneurs in Latvia are in the process of starting a new business or actively planning to do so. Typically, nascent entrepreneurs are still in full-time employment. In addition, within the previous 42 months some further 40,000 entrepreneurs have started a new business of which they are the owner-manager.

Table 1: Prevalence rates of entrepreneurial activity across countries 2005

	Nascent Entrepreneurial Activity	New Business Owners	Early-stage Entrepreneurial Activity (Nascent + New)*	Established Business Owners	Overall Business Owners (Nascent + New + Established)	Number of Observations
Thailand	9.7 %	13.1 %	20.7 %	14.1 %	34.8 %	2,000
Venezuela	18.8 %	7.5 %	25.0 %	8.6 %	33.1 %	1,856
New Zealand	9.4 %	10.0 %	17.6 %	10.8 %	28.2 %	938
China	5.6 %	9.4 %	13.7 %	13.2 %	26.7 %	2,109
Jamaica	10.5 %	6.7 %	17.0 %	9.5 %	26.4 %	2,031
Brazil	3.3 %	8.2 %	11.3 %	10.1 %	21.4 %	2,000
Australia	6.5 %	4.7 %	10.9 %	9.6 %	20.4 %	2,002
Ireland	5.7 %	4.7 %	9.8 %	8.1 %	17.7 %	1,541
Iceland	8.5 %	2.7 %	10.7 %	7.3 %	17.6 %	2,002
Greece	5.2 %	1.6 %	6.5 %	10.5 %	16.9 %	2,000
Canada	6.6 %	3.6 %	9.3 %	7.4 %	16.6 %	5,519
United States	8.8 %	5.2 %	12.4 %	4.7 %	16.2 %	1,530
Norway	4.4 %	5.2 %	9.2 %	7.3 %	15.6 %	1,562
Switzerland	2.6 %	3.7 %	6.1 %	9.7 %	15.4 %	5,456
Chile	6.0 %	5.3 %	11.1 %	3.8 %	14.4 %	1,733
Argentina	5.9 %	3.9 %	9.5 %	5.0 %	14.1 %	1,746
Finland	3.1 %	1.9 %	5.0 %	8.6 %	13.5 %	2,010
Spain	2.4 %	3.4 %	5.7 %	7.7 %	13.2 %	18,953
Singapore	3.9 %	3.7 %	7.2 %	4.7 %	11.9 %	3,876
Latvia	4.2 %	2.8 %	6.6 %	5.0 %	11.5 %	1,964
Italy	2.9 %	2.3 %	4.9 %	6.4 %	11.5 %	1,793
United Kingdom	3.4 %	2.9 %	6.2 %	5.1 %	11.2 %	9,167
Sweden	1.7 %	2.5 %	4.0 %	6.3 %	10.2 %	1,717
Slovenia	3.0 %	1.4 %	4.4 %	6.3 %	10.1 %	3,016
Croatia	4.1 %	2.5 %	6.1 %	3.7 %	9.7 %	1,555
Belgium	2.9 %	1.2 %	3.9 %	5.6 %	9.4 %	4,047
Germany	3.1 %	2.7 %	5.4 %	4.2 %	9.4 %	6,577
Netherlands	2.5 %	1.9 %	4.4 %	5.7 %	9.4 %	2,706
Austria	3.0 %	2.4 %	5.3 %	3.8 %	8.8 %	2,197
Denmark	2.4 %	2.4 %	4.8 %	4.4 %	8.8 %	1,968
Mexico	4.6 %	1.4 %	5.9 %	1.9 %	7.6 %	1,885
France	4.7 %	0.7 %	5.4 %	2.3 %	7.5 %	1,603
Japan	1.1 %	1.1 %	2.2 %	5.4 %	7.4 %	1,931
South Africa	3.6 %	1.7 %	5.1 %	1.3 %	6.0 %	2,736
Hungary	1.1 %	0.8 %	1.9 %	2.0 %	3.8 %	2,878
Average	5 %	3.9 %	8.4 %	6.6 %	14.8 %	108,604

* This measure corresponds to the Total Entrepreneurial Activity (TEA) Index used in previous GEM reports.

⁴ A small number of individuals qualify for more than one of the entrepreneurial stages because they are involved in more than one venture. The combined early-stage index and overall index count these individuals only once.

Although this research is the first that GEM has implemented in Latvia, we think that dramatic growth has occurred in the scope of entrepreneurship in Latvia over the last few years. Dombrovsky and Ubele (2005) used data from the Enterprise Register to calculate the number of new business owners and managers in 2003, in accordance with GEM classification. Findings showed that somewhat more than 12,000 individuals matched the criteria of being owners and managers of businesses less than 42 months old. This corresponds to a new business prevalence rate of 0.8 per cent, or less than one third of the 2005 figure. However, it would be premature to conclude that the number of entrepreneurs in Latvia has grown more than threefold since 2003. Some of the difference can be accounted for by sampling error and different definitions of manager in the two studies.⁵ At the same time, little doubt exists that much of the difference is due to a genuine increase in the level of entrepreneurial activity in Latvia. Indeed, this conclusion is supported by data from the Enterprise Register via Lursoft: since 2003 substantial growth has occurred in the number of new firm registrations, with 21,230 new firms registered in 2004 and 2005.⁶

Furthermore, signs indicate continuing future growth in entrepreneurship. The share of nascent entrepreneurship in total early-stage entrepreneurial activity in Latvia exceeds the average for the other GEM countries. Provided that many of the nascent businesses succeed in 'giving birth' to a functioning, wage-paying business, then further growth can be expected in the number of entrepreneurs. Encouraging signs include that only about two per cent of the adult population reported shutting down a business in the last 12 months. This falls substantially below the average across GEM countries (3.42 %) and is similar to shut-down rates in Ireland (2.25 %) and Sweden (2.33 %).

Table 2: Prevalence rates of early-stage entrepreneurial activity in regions

Riga	7.3 %
Vidzeme	8.9 %
Kurzeme	4.2 %
Zemgale	4.3 %
Latgale	5.3 %

REGIONAL DISTRIBUTION OF ENTREPRENEURSHIP

Latvia is characterized by substantial disparities across its five regions in terms of income, unemployment, and structure of population (see, for example, Fokins et al. 2005). Thus, we would expect that differences in the extent of involvement in entrepreneurial activity would also show up at the regional level. GEM research shows this to be the case (Table 2), with the prevalence rate of early-stage entrepreneurship in the most entrepreneurial region being twice as high as in the least entrepreneurial region.

The results in Table 2 are surprising. Riga has traditionally been the leading region in terms of GDP per capita, employment and participation rates, followed by Kurzeme (Fokins et al). Latgale, on the other hand, has traditionally been thought of as the most economically depressed region, with unemployment rates reaching 28 % in some areas.⁷ However, we find that Riga does not have a lead in the level of early-stage entrepreneurship. These findings have to be interpreted with caution because differences across regions are barely significant in the statistical sense.⁸ Nevertheless, it is remarkable that Vidzeme has emerged as the most entrepreneurial region in Latvia, with an estimated 8.85 % of its adult population involved in early-stage entrepreneurial activity.

ENTREPRENEURIAL MOTIVATION

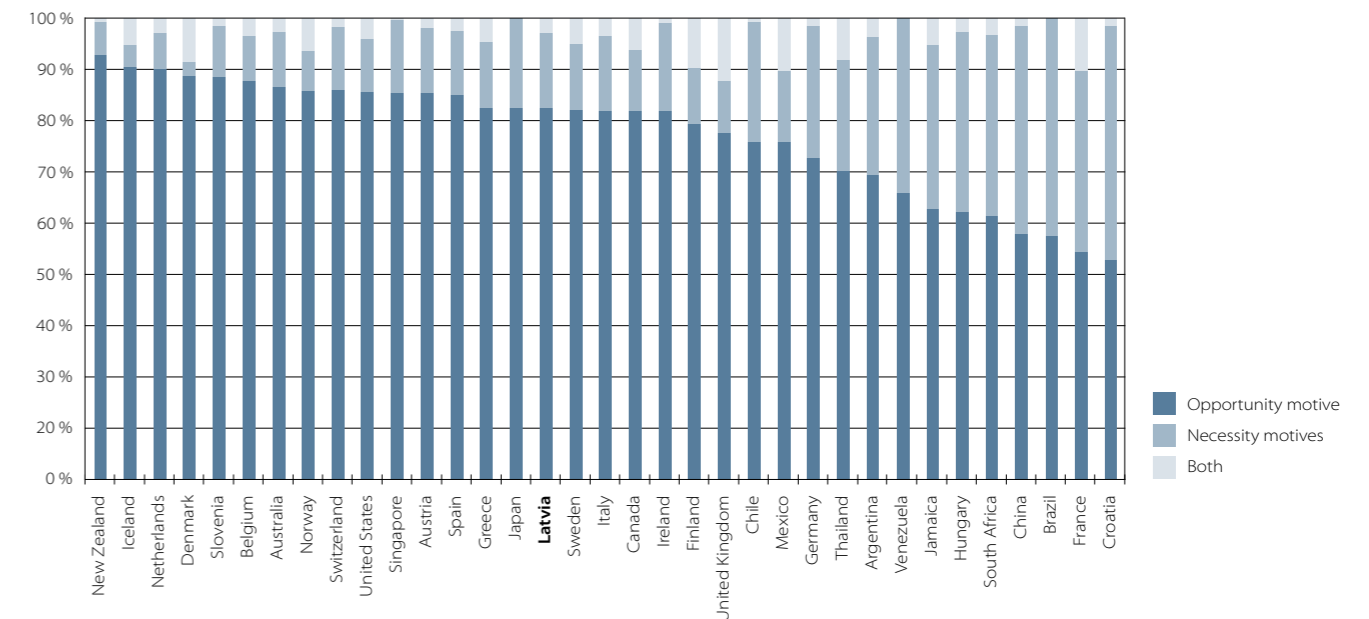
The GEM survey allows differentiation according to motives for entrepreneurial behavior. In the GEM framework, individuals start a business for two main reasons:

- They want to exploit a perceived business opportunity (opportunity entrepreneurs).
- They are pushed into entrepreneurship because all other options for work are either absent or unsatisfactory (necessity entrepreneurs).

GEM identifies both groups by asking all respondents involved in entrepreneurial activity whether they are involved in order to take advantage of a business opportunity or because they have no better employment alternative.⁹ The vast majority of early-stage entrepreneurs across the world claim that they are attempting to take advantage of a business opportunity. Yet, Figure 3 shows that variation also exists across countries in the balance of start-up motives. The highest percentage of opportunity-driven early-stage entrepreneurial activity is found in New Zealand, Iceland, and the Netherlands. At the lower end of the scale appear Croatia, France, and Brazil.

In Latvia, about 20 % of early-stage entrepreneurs were 'pushed' into entrepreneurship because they had no better employment alternatives. The incidence of necessity entrepreneurship in Latvia is very similar to that in countries such as Sweden, Italy, and Spain. Interestingly, the highest proportion of opportunity-driven entrepreneurs in Latvia can be found in the regions of Riga and Latgale, whereas necessity-driven entrepreneurship is more widespread in Kurzeme and Zemgale.

Figure 3: Early-Stage Entrepreneurship: Opportunity to Necessity



⁹ A few respondents cannot be unambiguously coded since they are involved in business for both reasons.

⁵ Whereas GEM relies on a survey instrument to identify owner-managers of new firms, the study by Dombrovsky and Ubele identified managers as individuals who had the legal right to sign a firm's documents. The latter is a stricter definition and is likely to yield a lower estimate of the number of new firm entrepreneurs.

⁶ See <http://www.lursoft.lv/stat/>

⁷ According to the online database of the Central Statistical Office (www.csb.lv), unemployment in Ludza (part of Latgale) was 28 % in 2005.

⁸ Differences across regions are only statistically significant at the 10% level of significance.

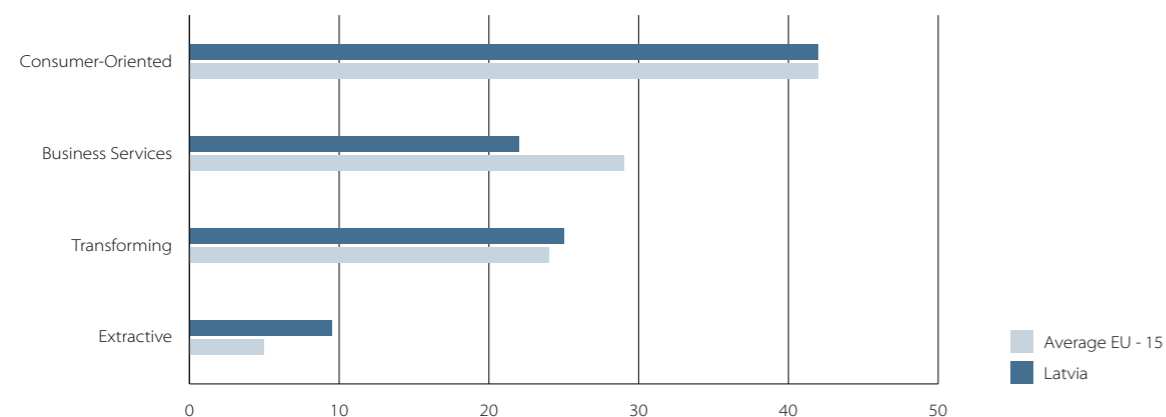
SECTORAL DISTRIBUTION OF ENTREPRENEURSHIP

To analyze the sectors in which people attempt to start businesses and compare their distribution with those of established business, GEM codes activity according to International Standard Industry Codes (ISIC).¹⁰ These codes identify more than five hundred different types of activity, which GEM consolidates under four main headings. These sectoral groups are:

- **Extraction:** agriculture, forestry, fishing, and mining (i.e., extraction of products from the natural environment).
- **Transformation:** construction, manufacturing, transportation, and wholesale distribution (physical transformation or relocation of goods and people).
- **Business Services:** where the primary customer is another business.
- **Consumer Services:** where the primary customer is a physical person (e.g. retail, restaurants and bars, lodging, health, education, social services, recreation).

Figure 4 presents the distribution of early-stage entrepreneurs by sectors, compared with the average for fifteen countries in the European Union in which GEM surveys took place.¹¹ Most early-stage entrepreneurs in Latvia operate in consumer-oriented services, such as the retail trade. The sectoral distribution of entrepreneurship in Latvia is broadly similar to the pattern in other European countries, except that a substantially larger proportion of Latvian start-ups are in the extractive industry, most notably agriculture. A possible explanation for this is Latvia's recent accession to the European Union, which opened European agricultural markets for Latvian producers, while, at the same time, Structural Funds have provided a boost to rural development in general.

Figure 4: Sectoral distribution of early-stage entrepreneurship



DOES LATVIA NEED MORE ENTREPRENEURS?

Scholars worldwide agree that new business creation has a significant impact on economic growth, innovation, and job creation (Gartner, Shaver, Carter, and Reynolds, 2004). Assessing the number of jobs created annually by nascent businesses is hard because of relatively small sample size and some data deficiencies.¹² However, some simple calculations suggest that from 37 to 55 thousand new jobs were created in 2004 and early 2005 as a result of entrepreneurial activity in Latvia.¹³

Although entrepreneurship as such is a desirable phenomenon, clearly not everybody can or should become an entrepreneur. Does Latvia need more entrepreneurs? It could be that some people, who are otherwise able and willing to begin an entrepreneurial career, fail to start new businesses because of imperfections in the legal and administrative environment or deficiencies in the educational system. GEM research shows that only about one-third of nascent entrepreneurs are likely to make it into the phase of running an active business. On the one hand, Latvia has higher levels of entrepreneurship as compared with some other post-communist economies such as Slovenia and Hungary. On the other hand, Latvia lags far behind some of the most advanced Western market economies. In the United States, often regarded as the benchmark against which the European Union compares itself, the prevalence of early-stage entrepreneurial activity is nearly twice as high as in Latvia. In Ireland, whose rapid growth Latvia wishes to emulate, the prevalence of early-stage entrepreneurship is 50% higher than in Latvia. Thus, we are inclined to conclude that 'more entrepreneurs in Latvia' is both desirable and feasible. Further research in the area should focus on elements in the business environment and education that may hold back the entrepreneurial drive of individuals in Latvia.

3. LATVIAN ENTREPRENEURS: WHO ARE THEY?

Ultimately, entrepreneurship is about people who create and run businesses. Knowing the individual backgrounds of those people is an important step towards understanding why some individuals choose to become entrepreneurs while others do not. Scholars of entrepreneurship in a variety of disciplines agree that age, gender, education, income, work experience, and family background are all significant socio-economic factors in a person's decision to start a business. The following is an analysis of the relationship between each factor and the behavior of both early-stage and established entrepreneurs in Latvia.

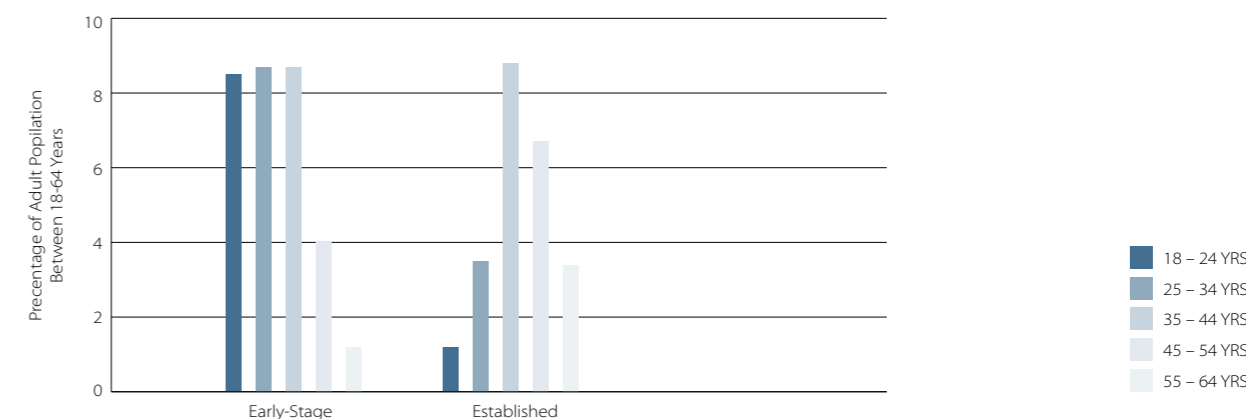
AGE

The relationship between age and participation in entrepreneurial processes in Latvia is broadly similar to that observed in most other countries. In most developed countries, such as the United States, entrepreneurial activity peaks for those in their early 30s, is rather low for those in their late teens and early 20s, and drops off to almost nothing for those in their late 50s (Reynolds, 2004). The pattern is likely to be explained by accumulation of work experience and access to financial networks that increase with age.

The age profile of Latvian entrepreneurs appears in Figure 5. The Latvian early-stage entrepreneur is relatively young, on average 34 years old. Two important features distinguish Latvian entrepreneurs from their counterparts in high-income countries. First, young people in Latvia are very active in entrepreneurship. Prevalence rates of early-stage entrepreneurship in the 18-24 year old cohort in Latvia are twice as high as for the same age cohort in high-income countries in the GEM survey. On the other hand, another feature of the Latvian entrepreneurial landscape is the very low activity of those over 45 years old. Strikingly, activity rates in the 55-64 year old cohort is only about one-third of the level in high-income countries, and only 25 per cent of levels in middle-income countries. This can be explained partly by Latvia's painful transition from a centrally-planned communist economy. Older people in general have found it difficult to operate in the market economy.

GEM research suggests that in the long run demographic change can influence the entrepreneurial capacity of a country. This is disturbing news for European countries in general and Latvia in particular because of the problem that they face of rapidly aging populations.

Figure 5: Entrepreneurial activity by age cohorts



¹⁰ ISIC is an international statistical standard to classify firms according to the main activity they carry out. ISIC is supported by the members of the United Nations and widely adopted and used across countries. It also corresponds with the Statistical Classification of Economic Activities in the European Community (NACE Rev.1.1). See <http://unstats.un.org/unsd/cr/registry/regcst.asp?Cl=17>.

¹¹ These are Greece, Netherlands, Belgium, France, Spain, Hungary, Italy, Austria, United Kingdom, Denmark, Sweden, Germany, Ireland, Finland, Slovenia.

¹² In particular, a relatively large number of entrepreneurs found it difficult to answer questions about the number of people they employ. Some have reported numbers that are too extreme to be believable.

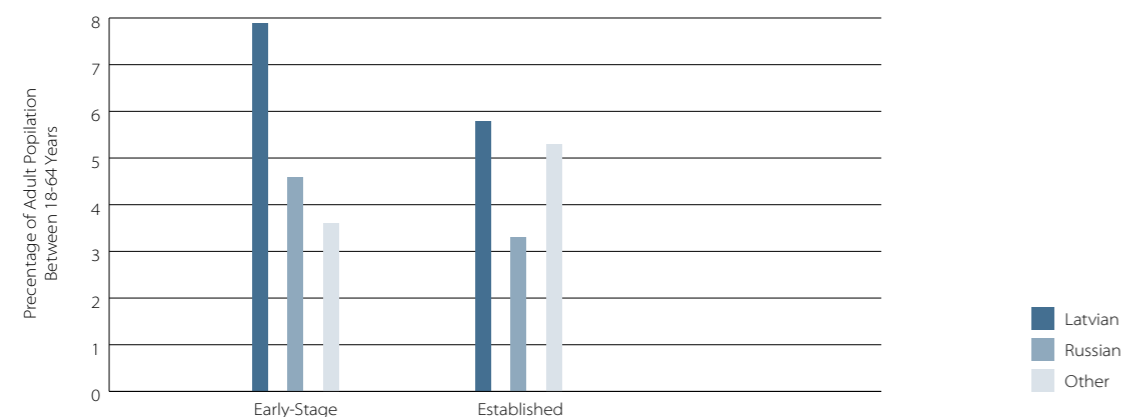
¹³ This estimate is based on the assumption that, on average, newly established enterprises employ 2 or 3 people. Note, however, that the estimate cannot be seen as net job creation in the economy because some of the jobs 'created' could reflect diversion, i.e. a simple transfer of workers from one firm to another.

ETHNICITY

A popular stereotype in Latvia holds that ethnic Latvians are typically farmers and state employees, whereas ethnic Russians are businessmen. GEM research demonstrates that this is not the case. As shown in Figure 6, ethnic Latvians have higher participation rates compared with ethnic Russians, both in early-stage and established entrepreneurship. For example, the prevalence rate of early-stage entrepreneurship for ethnic Latvian adults is 7.95 %, compared with 4.64 % for ethnic Russians.¹⁴ In other words, an ethnic Russian is only half as likely to be an early-stage entrepreneur as is an ethnic Latvian.

What could be the reasons for the low participation rates of ethnic Russians? A possible explanation is that low activity rates occur because the Russian-speaking minority has a poor knowledge of the state language (Latvian), which may make it more difficult for them to find their way through official regulations. Some empirical support exists for this explanation based on the assumption that citizenship is a proxy for knowledge of the language. The data show that prevalence rates for ethnic Russians who hold Latvian citizenship and, presumably, are proficient in Latvian, are substantially higher as compared with Russian non-citizens. No statistically significant difference exists in participation rates among ethnic Latvians and ethnic Russians who hold citizenship.¹⁵

Figure 6: Entrepreneurial activity by ethnicity

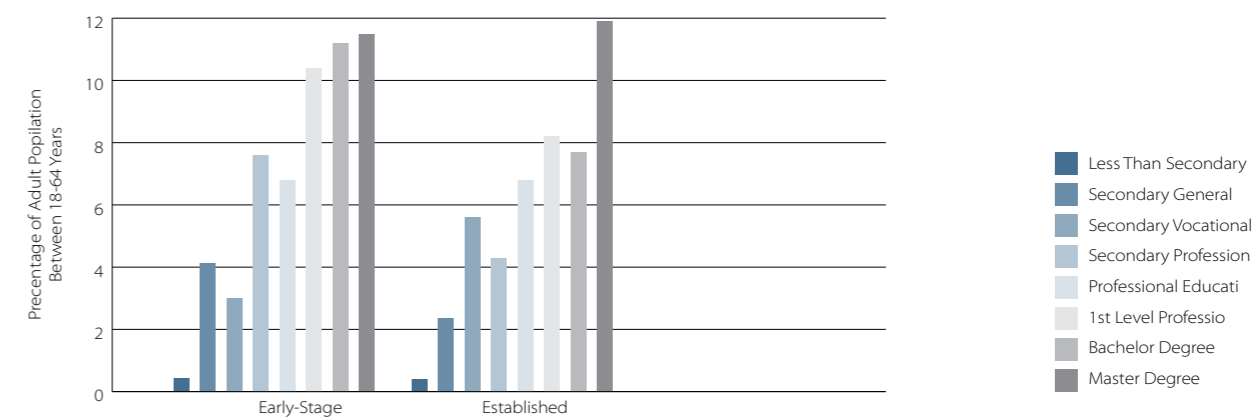


HOUSEHOLD INCOME

No consensus exists among researchers on the relationship between household income and participation in entrepreneurship. On the one hand, a potential negative correlation exists between income and early-stage entrepreneurship, because participation in business startup carries opportunity costs of income foregone from employment. Another argument suggests that low-wage workers are forced to pursue self-employment when excluded from the traditional wage labor market (Evans and Leighton, 1989). On the other hand, yet another argument goes that high income might help potential entrepreneurs to finance their business venture.

GEM research shows that, in both high-income and middle-income countries, individuals with a higher income are more likely to be involved in early-stage entrepreneurial activity. This is also the case in Latvia. According to the survey data, average household income of early-stage entrepreneurs is 290 Ls, as compared with an average of about 221 Ls for non-entrepreneurs. The same pattern is observed for nascent entrepreneurs, whose household incomes are substantially higher compared to non-entrepreneurs. Of course, using income alone to indicate the financial well-being of a household may be misleading if income and wealth were poorly correlated. For instance, a low-income household might own land that could be mortgaged to secure capital for a business startup. However, in the absence of data on the net worth of households, our findings point to the importance of availability of monetary assets (e.g. income) in explaining entry into entrepreneurship.

Figure 7: Entrepreneurial activity by education



EDUCATION

The relationship between education and entrepreneurship is theoretically ambiguous. On the one hand, better-educated individuals are well rewarded in the labor markets and, therefore, may have little incentive to enter entrepreneurship. On the other hand, education may impart skills that would increase the chances of being a successful entrepreneur. In Latvia, as shown in Figure 7, it appears that individuals with higher levels of education are more likely to be entrepreneurs. For example, in spite of often-heard stories to the contrary, the evidence indicates that, for an individual with less than secondary education the chances of being an entrepreneur are close to zero. In contrast, the highest prevalence rates of early-stage entrepreneurship are among individuals with 1st level professional higher education, bachelor, and master degrees. The same picture can be seen with respect to prevalence rates in established businesses.

Besides, when asked whether their education is useful for entrepreneurship, most entrepreneurs answered affirmatively. Only 12 per cent of all entrepreneurs said that their education was "not useful". Nearly half of all entrepreneurs reported having had (often additional) education or training in management. An unequivocal conclusion is that education is important to entrepreneurship and entrepreneurs perceive value in acquiring education.

¹⁴ This difference is statistically significant.

¹⁵ However, it should be noted that the difference in entrepreneurial activities between Latvians and Russian is harder to explain once age is taken into account. Clearly, more research is needed in this direction.

¹⁶ For established business owners, reported income levels are more likely to be a result than a precondition of entrepreneurial activity.

¹⁷ It should be borne in mind that these are income data reported by respondents.

¹⁸ Household incomes of established entrepreneurs are also higher compared to non-entrepreneurs but this is likely to be the result of their entrepreneurial activity.

EXPERIENCE

Some scholars (e.g. Lazear, 2004) hold the view that entrepreneurs are generalists, as opposed to specialists, that is, they are jacks-of-all-trades to some extent. As Lazear (2004, p. 208) puts it, "although they need not be expert in any single skill, they must be sufficiently good at a wide variety to make sure that the business does not fail." Our findings are consistent with this view. Most individuals entering entrepreneurship have had substantial work experience and have tried out at least a few professions. On average, early-stage entrepreneurs had about 15 years of work experience. Only about 7 per cent of all early-stage entrepreneurs reported no prior work experience at all. Furthermore, an average entrepreneur had experience in about three professions before entering entrepreneurship. Only about 17 per cent of all early-stage entrepreneurs reported that the business was their first professional activity. As in the case with education, most entrepreneurs said that their prior work experience was useful for their entrepreneurship.

Most entrepreneurs (42 %) involved in any kind of business made their transition to entrepreneurship from employment in the private sector. Interestingly, very few (4 %) of all entrepreneurs reported entering entrepreneurship from unemployment.

FAMILY BACKGROUND

A study using GEM data by Dombrovsky and Welter (2006) suggests that family background might be a particularly important influence on entrepreneurship in Latvia. Having entrepreneurial parents or siblings appears to be the strongest predictor of whether an individual is an entrepreneur. For example, some 35 per cent of early-stage entrepreneurs reported having parent-entrepreneurs, as compared with a mere 13 per cent among non-entrepreneurs. Such a family background is said to transfer knowledge, skills, self-confidence and also positive attitudes towards entrepreneurship, thus facilitating entry of the children into entrepreneurship.

A somewhat pessimistic interpretation of the above finding is that entrepreneurship "runs in the family", i.e. that some people are just born to be entrepreneurs. A more positive interpretation, however, is that a transmission mechanism can be emulated in educational institutions, that is, people can actually be taught to be entrepreneurs. At the moment, family entrepreneurship is an active area of scholarly research.

4. CAN THE LATVIAN ENVIRONMENT SUPPORT MORE ENTREPRENEURS?

A widespread belief exists that economic and social institutions play large role in determining the level of entrepreneurship in a country. Indeed, considerable research has been carried out on the business environment in Latvia. Most notably, this includes surveys of administrative barriers conducted by the Latvian Development Agency, the Business Environment and Enterprise Performance Survey (BEEPS) by the World Bank, and the Doing Business Database (World Bank). Therefore, our survey did not aim to create a comprehensive picture of how entrepreneurs and non-entrepreneurs perceive the business environment. Instead, we focused on four particular aspects of the Latvian environment: (i) the degree of cultural support for entrepreneurship; (ii) barriers to the expansion of existing businesses; (iii) perceptions of corruption; and (iv) the role of the courts in resolving commercial disputes.

CULTURAL SUPPORT

In the Soviet Union, those seeking private (and not collective) gain were often viewed with scorn and officially labeled anti-social elements. However, fifteen years after the collapse of communism, a legacy of distrust towards entrepreneurship is hard to find in Latvia. The GEM survey demonstrates that, compared with the fourteen other EU countries surveyed in 2005, Latvia is towards the high end in terms of measured levels of cultural support for entrepreneurship.

Nearly 75 per cent of respondents said that individuals successful at starting a new business are perceived to have a high level of status and respect. That puts Latvia 3rd highest in the ranking of EU countries surveyed with regard to this measure. It shares this position with Germany, normally considered to have much

deeper capitalist traditions. The measure is much lower in the other two new EU member states included in the 2005 survey, Hungary and Slovenia. Furthermore, nearly 70 per cent of all respondents perceived the media to be supportive of entrepreneurship, in which Latvia clearly stood out as compared with the other EU states in the GEM survey. Only Ireland recorded a higher percentage for this measure. However, only 58 per cent of Latvians saw starting a new business as a good career choice. This result suggests that, as compared with other countries, Latvians are cautious about the probability of success in entrepreneurship.

BARRIERS TO EXPANSION

We asked owner-managers of existing businesses whether they plan to expand their business in the next year and 42 % answered affirmatively. Further, entrepreneurs that did not plan to expand their business were asked to state the most important reason for non-expansion. The results are presented in Table 3.

Most of those who did not plan expansion were simply satisfied with their present situation. The biggest obstacle mentioned to expansion was difficulty in obtaining financial resources. Some other important obstacles reported were difficulty in finding reliable workers, and lack of management skills. Remarkably, very few respondents cited governmental or administrative problems as barriers to expansion.

All in all, the results suggest that the most important perceived barriers to firms' expansion are lack of demand and lack of financial resources. It does not appear that significant artificial barriers prevent growth of businesses in Latvia.

Table 3: The most important barrier to expansion (for existing businesses that do not plan to expand in the next year)

Insufficient demand	13.8 %
Hard to find financial resources	19.2 %
Big administrative requirements for big firms	3.7 %
High taxes for big firms	5.4 %
Fear of governmental barriers	1.9 %
Arrangement with competitors	1.1 %
Fear of hostility and envy	6.0 %
Hard to find good workers	8.2 %
Health condition	1.2 %
Lack of management skills	7.9 %
Satisfied with present state	23.1 %
Other	7.2 %

CORRUPTION

Another area that we chose to highlight in this report is the role of corruption. Latvia has consistently been ranked poorly for corruption among EU members. For example, the 2005 Transparency International corruption perception index ranks Latvia 51st in the world, behind all other EU states except Poland.¹⁹ On the other hand, a recent self-assessment report finds a general easing of administrative corruption but continuing difficulties in particularly prone areas such as construction permits and customs (Latvian Development Agency and Foreign Investment Advisory Service, 2003).

We included two questions in the GEM to gauge the extent of corruption.²⁰ First, all respondents were asked whether they thought that private entrepreneurs in their town paid bribes to public officials to avoid complying with regulations. Second, all respondents were asked whether entrepreneurs paid bribes to change the rules of running a business in their favor. The results are summarized in Table 4.

Table 4: "Do entrepreneurs bribe public officials?"²¹

	"To avoid complying with regulations"		"To change the rules of running a business"	
	Percentage of all entrepreneurs	Percentage of all non-entrepreneurs	Percentage of all entrepreneurs	Percentage of all non-entrepreneurs
"Very often"	13.4	15.8	10.7	13.2
"Often"	29.1	28.4	22.7	26.6
"Sometimes"	24.8	25.2	26.6	22.9
"Seldom"	10.6	7.9	15.4	10.1
"Never"	5.4	4.1	6.0	5.6

The findings are devastating. For example, about 43 per cent of all entrepreneurs think that public officials are bribed "often" or "very often" in order to avoid compliance with regulations. Only about 4 to 6 per cent of entrepreneurs or non-entrepreneurs think that public officials are "never" bribed. It has sometimes been suggested that most people have not had experience of corruption but have been influenced by numerous stories in the media, so that the true extent of corruption is probably over-estimated. However, our data show no statistically significant difference between corruption perceptions between non-entrepreneurs and (supposedly better informed) entrepreneurs.

COURTS

Another area commonly cited as a key barrier to economic development is the courts. An influential study by Johnson, McMillan and Woodruff (1999) argued that effective contract enforcement in the courts may be a key to unlocking growth potential of small businesses, especially in post-communist economies. When courts are not effective, established firms would be reluctant to replace their traditional suppliers with better deals from young (but unknown) firms because of the risk that the contract would not be honored. Thus, young firms would find it harder to struggle in an environment where dispute resolution in courts is not effective and efficient.

In an attempt to gauge the extent to which the judicial system in Latvia is perceived to be effective, we asked more established businesses whether they would go to court to resolve a dispute with a business supplier or a customer. Further, we asked owners of existing businesses whether they would go to court to defend their interests against a public official who is abusing their position. As shown in Table 5, more than half of all respondents expressed readiness to defend their interest in the courts against either private suppliers, or public officials. Nevertheless, entrepreneurs were somewhat less ready to file a lawsuit against a public official.

When asked about the main reason why they would not use the courts against a private supplier or customer, nearly half of all entrepreneurs that would not go to court said that it is easier to resolve the conflict without going to court. Two other important reasons named were that the proceedings were expensive and that court decisions are not objective.

Interestingly, nearly 35 per cent of those who would not use the court said that court decisions are not objective in a dispute against public officials. Our findings indicate that the courts are perceived to be less effective in defending entrepreneur interests against public officials, possibly indicating a systematic bias in favor of public officials.

In fact, not only were the entrepreneurs in our sample willing to use the court system, but it turned out that 9 per cent of them had already done so. Most frequently this was due to a conflict with customers. However, the next most frequent object of court action was government officials. Those entrepreneurs who have used the courts are more positive about them than those who have not used them. The proportion of those who would go to the courts to protect their rights is higher among the former. The difference is pronounced and significant in cases when a supplier or a customer is involved, but not so much in case of a government official.

In general, our findings are in line with a number of other studies. For example, Johnson et al. (1999) report that two-thirds of entrepreneurs in the largest Eastern European countries stated they could use the courts to settle a dispute. The "Doing Business Database" of the World Bank also suggests Latvia is not doing so badly in this area.²² When measured by number of days to resolve a dispute through the courts, Latvia is ranked 22nd in the world, ahead of countries such as Sweden and the USA. And the average cost of court action as a proportion of debt owed, at 10.4 per cent, is ranked 26th in the world, ahead of countries such as Germany and Canada.

Table 5: "Would you file a lawsuit to defend your interests against..." (percentage of owners of existing businesses)²³

	Private supplier/customer	Public official
"Yes"	62.1	56.0
"No"	21.4	23.1
"Don't know"	14.3	19.3

¹⁹ Available at: http://www.transparency.org/policy_and_research/surveys_indices/cpi/2005.

²⁰ The standard GEM instrument does not include questions about corruption. Thus, we included a number of questions similar to those used by Djankov et al. (2005) in a survey of Russian entrepreneurs.

²¹ The results in the columns do not sum up to 100 % because of results omitted for those who did not know or declined to answer the question.

²² Available at <http://www.doingbusiness.org/ExploreTopics/EnforcingContracts/>

²³ The results do not sum up to 100 % because of omitting those who declined to answer the question.

FOCUS INSERT 1: FINANCING OF ENTERPRISES

BY EGITA UZULĒNA

Lack of finance is always and everywhere mentioned as a barrier to new enterprise creation. Latvia is no exception in this respect. Accordingly this section is devoted to examining what the 2005 Latvian GEM survey reveals about the financing needs of entrepreneurs in Latvia together with the main sources of finance that entrepreneurs expected to utilize to start a new venture or to expand an existing business. Particular attention is paid to informal investment, which is the main alternative to bank finance available in Latvia²⁴. The financing needs and aspirations discussed below are based on the responses to a number of financing questions addressed to the group of nascent entrepreneurs identified in the survey. It is shown that the amount of financing that nascents expect to need to start up an enterprise in Latvia is quite low, although access to capital is rather limited. This suggests that an increase in entrepreneurial activity could be achieved with non-expensive policy solutions.

FINANCING A NEW ENTERPRISE IN LATVIA

The average cost of establishing a start-up enterprise in Latvia in 2005 was € 36,200, a relatively high figure for a country boosted by the presence of a few very large nascent businesses. Relative to the 2004 GEM average of € 45,600, Latvian costs can still be regarded as low, especially taking into account that half the enterprises in Latvia were established with capital below € 9,960.

Table 6: Start-up Financing Requirements of Latvian Enterprises

Range of start-up financing required	Less than € 15,000	€ 15,000 to € 22,000	Greater than € 22,000
Average amount expected to be needed	€ 2,910	€ 18,210	€ 222,780
Percentage to whom this range applies	46 %	42 %	12 %

Table 6 below summarizes the expected start-up financing needs of new enterprises in Latvia, where the sample of nascents has been collected into three distinct groups depending on the anticipated amount of financing requirements using standard clustering techniques²⁵. Accordingly, almost a half (46 %) of prospective new enterprises in Latvia would require start-up financing of, on average, only € 2,910, reflecting the high incidence of new businesses in the trade and service sector where capital requirements are low. The median expected start-up cost is € 9,960. However, the survey suggests that start-up costs can become very large. Thus, 42 % of entrepreneurs expect that they need €18,210 on average to start a new business. The third group, comprising 12 % of new entrepreneurs, expects rather large start-up financing needs – on average € 222,780. The presence of this group drives up average expected financing needs to € 36,200 (which compares with the 2004 GEM average of € 45,600). Clearly the average figure is unduly influenced by a few very high start-up cost outliers, so that a better measure of typical expected start up costs is the median or even the € 2,910 of the first group.

It is of interest to note that opportunity-driven enterprises report much higher expected start up costs (average € 62,400), than necessity-pulled ventures (average € 21,100). This observation is consistent with evidence from the 2004 Global Entrepreneurship Monitor, which reported that opportunity-driven enterprises on average expect to require about twice as much start-up capital as necessity-driven ones.

IMPORTANCE OF OWN FINANCING SOURCES

The 2005 GEM Latvia survey clearly indicates the importance of own capital for financing a start-up. Availability of own capital appears to be particularly important for enterprises whose start-up capital requirements are expected to be less than € 15,000, for which 73 % of financing is expected to come from own capital (see Table 7). Larger projects appear to be able to attract more funding from other sources, especially those where start-up financing is expected to be above € 22,000, where the entrepreneur's own contribution is on average expected to be just 15 %.²⁶

This result can be related to the financing conditions of local banks that are willing to allocate more funding to larger projects that can offer better collateral. Currently, considerable competition exists among banks in Latvia, which explains why at times bank finance can reach up to 90% of project value. Expert interviews also stressed the importance of debt capital in financing new and growing businesses in Latvia. At this stage, the banks do not seem to be interested in financing smaller start-ups, which constituted almost one half of all nascent businesses in 2005. This suggests the need to examine innovative policy action to support small businesses.

SOURCES OF FINANCING

The GEM 2005 adult population survey in Latvia asked all nascent and established businesses to state the main financing source they used or are intending to use for establishing an enterprise. The survey also asked established businesses whether they envisage expansion and, if so, what would be the main sources of financing.

The answers to these questions are summarized in Table 8 below, which shows that about 38 % of all entrepreneurs (both nascent and established business owners) regard own capital as the main source of funding a start-up. However, established businesses place even greater reliance on own capital, i.e. 55 % of respondents identified retained earnings of the enterprise as the main financing source for expansion.

About one in four businesses regarded banks as the main source of funding, and interestingly the same proportion of entrepreneurs appears to prefer traditional forms of financing, i.e. bank loans, for opening a business and for expansion. This result should come as no surprise, as few alternatives to traditional forms of borrowing exist in Latvia, while institutions such as venture capital funds are practically non-existent – as indeed indicated in the Telia Sonera discussion paper on venture capital in Latvia and supported by expert interviews. However, informal forms of funding, such as borrowing from friends and relatives, identified among the main sources of financing for opening new businesses, are not used widely for expansion purposes.

Table 7: Sources of Financing for Business Startups

Range of start-up financing required	Less than € 15,000	€ 15,000 to € 22,000	Greater than € 22,000
Average amount expected to be needed	€ 2,910	€ 18,210	€ 222,780
Own financing	€ 2,130	€ 8,540	€ 32,800
Financing from other sources	€ 780	€ 9,670	€ 189,980
Percentage of own financing	73%	47%	15%

Table 8: Main Sources of Financing for Enterprise Establishment and Expansion

Main sources of financing, % of enterprises	For start-up	For expansion
Own capital	38 %	0 %
Retained earnings of the enterprise	0 %	55 %
Banks	24 %	28 %
Friends and relatives	16 %	2 %
Other	22 %	15 %

²⁴ Venture capital remains a negligible source of funding for most new enterprises.

²⁵ Grouping performed using K-median clusters and L2 distance measure. Differences between groups are significant at 1% level of significance.

²⁶ Differences between groups are significant at 1 % level of significance

INFORMAL INVESTMENT

Considering the fact that venture capital in Latvia is not widespread and the banks are not willing to extend financing to small start-ups with poor collateral, virtually the only alternative to own capital is so-called informal investment: family, friends, colleagues, and other business angels. As indicated in the previous section, virtually 16 % of entrepreneurs regard informal investors as the main source for start-up capital of businesses; hence they represent the third most important source of start-up finance after own capital and bank finance. This section examines the range of financing extended by informal investors in Latvia in the last three years, including analysis of the factors that motivate such investment.

The 2005 Latvian GEM survey suggests the incidence of informal investments in Latvia stands marginally above the average of the GEM EU countries (Figure 8). About 2.7 % of respondents reported that they had provided financing for creation or expansion of enterprises in Latvia over the last three years. Average informal financing in 2005 was €14,840 compared with the EU average of € 38,000 but the typical investment was much lower as 50 % of informal investors had invested only about €2,130. Nevertheless, the expected total amount of informal financing in Latvia reached 27 % of the capital required to finance establishment of nascent enterprises, which lies somewhere midway between the GEM EU lowest and highest figures in 2004, i.e. ~5 % in Hungary and ~55 % in Sweden. This evidence implies that alternative sources of capital are available to establish new enterprises, even if bank capital is inaccessible.

Table 9 provides more detailed information on the average funding provided by informal investors for enterprise development over the last three years²⁷. Nearly 70 % of investment was below €2,620, which implies that informal sources would be sufficient for financing only the smallest new enterprises in Latvia (as indicated in Table 6), which require external financing of €780, whereas projects with value above €22,000, which on average require external financing of €189,980, would have to seek alternative sources of funding. However it can be argued that at present the market is segmented so that demand for financing from each group of enterprises can be at least partially accommodated by supply from informal investors and banks.

Nevertheless, the question remains as to the extent to which informal financing is widely accessible, and what the factors constraining informal investment activity might be. Evidence from the survey suggests that the largest group of informal investors consists of close relatives and spouses, who provide financing in 41 % of cases. The next largest group is friends and colleagues, with 26 % respectively. More distant relatives provide 11 % of financing, while non-related individuals provide 15 %. Overall it is clear that informal investment is largely restricted to individuals with more wealthy relatives who are willing to donate. Other potential small entrepreneurs in Latvia have practically no access to financing besides own available capital.

The results summarized above point strongly to the fact that new enterprises in Latvia currently enjoy very narrow financing options. Practically no venture capital is available, while informal investors other than close relatives do not appear to have a strong interest in engaging in the market. Limited access to financing is also regarded as the main barrier to expansion by 16 % of entrepreneurs surveyed who were considering enlarging their businesses in the near future. However, given that businesses can be established in Latvia with rather low capital expenditure, room exists for policy intervention aimed at stimulating new entrepreneurial activity at relatively low cost.

Figure 8: Prevalence Rates of Informal Investors in the EU

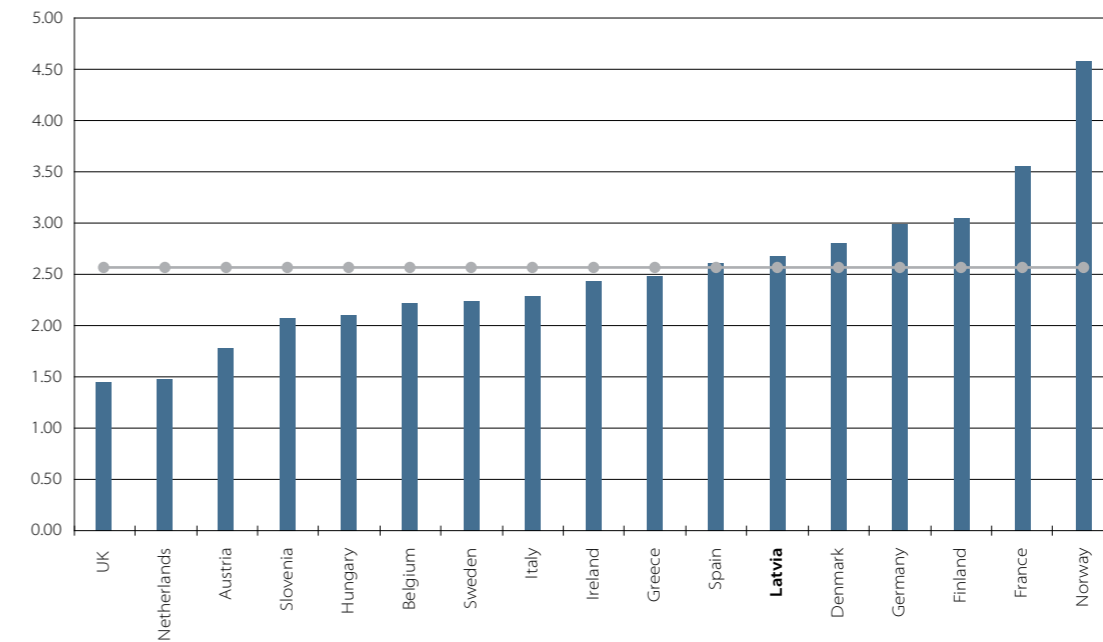


Table 9: Range of Informal Investments

Range of informal financing	Less than € 1,400	€ 1,400 to € 2,620	Greater than € 2,620
Average financing	€ 710	€ 2,030	€ 41,200
Percentage to whom this range applies	23 %	43 %	33 %

²⁷ Again grouping was implemented using K-medians clusters and L2 distance measure. Differences between groups are significant at 1 % level of significance.

FOCUS INSERT 2: HIGH-EXPECTATION ENTREPRENEURSHIP AND INNOVATIVENESS

BY OLGA RASTRIGINA

The GEM methodology aims to identify the incidence of new enterprises that are likely to be responsible for economic growth and new job creation. High-expectation and innovative enterprises are regarded as being in this category. This section reports on the 2005 Latvian GEM results with respect to such enterprises or entrepreneurs.

High-expectation entrepreneurs are defined in the standard way used in GEM as those entrepreneurs who expect to employ 20 or more employees within 5 years time.

Innovativeness in entrepreneurship is measured from three perspectives: production of goods that are new to customers, entering the market with no direct competitors, or use of a new technology in the production process. Those individuals who reported that their entrepreneurial activity possesses at least one of the above features are considered to be innovative. Further, innovative entrepreneurs are divided into those who have a profound growth potential (these businesses have all three mentioned features of innovativeness) and those who have only some growth potential²⁸.

High expectations and innovativeness are not evenly distributed among the Latvian population of entrepreneurs. Only around 20 % of all entrepreneurs have high-expectations with regard to their future employment growth, while somewhat less than that fall into the innovative category.

As expected, the percentage of high-expectation and innovative entrepreneurs stands higher among nascent entrepreneurs as compared to new businesses. One explanation for this discrepancy is that nascent firms must possess at least some degree of growth potential in order to enter a new market. Another reason could be existing firms' better knowledge of the market and perhaps more realistic expectations. However, no statistically significant difference exists between early-stage and established firms in this respect.

Table 10: Prevalence of high-expectation and innovative entrepreneurship in Latvia, by firms

	% of group total		% of the adult population	
	High-expectations	Innovative	High-expectations	Innovative
Nascent entrepreneurs	22.3 %	25.7 %	1.0 %	1.1 %
New firm entrepreneurs	16.7 %	7.4 %	0.4 %	0.2 %
Early-stage entrepreneurs	21.1 %	18.0 %	1.4 %	1.2 %
Established entrepreneurs	19.9 %	18.0 %	1.0 %	0.9 %
Overall entrepreneurial activity²⁹	20.7 %	19.0 %	2.3 %	2.1 %

Latvian entrepreneurs demonstrated higher employment expectations than in the majority of countries and world regions reported in the overall 2005 GEM survey. For example, the proportion of new businesses in Latvia that plan to hire 20 or more employees in five years (16.7 %) is comparable to such highly entrepreneurial countries as the USA and Germany. Moreover, the percentage of nascent entrepreneurs who have high-expectations (22.3 %) stands considerably higher than in these countries.

Although general prevalence rates of entrepreneurial activity in Latvia are about average, much more high-expectation entrepreneurship occurs in Latvia compared with most other countries. High-expectation early-stage entrepreneurs account for 1.4 % of the adult population, while the comparable measure in the GEM 2000-2004 combined data set is only 0.8 %. In this regard Latvia appears to be closer to the USA - where 1.6 % of the adult population are high-expectation early-stage entrepreneurs - than to Europe, with an indicator as low as 0.5 %. The proportion of high-expectation early-stage entrepreneurs in the adult population in Latvia is twice as large as in the UK or Germany. However, it is hard to say whether these expectations reflect genuine economic conditions in the country, or if they are simply fueled by the extremely high rates of economic growth experienced over recent years.

Given the above results, it is surprising that Latvia compares less favorably with respect to innovative entrepreneurship. The percentage of innovative early-stage entrepreneurs in Latvia is only half of that observed in middle-income and high-income countries (Table 12).

These findings imply that Latvian entrepreneurs may have lower growth potential than in other countries. As shown by the survey results, the proportion of entrepreneurs with growth potential is considerably lower for Latvia as compared with middle-income and high-income countries (see Figure 9 and Figure 10).

How to explain these results? Is it that some particular innovative quality is uncommon among Latvian entrepreneurs, thus making them so much less innovative in comparison with the entrepreneurs of other regions? To address this question we take a deeper look at the innovative characteristics of Latvian entrepreneurs. The results are reported in Figures 11-13. Clearly, all three innovative characteristics are relatively rare among Latvian firms. The discrepancy is especially pronounced when comparing Latvia with middle-income countries with respect to the newness of technologies used in the production process. It appears that, compared to their counterparts in other countries, Latvian entrepreneurs typically do business in a more traditional way. At least, relative to the average level of product variety and technological development they are less likely to offer new products, enter into new business niches, or use new technologies.

Table 11: Prevalence of high-expectation entrepreneurs by country

	Latvia	World	Europe	USA	UK	Spain	Sweden	Germany
Nascent entrepreneurs (% of group total)	22.3 %	9.6 %	11.8 %	14.1 %	14.4 %	3.0 %	13.6 %	17.2 %
New businesses (% of group total)	16.7 %	10.1 %	11.4 %	16.8 %	12.3 %	5.7 %	11.4 %	16.7 %
Early-stage entrepreneurs (% of the adult population)	1.4 %	8.0 %	0.5 %	1.6 %	0.7 %	0.2 %	0.5 %	0.7 %

Table 12: Proportion of innovative entrepreneurs by country (% of group total)³⁰

	Latvia	Middle-income countries	High-income countries
Early-stage entrepreneurs	18.0 %	51.7 %	40.9 %
Established firms	18.0 %	34.8 %	30.0 %

²⁸ This division of innovative entrepreneurs is in line with the definition of the compound index of growth potential used in the GEM 2005 Executive Report.

²⁹ Overall Entrepreneurial Activity = Nascent + New firms + Established firms. (Those individuals engaged in several enterprises and who thus appear in several categories simultaneously are counted only once.)

³⁰ The data on innovative entrepreneurship in middle and high-income countries are from the GEM 2005 Executive Report.

Figure 9: Compound index of growth potential (for early-stage entrepreneurs)

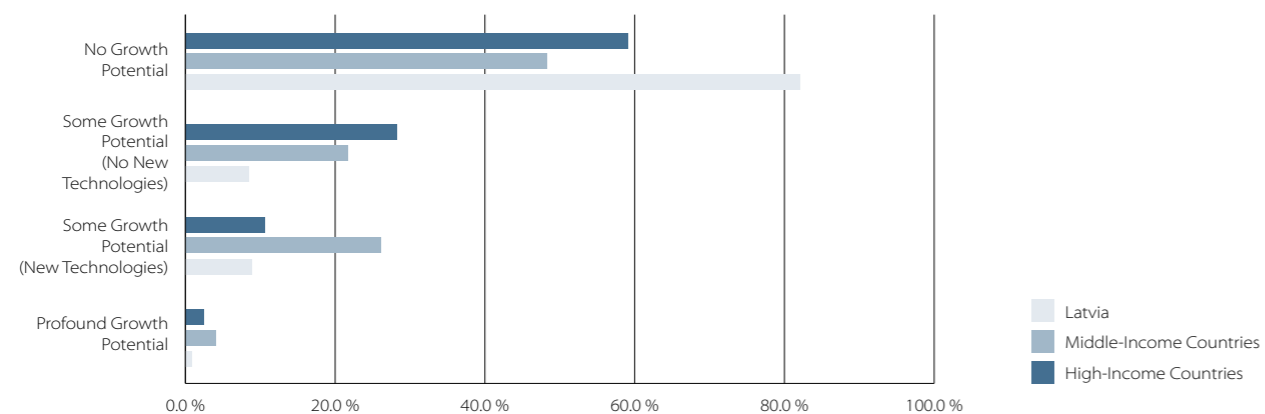


Figure 10: Compound index of growth potential (for established entrepreneurs)

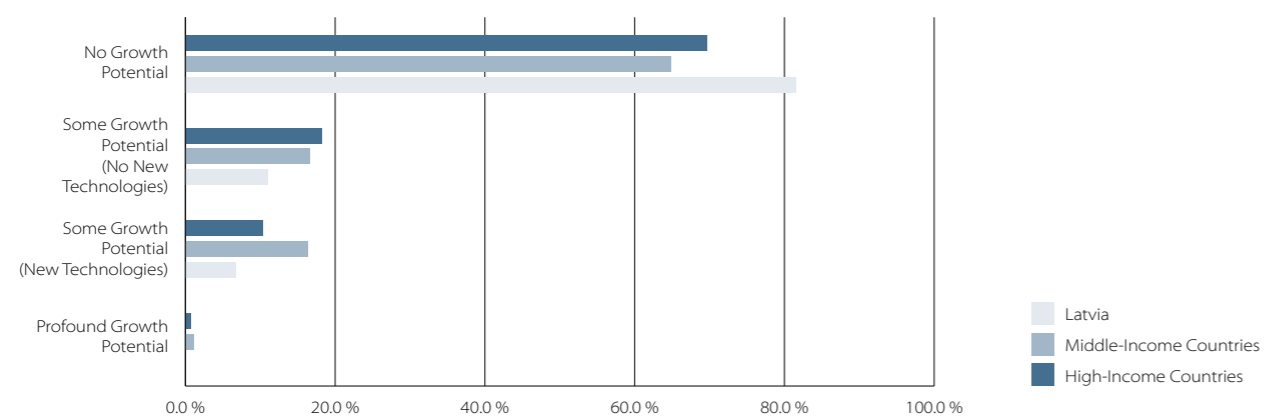


Figure 11: "To how many customers is the product new?"

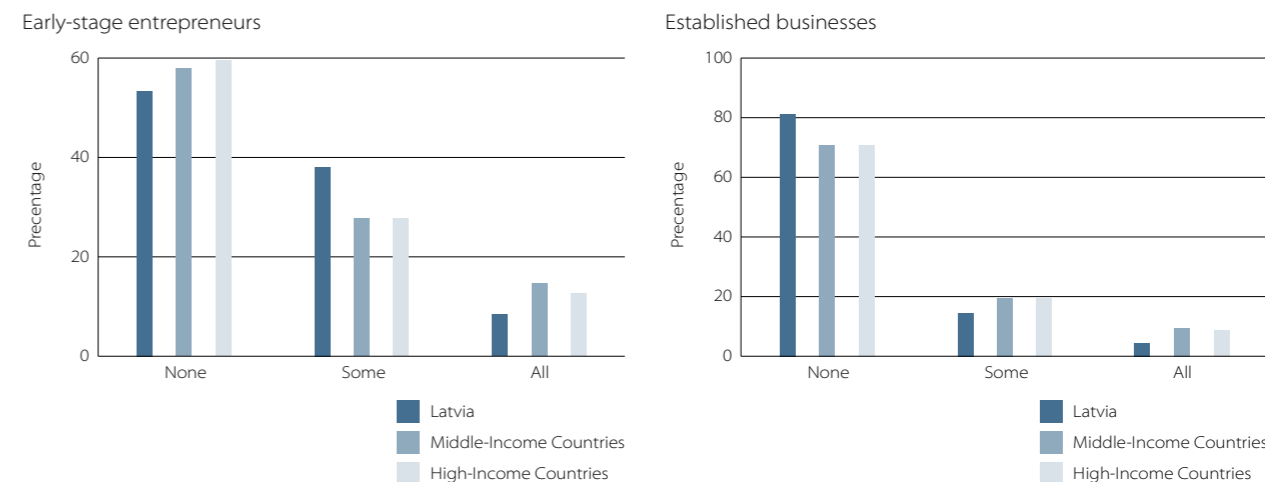


Figure 12: "How many competitors are expected?"

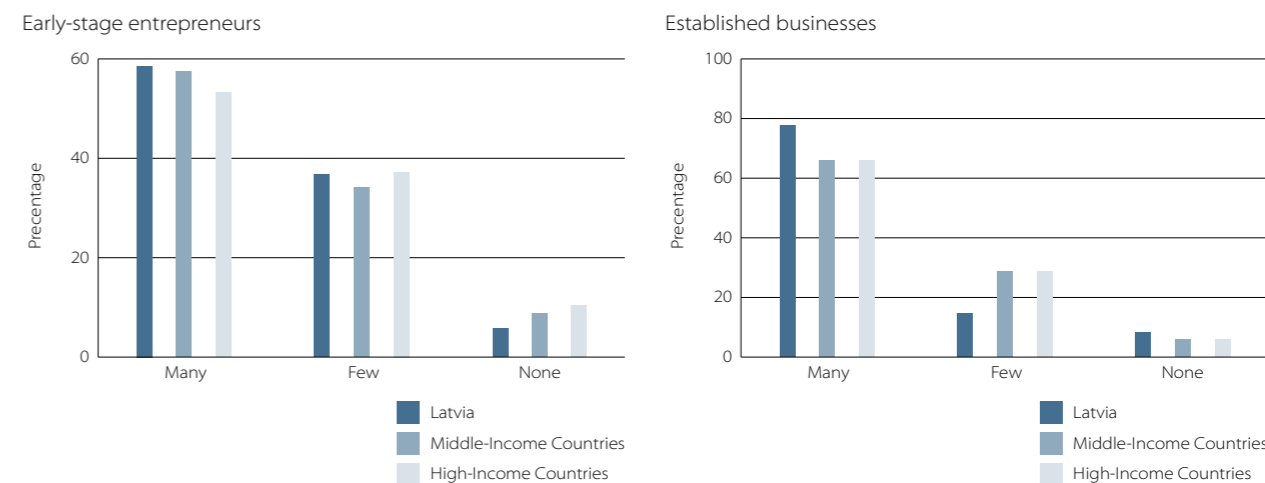
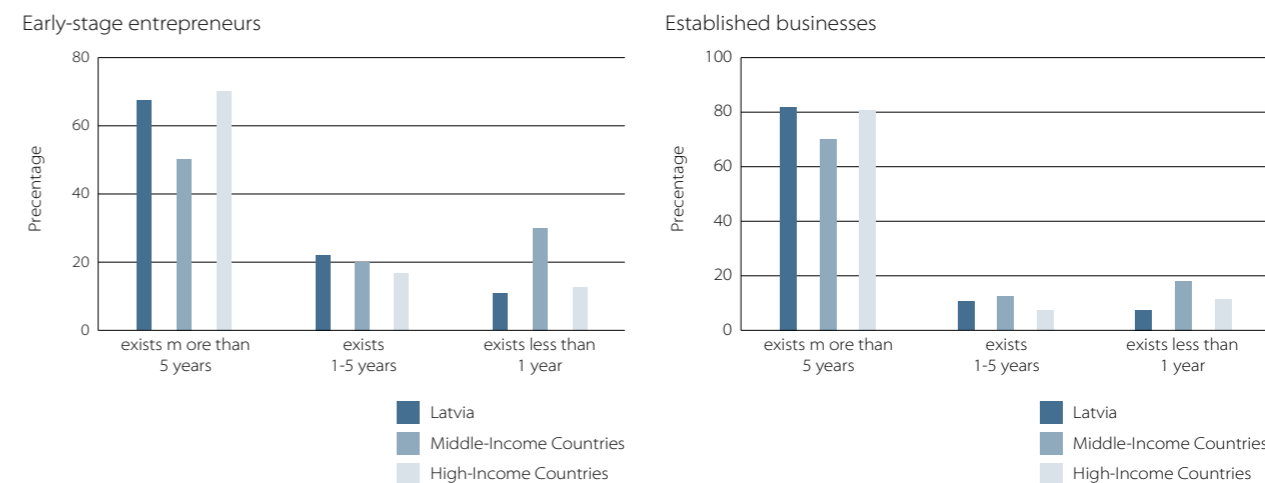


Figure 13: "How new is the technology?"



The experts interviewed seemed to agree that technological development may constitute a potential problem for Latvian entrepreneurs. Around 80 % of experts admit that no sound scientific and technological base exists in Latvia, while universities and public research organizations play little role in transferring knowledge to new and growing firms. Besides, 66 % of experts consider that new and growing firms face problems in affording new technologies. More than half the experts also see serious problems with intellectual property rights, copyrights, patents, and inventor's rights in Latvia.

Why are some entrepreneurs innovative and have high growth expectation while others are not? Although addressing this question is clearly beyond the scope of this report, we summarize the main differences between 'ordinary' and innovative/high-expectation entrepreneurs.

It appears that both high-expectation and innovative entrepreneurs are likely to be individuals of prime age (35-44 years old). However, in contrast to the GEM 2005 Report on High-

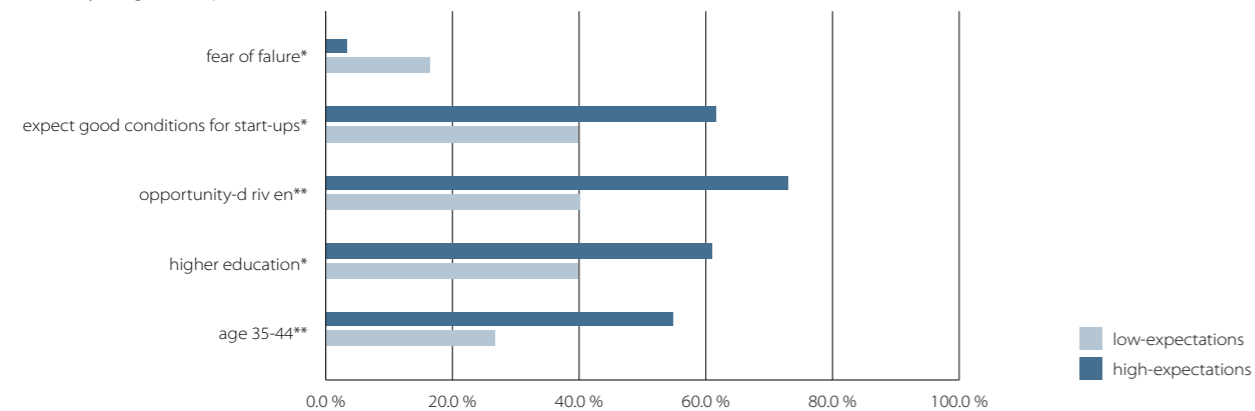
Expectation Entrepreneurship, gender and income differences for Latvian entrepreneurs are not significant: males and females as well as high income individuals (the top third of income distribution) constitute roughly similar proportions in groups with high and low-growth potential entrepreneurs.

Early-stage high-expectation entrepreneurs are likely to have higher education and be opportunity-driven. They also optimistically evaluate regional conditions for starting up a business in the near future and only a few of them fear business failure.

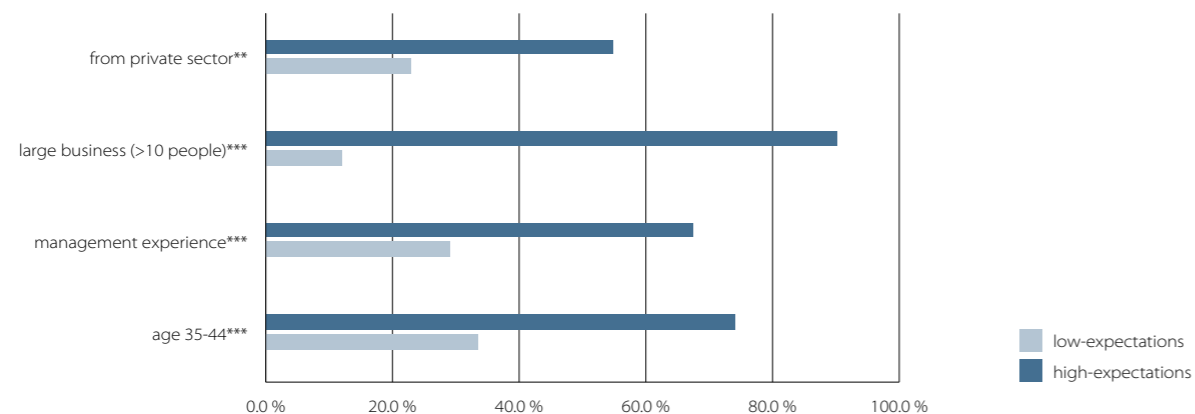
Owners of established businesses that plan considerable employment growth in 5 years are also likely currently to be big businesses. Higher education is not a significant characteristic for them. However, a managerial position occupied in the past appears to be a useful experience for establishing a business with growth potential. In addition, established high-expectation entrepreneurs are more likely to enter this business from elsewhere in the private sector.

Figure 14: Comparison of high-expectation and low-expectation entrepreneurs

For early-stage entrepreneurs



For established businesses



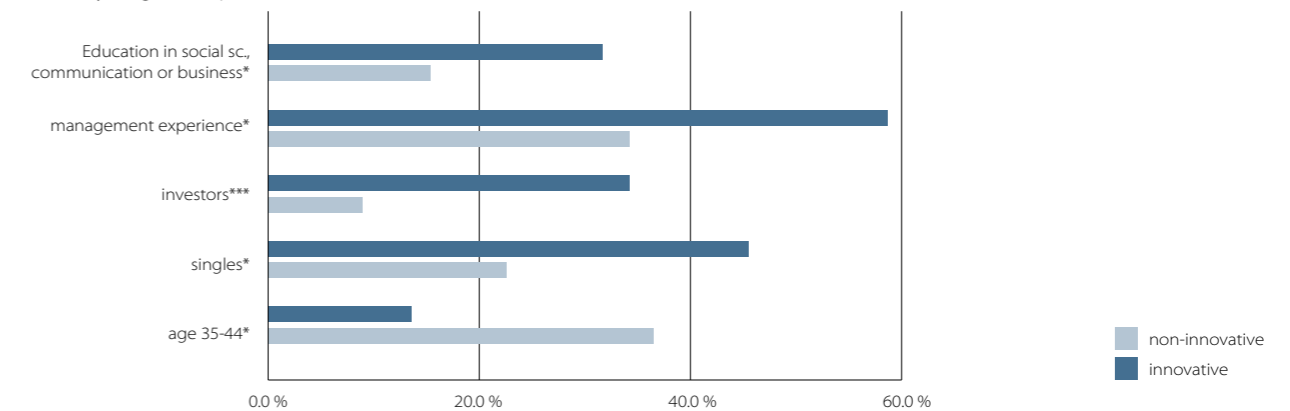
*** significant at 1% level
** significant at 5% level
* significant at 10% level

Some interesting differences exist between innovative and high-expectation entrepreneurs. For example, innovative entrepreneurs are more likely to be single. Surprisingly, having higher education in general is not significantly correlated with being innovative. However, education in such fields as business, social sciences, or communication sciences is characteristic of the group of early-stage innovative entrepreneurs. As with high-expectation entrepreneurs, innovative entrepreneurs are more likely to have management experience in the past.

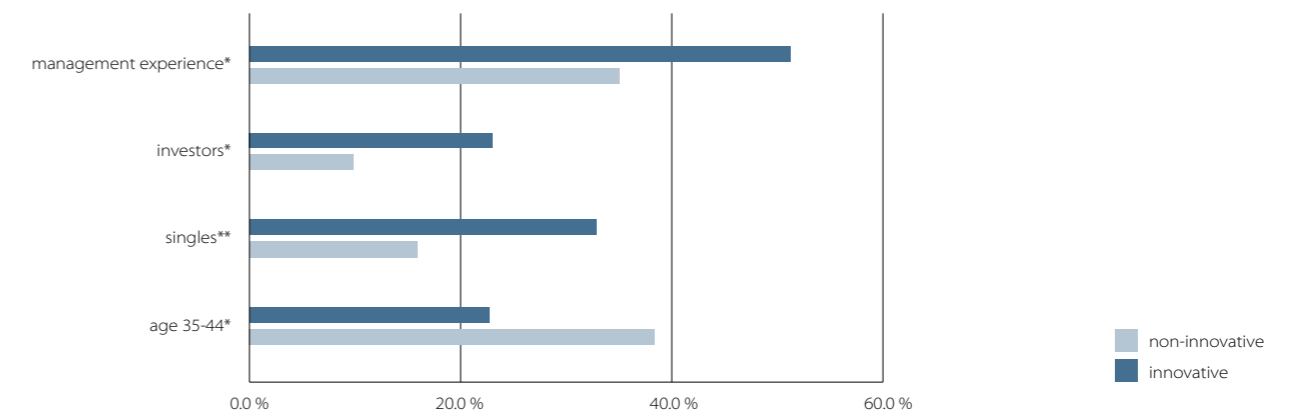
However, an interesting result is that the proportion of those who received some education or training in management is the same among entrepreneurs with high-growth potential as it is among entrepreneurs with low-growth potential. Thus management education appears to be of little help in creating high expectation and innovative entrepreneurs.

Figure 15: Comparison of innovative and non-innovative entrepreneurs

For early-stage entrepreneurs



For all businesses



*** significant at 1% level
** significant at 5% level
* significant at 10% level

FOCUS INSERT 3: FEMALE ENTREPRENEURSHIP

BY FRIEDERIKE WELTER

As in many other countries, entrepreneurship in Latvia has a strong gender dimension. Only about 40 per cent of all early-stage entrepreneurs are women. Compared with other countries in the GEM project, however, women in Latvia are highly active in entrepreneurship.

Female nascents are slightly older compared to their male counterparts, reflecting child-bearing periods: 23 % of women and 8 % of men respectively are between 45-54 years of age. In terms of educational background, both women and men are highly educated, confirming a general trend known from several studies of former Soviet countries. Moreover, a comparatively larger proportion of female nascents had pursued academic education, either having obtained a bachelor or master's degree. This reflects a recent trend in Western economies such as Germany, where more and more female entrepreneurs are highly qualified.

Until recently, the mass media in transition economies have tended to depict female entrepreneurs as women forced by circumstances to trade in the market place in order to provide support for their families or because of their poor employment possibilities. The GEM data show a differentiated picture for Latvia: Although some female nascent entrepreneurs are pushed by negative circumstances (i.e. they state that they have no other option), a large proportion is pulled by positive opportunities. 18 % state that they are looking for other opportunities than their current employment in starting their venture, while nearly

42 % wanted to pursue an opportunity, compared to 41 % of men. On the other hand, the proportion of female nascents being pushed into entrepreneurship is comparatively higher, with 23 % for women and 12 % for men.

A tendency often exists to perceive female businesses as ventures that contribute little, if at all, to economic growth and development because of their small size. In this context, GEM data show some interesting trends related to business goals of existing ventures. These contradict most Western studies illustrating that more women than men are inclined to stay small. Asked for the most important goal, both women and men state business growth as their foremost goal, followed by survival. Analysis of the three most important goals shows a slightly different distribution, with both women and men stating their foremost need to increase their private income and make a living for their families, followed by growth in the case of female-owned ventures, and survival in the case of male-owned ventures.

The overall high preference of Latvian female entrepreneurs for growing their business does conform with other studies for Post-Soviet countries in illustrating that a high proportion of female entrepreneurs are in fact growth-orientated (e.g., Wells et al. 2003; Welter et al. 2006). However, this phenomenon is often closely connected to the sectors where women create their businesses or to economic motives such as the need to increase business income in order to provide a living for families, which is clearly visible in the Latvian data as well.

Table 13: "What was your main goal in the last 12 months?"

	Males	Females	Total
Firm growth	29.8 %	28.2 %	29.2 %
Survival	26.3 %	24.6 %	25.7 %
Decrease shadow turnover	1.7 %	0.0 %	1.1 %
Make living for family	22.8 %	21.8 %	22.4 %
Increase private income	19.4 %	19.8 %	19.5 %
Other	0.0 %	5.4 %	2.1 %
Total:	100.0 %	100.0 %	100.0 %

CONCLUSIONS AND POLICY IMPLICATIONS

In spite of an apparent surge in entrepreneurship over the last several years, the levels of entrepreneurship in Latvia are still substantially lower compared with countries like Ireland, United States, and China. This suggests that Latvia may need more entrepreneurs to match the highest performing economies and ensure sustainable economic growth and job creation. Policy efforts should focus on identifying and removing the remaining obstacles that restrain the entrepreneurial spirit of the Latvian people. The findings reported above are an important first step towards identifying some of the possible obstacles, highlighting the issues of importance, and suggesting areas for further research.

Some of the findings reported above point to important imbalances in entrepreneurship in Latvia. First, there is the regional disparity in entrepreneurship. Second, women remain under-represented among entrepreneurs, although to a much lesser degree than in other countries. Third, the level of entrepreneurship among the Russian-speaking ethnic minority is substantially lower as compared with ethnic Latvians. To avoid deeper divisions of society along regional, gender, or ethnic lines there might be a need for policies to encourage entrepreneurship in certain regions, as well as among disadvantaged social groups.

Otherwise our findings are encouraging regarding the entrepreneurial environment in Latvia. There seem to be few significant barriers to starting or expanding a business and, the Soviet legacy notwithstanding, entrepreneurs in Latvia enjoy high levels of social support and approval. One notable exception in this favourable picture is the very high level of corruption reported by entrepreneurs. It is especially worrying that there is a perception that public officials accept bribes to change the rules of running business. The implication is that some (usually large and established) businesses collude with public officials to make it more difficult for new businesses to enter their industry and, thus, obtain extra profits.

Findings of the GEM research suggest that participation in entrepreneurship is significantly and positively correlated with educational background and family background, especially having parents who are or were entrepreneurs. Clearly, deeper understanding of the factors shaping entrepreneurship in the educational system and at the family level is key to devising effective policies to promote entrepreneurship.

The results summarized above point strongly to the fact that new enterprises in Latvia currently have very narrow financing options. Practically no venture capital is available, while informal investors other than close relatives do not appear to have a strong interest in engaging in the market. However, the amount of financing that nascents expect to need to start-up an enterprise in Latvia is quite low, although access to capital is rather limited. About half of nascent entrepreneurs surveyed consider that their start-up financing will not exceed € 10,000. This suggests the need to examine innovative policy action to support small business.

Since innovative entrepreneurship was found to be a rare phenomenon in Latvia, there could be a need to develop highly selective support initiatives for innovative entrepreneurs. Clearly, more research is needed on the factors underpinning knowledge intensity of new businesses.

APPENDIX A1: RECOMMENDATIONS OF EXPERTS AND ENTREPRENEURS CONSULTED

As part of the GEM project, we also conducted face-to-face interviews with a number of experts and entrepreneurs, who provided their recommendations on how entrepreneurship and an environment fostering entrepreneurial activity can be developed in Latvia.⁶⁰ All suggestions have been grouped in various categories. Recommendations related to government policy, government programs, education and training, financial support and the political, institutional and social context featured strongly among respondents.

GOVERNMENT POLICY AND GOVERNMENT PROGRAMS

Almost every national expert expressed a comment related to government policy matters. A number of entrepreneurs suggested that the level of bureaucracy and amount of paperwork to obtain necessary licenses and permits should be considerably decreased to facilitate business start-ups. It was also pointed out that introduction of e-government would help reduce bureaucracy by improving information flows between government and business.

The experts also pointed to the need to make legislation more transparent. In some areas such as, for example, the construction industry, existing laws need review and improvement. The following quote summarized the opinions expressed by a number of experts and entrepreneurs:

"Transparency of legislation needs to be improved and enforced. Very often new and growing firms are not informed of legal requirements in due time."

The system of taxation and tax administration forms another important policy area raising concerns among national experts and entrepreneurs. More specifically, one expert suggested that the tax-deductible minimum should be increased; and tax relief should be introduced for certain prioritized industries. A number of experts called for lowering the tax burden on new businesses. As put by one expert:

"There is a need to establish a new taxation model on a national level. Income taxes need to be lowered for new and growing enterprises so that they are not discouraged by the tax burden."

The importance of start-up capital, increase of support programs and business incubators, provision of state-guaranteed loans, and especially access to EU funds featured strongly among issues suggested in relation to government policy. Experts and entrepreneurs alike were concerned about the complex application procedures for EU structural funds, fair distribution of EU funds across the country. As put by one expert:

"There should be more specialists advising on EU funds to provincial entrepreneurs. Something of a support agency must be set up in every large town. Currently available consultations are either too expensive or of unsatisfactory quality."

EDUCATION AND TRAINING

Many experts highlighted the importance of education and training in developing entrepreneurship. The government should take a lead in supporting innovative and knowledge-intensive businesses and devoting a larger share of GDP to education and science. The experts noted that the current educational system is stagnating and little attention has been paid to subjects related to entrepreneurship. Several experts stressed that an interest in studying technical and engineering sciences should be re-gained among students. The whole educational system should be changed and such modules as mathematics, physics, and chemistry should be mandatory for students of higher education as those subjects are directly linked to economics and entrepreneurship. Courses in entrepreneurship should also be included in technical and engineering faculties of universities, which should raise motivation among students to become entrepreneurs:

"The educational system needs to develop programs that would inspire more students to turn to the field of entrepreneurship. It should include more subjects on entrepreneurship in schools."

Some respondents also mentioned the necessity of establishing an adult vocational education centre, tailoring the program offered to entrepreneurs according to their needs. Training institutions, along with business incubators that would offer courses on how to lead new and growing businesses, will also be essential for entrepreneurs needing additional knowledge and experience in these areas.

FINANCIAL AND PROFESSIONAL SUPPORT AND INFRASTRUCTURE

Several recommendations were made concerning loans and other financial support from banks. A flexible and supportive bank loan policy is needed for start-ups, especially at their early stage. Respondents also noted the need to increase public awareness about entrepreneurship by using different sources of information and by establishing various state and public structures:

"Agencies providing consulting services should improve their work as well as the information they provide. There could be more information in booklets and handouts, as well as in their home pages. In addition, they could create support teams around the whole country."

MARKET OPENNESS

In relation to market openness, some experts and entrepreneurs expressed their views on corruption and ways to eliminate it. Salary increases in the governmental sector - which is directly linked to increase of living standards for people employed in the sector - is one opportunity:

"Corruption needs to be eliminated by securing transparency in deals related to state institutions. More support has to be provided to the Competition Council. Additionally, wages for state officials need to be increased to the level prevailing in private structures - this also would eliminate corruption."

Although several experts noted that more EU countries should open their labor markets for people from Central and Eastern European countries, some respondents stressed that the govern-

ment should develop different schemes to maintain the labor force in the home country and to encourage employees to return to Latvia.

REGIONAL DEVELOPMENT

A number of respondents were concerned about regional development in Latvia. Improving and further developing infrastructure across the country, and establishing programs aimed towards development of regions could feature among solutions to encourage entrepreneurship in the regions. As summarized by one expert:

"More and better programs aimed at local economic development are desperately needed. We will not achieve this goal without the help of affluent EU members. The current income gap is large and persistent. In some parts of Latvia, new jobs are being created far too slowly."

APPENDIX A2: THE GEM APPROACH AND DATA COLLECTION

THE GEM PROJECT EXPLAINED

The Global Entrepreneurship Monitor (GEM) is a research programme whose co-ordination centre is hosted jointly by London Business School and Babson College in the USA. Research also involves a consortium of national teams from each of the countries involved in the study. The aim of GEM is to create an annual assessment of levels of entrepreneurial activity across countries. The research also explores a variety of factors both within and across countries that might give rise to systematic differences in entrepreneurship rates. Through a greater understanding of these factors, policies to enhance the level of entrepreneurial activity can be based on solid research, while the role of entrepreneurship in contributing to a positive economic environment can be better understood. GEM started in 1999. The first study began with 10 countries, and has involved 40 different countries since its inception. Thirty-five countries participated in the 2005 research cycle and more than 150 scholars from the various national teams collaborated with the coordination team in collecting data and developing the project.

GEM's major activity has been creation of a large data set and construction of harmonized measures of entrepreneurial activity. In this year's round, the Latvian team collected two types of data: adult population surveys, and national expert interviews.

ADULT POPULATION SURVEY

Representative samples of randomly selected adults, ranging in size from 1,000 to almost 27,000 individuals, are surveyed each year in each country in order to provide a harmonized measure of the prevalence of entrepreneurial activity. An extensive description of these procedures may be found in Reynolds *et al.* (2005). The interview schedule consists of a set of core questions used to derive entrepreneurial activity rates and additional

questions concerning the attributes and characteristics of the respondents.

In Latvia, face-to-face interviews were conducted by a professional survey firm (*Latvijas Fakti*) with a total of 1,964 adults (aged 18-64 years) in May-June 2005. Interviews took 20 to 65 minutes on average, depending on whether a respondent was identified as a potential entrepreneur or not. Observations were then weighted by age, gender, and geographical region. A multi-stage survey design was implemented with 370 sampling points (primary sampling units) at the first stage.

NATIONAL EXPERT INTERVIEWS

During 2005 the GEM team in Latvia interviewed 38 leading experts and entrepreneurs to receive their opinion on entrepreneurship in Latvia. Experts and entrepreneurs were interviewed individually for the first time by a member of the GEM team. All respondents completed detailed questionnaires and shared their opinions during interviews on what they consider should be carried out to foster entrepreneurial activities and to encourage more people to become entrepreneurs in Latvia.

Almost one third, or eleven interviewed respondents, represented successful entrepreneurs from production, services, finance, consulting, and other sectors. Some entrepreneurs had begun entrepreneurial activities during the last 3-5 years. However, more than a half of respondents had been entrepreneurs for 10 years and more. The experts included senior state and government officials, executives of the State Development Agency and Project Development Institute, consultants for the private sector, support and finance for new enterprises, executives of technology parks that facilitate transfer of research and technology to commercial enterprises, and academics.

⁶⁰ Please see the appendix for details.

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