

Entrepreneurship *in* LATVIA

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Entrepreneurship in Latvia: A Comparative Perspective

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Foreword

This is the second discussion paper of the TeliaSonera Institute which is located at the Stockholm School of Economics in Riga. The Institute, generously supported by TeliaSonera, aims to promote applied economic research in areas such as entrepreneurship, regulation, and many other aspects of market economics. This discussion paper, on Entrepreneurship in Latvia, was prepared by Vyacheslav Dombrovsky and Ieva Ubele for the TeliaSonera Day on Entrepreneurship at SSE Riga in November 2004.

The first discussion paper was on Venture Capital in Latvia and the themes for future discussion papers include: the new EU telecommunications regulatory framework in the Baltic context, and entrepreneurship in transition economies. Copies of the discussion papers can be ordered from the SSE Riga library.

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Introduction

Entrepreneurship is widely believed to be a major driving force for innovation and economic growth. Governments throughout the world pursue a host of policies designed to promote and encourage entrepreneurial activity. However, our understanding of the phenomenon of entrepreneurship is very limited. What factors shape entrepreneurship? What is the interrelationship between entrepreneurial activity and economic growth? Answers to these questions are crucial to designing more effective policies and achieving dynamic economic growth.

The Global Entrepreneurship Monitor (GEM) program, initiated in 1998, seeks to address these and other questions by producing harmonized measures of entrepreneurial activity in a wide range of countries. From 1999 to 2003, over 350,000 individuals in 41 countries were interviewed about their participation in and attitudes toward entrepreneurial activity. To date, Hungary, Poland and Slovenia had been the only members of the GEM consortium in Central and Eastern Europe.²

Meanwhile, our major objective here is to produce measures of entrepreneurial activity in Latvia for the year 2003 that would be compatible with the GEM data on entrepreneurship in other countries. Thus, this discussion paper should be viewed as a forerunner to the GEM National Survey for Latvia in 2005. Although conducting a survey for 2003 was not an option, we were able to gauge the extent of entrepreneurial activity in Latvia using the Enterprise Register data, kindly provided to us by Lursoft. Our results are based on a random sample of 2,000 owners and managers of new firms and are comparable with GEM data on new firm entrepreneurs. In this study we adopt a very narrow definition of an entrepreneur as a person who manages a business that is not older than 3.5 years that he or she owns (fully or partly). This is the definition of new firm entrepreneur in the GEM studies.

We find that, compared with most other countries, the level of entrepreneurial activity in Latvia is very low. This finding delivers a blunt message to policy-makers. Although the Latvian economy has recently been growing at a very high rate, this growth may not last for long if a vibrant entrepreneurial sector is lacking. In addition to producing a robust measure of entrepreneurial activity, we have also obtained some information about the typical entrepreneur. We find that a typical entrepreneur is a male, 39 year old ethnic Latvian, who works in the wholesale or retail trade sector, who has no long-term loans from banks or other financial institutions. A more comprehensive survey of the adult population, to be conducted in 2005 within the GEM framework, will help us to get a more detailed profile of the entrepreneurs.

As the level of entrepreneurial activity is relatively low, we have undertaken a preliminary look at the possible causes. We have reviewed existing studies that examine the effect of economic institutions and institutional barriers on entrepreneurship in Latvia. The evidence we have suggests that formal institutions for entrepreneurship in Latvia are not worse in comparison with other transition economies or even developed countries. It is relatively easy to set up companies, corporate tax is among the lowest in the world, labor markets are flexible and there seem to be no significant

problems with the enforcement of contracts. However, access to credit, 'wages in envelopes', and administrative excesses related to registration of property seem to hinder the development of businesses. There is clearly a lack of good quality studies of entrepreneurship in Latvia but our analysis seems to point to informal institutions, such as an 'entrepreneurial culture' that may be responsible for why there is so little entrepreneurship in Latvia.

² Latvia will take part in the 2005 round of the Global Entrepreneurship Monitor program.

I. Entrepreneurs in Latvia

1. How Entrepreneurial is Latvia?

Our study has produced reliable estimates of the number of 'new firm entrepreneurs' in Latvia and their characteristics. Remarkably, our measure of entrepreneurial activity can be readily compared with many countries participating in the GEM project. It therefore provides a new information resource for policy makers and all interested in learning more about entrepreneurship. To the best of our knowledge, this is the first such measure of entrepreneurship that has been created in Latvia.³

According to the GEM classification, a new firm entrepreneur is an individual who owns and manages an operational firm that was registered within the last 3.5 years. According to Lursoft data, in 2003 there were 12,377 such persons in Latvia. For comparison, in 2002 there were 13,283 new firm entrepreneurs. To compare the level of entrepreneurial activity in Latvia with other countries, we have calculated the New Firm Prevalence Index, defined as the number of new firm entrepreneurs per 100 inhabitants aged 18 to 64.⁴ Our findings are presented in Figure 1.

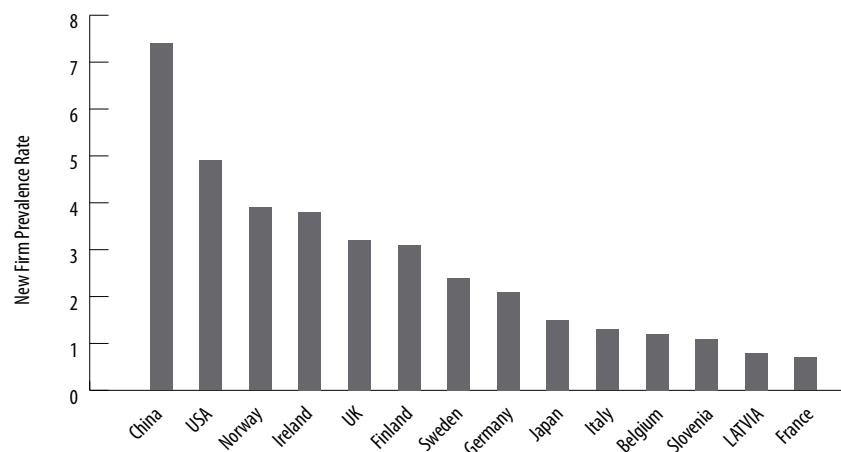


Figure 1: New firm entrepreneurs - comparative perspective (2003)

Source: GEM, Lursoft.

Our major finding is that the level of entrepreneurial activity in Latvia, as measured by the New Firm Prevalence (NFP) Rate, is among the lowest when compared with countries covered by the GEM program. The GEM 2003 Global Report classifies 40 countries into 5 groups, based on their scores in various aspects of entrepreneurial activity. Our findings suggest that Latvia can be classified as a group E country, with the lowest levels of entrepreneurial activity. The average new firm prevalence rate for group E is 1.5, and some of the other countries in that group are Croatia, Netherlands, France, Japan, Russia, and Poland. For comparison, the average NFP rate for countries in the top group A is 9.5. Some of the most entrepreneurial countries in the world are Chile, Korea, New Zealand, and, surprisingly, Uganda and Venezuela.

It is difficult to reconcile our results with the observation that, in 2003 as well as in 2004 Latvia was one of the fastest growing countries in Europe.⁵ However, if one believes that entrepreneurship is crucial to sustained long-term growth, our findings suggest that the present pattern of economic growth in Latvia is largely driven by short-term factors and may not be sustainable in the long run.⁶

Interestingly, 5.10% of entrepreneurs in our sample have an ownership share in more than one company. This finding is consistent with observation that the so-called portfolio entrepreneurship is a common feature in transition economies (Welter and Smallbone, 2003).

Although the level of entrepreneurship in Latvia does not seem to be very high compared with most countries, it is quite similar to other ex-communist countries like Slovenia or Poland. Of course, the real policy question is in regard to why the level of entrepreneurship in Latvia is so low and what can be done about it. In the second part of this paper we attempt to propose some tentative explanations for it by focusing on the entrepreneurial environment in Latvia. We hope that Latvia's participation in the GEM program will shed more light on the factors shaping entrepreneurship in this country.

³ See Appendix 1 for a detailed description of the methodology used in our study.

⁴ The presentation of population statistics provided by the Central Statistical Bureau of Latvia does not allow for precise calculation of the number of people aged 18 to 64. Therefore, the number of people aged 18 and 19 years was imputed from the 15-19 years age group. The inaccuracy is likely to be negligible as the imputed number of people aged 18 and 19 is less than half a percentage point of the number of people aged 18 to 64 years.

⁵ Latvia is not an exception as GEM research points towards a more complicated relationship between the level of entrepreneurial activity and economic growth (See GEM 2004 Executive Report)

⁶ Such factors could be the inflow of EU structural funds or a shift of shadow economy activities into the official economy.

2. Who are the Entrepreneurs?

Entrepreneurship is, ultimately, about people who create and run new businesses. Knowing the individual backgrounds of those people is an important first step to understanding why certain people choose to be entrepreneurs. Among the most important factors to consider are the age and gender of the individuals. In the Latvian context, the ethnicity of entrepreneurs is also of interest. A typical new firm entrepreneur in Latvia is male, 39 years old, and ethnic Latvian.⁷ Across all GEM countries the 25 - 34 age group is the most common age for men and women to be active as entrepreneurs, while in Latvia, entrepreneurs are most likely to be within the 35 - 44 age group (Figure 2).⁸ The reason why most of the entrepreneurs are of slightly higher age group may not come as a surprise. They may have chosen to wait until they accumulated experience about the products and the customers they would be trying to sell to; they perhaps needed time to build business networks and accumulate some personal financial resources. Kuzmina (2003) reports similar results for a survey of 180 entrepreneurs in Riga in 1998. She found that more than 50% of entrepreneurs are 35-50 years old, and about 50% of them already had a higher education when they started a business.

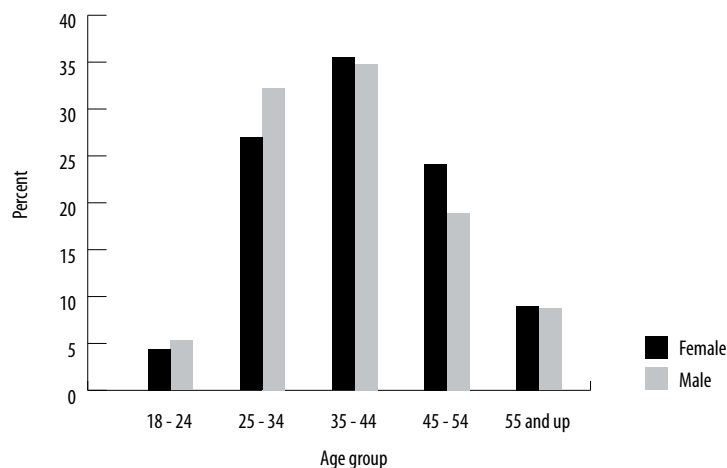


Figure 2: Age profiles of entrepreneurs by gender in 2003

Source: Lursoft

⁷ Medians were used to calculate average characteristics of entrepreneurs.

⁸ Note that the GEM figures for age refer to nascent entrepreneurs as well as the new firm entrepreneurs. Our comparisons therefore are only valid if there are no systematic differences in age structures of those two groups across countries.

On the other hand, it is disturbing that very few young people qualify as new firm entrepreneurs in Latvia. According to Figure 2, less than 5% of all entrepreneurs are in the 18 - 24 age group. For comparison, 11.5% of all new firm entrepreneurs in GEM countries are between 18-24 years old. In some countries, such as Ireland, this figure is almost 19%, indicating that the young individuals are very involved in new business creation. This finding suggests that the apparent lack of new entrepreneurs in Latvia may, at least partly, be due to young individuals being unable or unwilling to be involved in the creation of new businesses. It may also point to a defunct education in entrepreneurship in schools. This phenomenon certainly merits more research in the future.⁹

The great majority of entrepreneurs in Latvia are men (65%). This in itself is not surprising as GEM research has shown that in general men are more likely to be entrepreneurs than women. It is possible to compare the degree of women's involvement in entrepreneurship with other countries (Figure 3). The rate of entrepreneurial activity among women in Latvia is on a par with countries like Germany and the USA. This fact notwithstanding, there is still an imbalance in terms of the gender dimension of entrepreneurship, which is highlighted by comparison with countries such as France, Italy, and China. The age distribution of female entrepreneurs is very similar to that for males (Figure 2). One notable exception is that, compared to men, women in the age group of 45-54 are more likely to be entrepreneurs. This could be because women are more likely to enter entrepreneurship after child rearing.

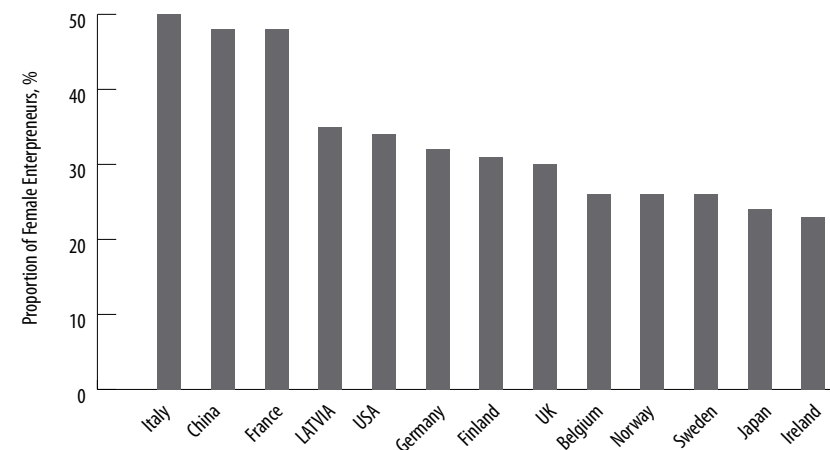


Figure 3: Gender dimension of entrepreneurship

Source: GEM, Lursoft

⁹ It might be tempting to explain this result as due to plentiful wage employment opportunities for the young. However, available evidence on the age structure of employment in Latvia suggests that this is not the case (Hazans, 2005).

It is also interesting to investigate the ethnic dimension of entrepreneurship. Ethnic entrepreneurship is defined as a set of connections and regular patterns of interaction among people sharing a common national background or migration experiences (Walding et al, 1990).

Our findings regarding ethnic backgrounds of entrepreneurs are less reliable, compared with characteristics like age and gender, because of a very small sample size – only 100 observations on the ethnicity of entrepreneurs are available. Fifty-eight percent of new firm entrepreneurs in our sample are ethnic Latvian, and 38% are likely to belong to Russian-speaking minorities.¹⁰ Given that 58.5% of the total population in Latvia is made up of ethnic Latvians, our results support a hypothesis that, in general, Russians and Latvians are equally likely to start businesses in Latvia.

More interesting findings emerge when we examine the personal backgrounds of Russian and Latvian entrepreneurs. First, our results suggest that the degree of gender imbalance in entrepreneurship is much smaller for individuals of Latvian ethnicity, as compared with ethnic Russians (Figure 6 in the Appendix 2). While only 33% percent of all Russian entrepreneurs in the sample are females, the corresponding figure for entrepreneurs of Latvian ethnicity is almost 44%. Second, the age profiles of Russian and Latvian entrepreneurs are very different, leading to some interesting observations (Figure 7 in the Appendix 2). Young ethnic Russians seem to be more active than their ethnic Latvian counterparts. A new firm entrepreneur, aged 18-24 years old, is twice as likely to be a Russian than a Latvian. Less surprisingly, older Russians are much less likely to be entrepreneurs, as compared with Latvians. For example, an entrepreneur more than 55 years old is eight (!) times more likely to be a Latvian. Thus, our results suggest that the pattern of participation in entrepreneurship is very different in the Russian and Latvian communities living in Latvia.

As it was already mentioned, the results about the ethnicity of entrepreneurs are based on a sample size that is too small to make a reliable statistical inference about the population at large. Thus, these findings should be viewed as tentative, at best. An adult population survey of a much larger sample would yield a more accurate picture of the ethnicity dimension of entrepreneurship in Latvia.

3. What Kind of Businesses?

The types of business activity reported by the companies owned and managed by the new firm entrepreneurs were coded according to the NACE classification of economic activities in the European Union.¹¹ Taking a bird's eye view of the economy, we may classify all businesses in three major types of activity. The “extractive” sector includes agriculture, fishing, forestry, and mining (all involved extraction of products from the natural environment). The “manufacturing” sector includes construction and manufacturing. The “services” sector includes all activities in which the primary customer is another individual or business – retail, hotels and restaurants, education, health, and the like.

¹⁰ Ethnicity of the remaining four percent of entrepreneurs could not be unambiguously determined to be Latvian or Russian. Those are likely to be non-Russian foreigners.

Most new firm entrepreneurs work in the services sector (76.2% of all). 19.9% of the new businesses were in the manufacturing, energy and construction sector, and only 3.9% were in the extractive sector of the economy. A more detailed picture of the kinds of businesses that are established by the new firm entrepreneurs is provided in Table 1. The majority of businesses are established in “wholesale and retail trade” and “other services”. Our findings are compared to official data on the contribution of each sector to GDP. The data suggest that the entrepreneurs are most active in the areas of trade, hotels and restaurants, construction, real estate and business-to-business service.¹²

Nearly all - (96.6%) - of new firm entrepreneurs in the sample own and manage limited liability companies, which seems to be the dominant form of registration. Less than one per cent of all companies in the sample are registered as joint stock companies. Consistent with our expectations, the city of Riga is the hub of economic activity in Latvia, with 67% of all enterprises registered in its area.¹³

	National accounts (2003)		Lursoft data
	Growth rates, per cent	Contribution to GDP, percent	Percent of entrepreneurs in the sample
Gross domestic product	7.5	100	
Production of goods	8.1	27.1	23.8
Agriculture and hunting	-2.3	2.4	1.7
Forestry	4.9	1.8	1.8
Fishery	9.7	0.2	0.2
Mining and quarrying	7.2	0.2	0.3
Manufacturing	9.1	13.9	11.8
Electricity, gas and water supply	2.8	3.0	0.5
Construction	13.7	5.6	7.6
Services	6.8	72.9	76.2
Trade	11.3	18.1	33.2
Hotels and restaurants	16.4	1.3	5.7
Transport, storage and communications	8.9	15.5	5.6
Finances	10.4	5.4	1.1
Real estate, renting and business activities	2.3	13.2	23.3
Public administration and defense; compulsory social security	2.4	7.8	0.1
Education	3.3	4.8	1.6
Health and social work	3.4	2.9	1.3
Other community, social and personal service activities	4.9	4.0	4.5

Table 1: What kind of businesses?

Source: Lursoft, Latvian Ministry of Economy (2004)

¹¹ Unfortunately, comparisons of areas of reported business activity with GEM countries is likely to be less than accurate because of different coding procedures used by the GEM. Whereas Lursoft uses NACE procedures to code business activity, GEM relies on International Standard Industry Codes (ISIC), developed by the United Nations.

¹² The picture is only suggestive – different units of measurement and firms may be of unequal sizes and, therefore, different contributions. It could be that there are profits in some industries but there are barriers to entry (e.g. scale economies).

¹³ This figure should be interpreted with caution because the place of registration may not be the same as where a most of a company's assets and operations are located.

4. Sources of Financing

It is widely claimed that access and availability of finance is a key issue for entrepreneurs. GEM research tries to ascertain the extent to which access to finance could be a problem by asking a set of questions on how much money is needed to start a business and which sources of finance are used by entrepreneurs. Although the design of our study does not let us fully answer such questions, we shed additional light on the amount and sources of finance used by the entrepreneurs in Latvia. Our main source of data on financing is the balance sheets of the companies owned and run by new firm entrepreneurs.

We may identify four potential sources of finance for an entrepreneur wishing to start a business. He or she may (i) take a bank loan; (ii) use his or her own accumulated funds; (iii) borrow from friends or relatives; or (iv) receive equity financing from a business partner, venture capitalist, business angel, etc. Of course, it is also likely that an entrepreneur is using some combination of the above-mentioned sources of finance. We may ascertain the extent to which new firm entrepreneurs rely on bank financing in a very straightforward way – by looking at the share of long-term (i.e. with a duration more than one year) loans in the total assets of a firm. Unfortunately, we can only arrive at some estimates of the importance of other sources of financing through a combination of careful interpretation of data and educated guesses.

About 30.4 percent of all new firm entrepreneurs had long-term loans on their balance sheets. The frequency distribution of the proportion of long-term loans in assets is almost uniform, with a median of 0.42, implying that the banks are willing to provide substantial amount of finance for a given enterprise relative to its size. Can our finding be viewed as solid evidence that banks do not provide 'enough' financing to new firms? The answer is likely to be no. Firstly, the GEM project does not have comparable data on how many entrepreneurs receive finances from banks or other financial institutions. Secondly, providing bank financing to all new firms is may not be in society's best interests because most business projects are risky, and many are not going to succeed.

Welter and Smallbone (2003) have suggested that a high concentration of new businesses in trade or services may be a way for the entrepreneurs to accumulate the financial resources needed to proceed to more sophisticated ventures. The authors called this phenomenon "serial entrepreneurship", which may be present in a context where the financial system and access to external finance is inadequate. Our finding that many Latvian entrepreneurs are in the trade sector seems to be consistent with the hypothesis of serial entrepreneurship.

Further, we may use data on a new entrepreneur's ownership share in the company's equity capital to make some educated guesses about where the rest of the capital is coming from. Our reasoning is as follows. A sole owner of a business is likely to finance his business using his own accumulated funds, or rely on informal investors such as his friends or family members. On the other hand, an entrepreneur who owns 50%, 33.33%, or 25% of his or her company is likely to rely on business partners. Finally, those owning relatively low percentages of their companies are likely to have received equity investments from venture capitalists and business angels.

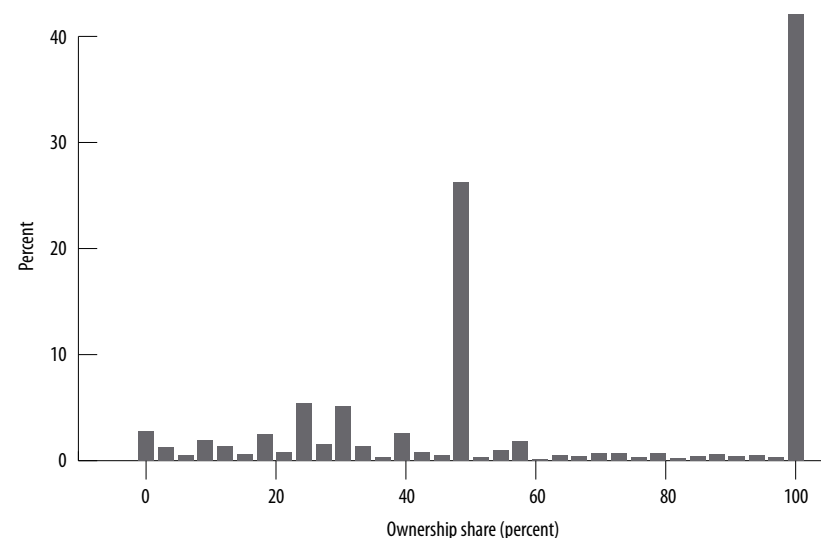


Figure 4: Ownership share of new firm entrepreneurs

Source: Lursoft

42% of all new firm entrepreneurs in our sample are sole owners of their companies. About 28.4% of all entrepreneurs are sole owners and do not have any long-term loans from banks or other financial institutions. This is our best guess of the proportion of entrepreneurs that relied on their own accumulated funds or informal investors only. The second most popular ownership structure is when an entrepreneur owns 50% of the company (24.1% of all entrepreneurs). We may also ask how many entrepreneurs owned relatively little of the company they managed and had no long-term loans from the banks, i.e. received formal equity investment. The corresponding numbers are 6.9 and 2.8 percent of all entrepreneurs in our sample who had ownership stakes of less than 25 and 10 percent, respectively. This represents our best guess on the proportion of entrepreneurs that were financed by venture capitalists, business angels, or other formal investors. Our results are consistent with what is known about venture capital in Latvia. Vanags and Dijokas (2004) also conclude that the private equity market in Latvia is at an early stage of development, as indicated by the very low amount of private equity investment per capita as compared with other countries, and the very low total number of investments made in companies' equity.

II. The Entrepreneurial Environment in Latvia

Our findings, presented in the previous section, deliver a blunt message to the policy-making community. Although the Latvian economy has recently been growing at very high rates, this growth may not last for long if a vibrant entrepreneurial sector is lacking. If policy initiatives are to take place, however, they must be based on a sound socio-economic analysis of the phenomenon, which would inform public policy discussion. Why is the level of entrepreneurship in Latvia so low, as compared with other countries? One of the popular explanations is that there are institutional barriers that prevent potential entrepreneurs from realizing their full potential.¹⁴ In this section we seek to contribute to the public discussion of the factors shaping entrepreneurship by summarizing pertinent evidence, collected from a number of sources, on the obstacles to starting and running a business in Latvia. Our discussion proceeds in accordance with actual stages of business formation, starting with its inception in the mind of an entrepreneur-to-be, and concluding with survival concerns facing an existing business. We also outline policy initiatives that aim to address some of the identified issues and promote entrepreneurship in Latvia.

1. Pre-startup phase

Most studies of the entrepreneurial environment in Latvia focus on administrative and financial barriers to the development of existing businesses. However, little or no evidence is available about the pre-startup phase, which we loosely define as the turning point when an individual gets into an 'entrepreneurial mode of thinking', i.e. starts contemplating a business enterprise. In this section we try to summarize the evidence that sheds light on the question of why some people choose to try to become entrepreneurs and some do not.

1.1 Social norms and cultural values

It is now taken as an axiom that some individual traits and characteristics of the business environment are among the most important factors in explaining the entrepreneurial choice. In a recent study using Swedish data, Giannetti and Simonov (2004) find evidence that cultural values and social norms also matter. Their study suggests that individuals are more likely to become entrepreneurs where there are more entrepreneurs, even if entrepreneurship pays less than paid employment. Some observed facts on the dynamics of new firm creation in Latvia are consistent with this theory. In other words, entrepreneurship breeds more entrepreneurship. As pointed out by an OECD study, more than half of all Latvian enterprises are registered in Riga, and most new enterprises are also created in Riga (OECD, 2003). These findings lend support to the view that there are spillover effects from entrepreneurship, i.e. that individuals benefit from the business experience of other individuals in their community; they become more productive and hence more inclined to become entrepreneurs.

Professor Ķeniņš-Kings had done some of the most comprehensive research on entrepreneurship in Latvia. In his book "Uzņēmību!", he reviews the history of Latvian entrepreneurship and discusses business development which has taken place after the regaining of independence in 1991. He also looks at the interaction between the society and entrepreneurs, and talks about spillover effects

and institutional infrastructure (e.g. values embedded in laws, norms accepted by the society), which could both hinder and promote entrepreneurship. He argues that social capital also plays an important role in business development, and suggests that some legal, social and educational reforms could contribute to building social capital and positively affect the level of entrepreneurial activity in Latvia (Ķeniņš-Kings, 1999).

When it comes to the background of individuals, factors like risk aversion and initial wealth, education, and some personal traits are the usual characteristics that come to mind. Contrary to conventional wisdom that the initial wealth of a future entrepreneur is important for startup capital, Giannetti and Simonov argue that the initial wealth might matter because it affects individual risk aversion. In this case, the relationship between the level of initial wealth and the decision to become an entrepreneur may differ depending on the institutional environment. For instance, even a small amount of wealth may increase an individual's propensity to take risks in countries where institutions provide social insurance, like in Sweden, but a much larger buffer is needed if institutions do not provide a safety net. Although the tax-and-redistribute 'welfare state' has often been criticized for its negative effect on businesses, these findings imply that social safety nets may also encourage entrepreneurship by alleviating the consequences of business failure. Giannetti and Simonov also find that individuals with experience in many different roles are more likely to become entrepreneurs. One implication of this result is that a less specialized and more versatile educational background may help to foster a more entrepreneurially-minded population. Our fundamental understanding of the factors shaping entrepreneurship, however, is quite limited. More research is needed in this area.

1.2 Education for entrepreneurship

Although few would deny that education is important factor in successful entrepreneurship, the relationship has not been empirically validated in Latvia. We also know very little about whether specific types of education are especially conducive to entrepreneurship. Thus, this section merely reviews the possibilities for acquiring a business education both in schools and higher education institutions, as discussed in some recent studies.

Courses and topics on entrepreneurship are now an integral part of primary and secondary school curriculum in Latvia. "Introduction to Economics" in the 8th grade and "The Economic Basis of Business" in the 10th-12th grade are mandatory courses and more than half of the graduates (61.4%) choose to take these subjects as one of the exams for graduation.¹⁵ The courses on entrepreneurship (e.g. "Basics of Business") are also included in the vocational education programs and it is possible to acquire a number of qualifications related to running small businesses from vocational education institutions, which might form a good basis for starting one's own business. There seems to be an understanding that "the most essential requirement for the current business education in Latvia is to develop programs that foster entrepreneurship and self-employment. This problem has to be targeted via interconnection of theoretical vocational courses with the current best practice of entrepreneurship."¹⁶

¹⁴ There are, of course, other explanations for why there are entrepreneurs (see Djankov et al 2004 for a short summary). Sociologists emphasize the role of values and social networks. Psychologists point to the psychological traits of individuals.

¹⁵ The European Charter for Small Enterprises. Questionnaire 2003. Answers of the Republic of Latvia, p.2

¹⁶ The European Charter for Small Enterprises. Questionnaire 2003. Answers of the Republic of Latvia, p.3

On the university level there are several academic/professional degrees offered in the fields of business administration and economics. However, no information is available on how many graduates of business programs have actually become entrepreneurs.

In addition to formal education, there are also other initiatives aimed at stimulating entrepreneurship among young people, which include business plan competitions (e.g. the annual competition organized by the Latvian Economic Development Fund), and competitions for primary and secondary school students organized by Junior Achievement Latvia (e.g. "Your Advertisement", "Junior Businessman", "The Way to Economic Thinking", etc.).

In general, young people in Latvia are exposed to business and entrepreneurship through education, but further study would be required to evaluate the impact of this education on the level of entrepreneurial activity among them.

2. Start-up environment

Once an individual has decided to start his/her own business, he or she has to deal with a number of practical aspects, such as acquiring information about running the business, registration of the company, and getting financing to start the activities. This section looks at those three aspects in the start-up environment in Latvia.

2.1 Availability of professional services and information

Knowledge of the marketplace, as well as knowledge of the legal and regulatory environment for business is crucial to entrepreneurs. It is not clear, however, whether Latvian entrepreneurs have adequate access to information and consultancy services. A Latvian Development Agency survey of businesses conducted in 2002 revealed that the difficulty in obtaining information about changes in legislation was perceived as the second most important obstacle to business development. On the other hand, a lot of information is available on the various websites of state institutions (Ministry of Economy, State Revenue Service, Register of Enterprises, Latvian Development Agency) aimed either at entrepreneurs and SMEs (e.g. information on how to register the company, start the business, what are the available support programs, etc.). Some observers have noted that Latvian companies rely on personal contacts with authorities to gain legal assistance in their dealings with every-day issues with Latvian institutions, although there is a wealth of information available on government and government agency websites pertaining to laws, rules and regulations that are easily accessible for companies (OECD, 2003).

One explanation could be that rates of Internet penetration are still relatively low. According to information provided by the Central Statistical Bureau, in 2003 only 21% of SMEs used the internet for interaction with public authorities. Of the 21%, 94% were looking for information, 40% were seeking forms and only 14% were returning the filled-out forms.¹⁸

Business information centers are a major source of information for entrepreneurs. In 2002, Latvia joined the Multi-annual Program for Enterprise and Entrepreneurship for 2001-2005. The goals of the program will be implemented through a number of activities, including the development of a network of European Information Centres (EIC). In Latvia the first EIC was established in 1997 under the supervision of the Latvian Development Agency. The EIC provides its clients with exhibition catalogues and information about potential business partners' abroad, economic reports about Latvia and foreign countries, access to electronic databases, and information about the

European Union. On March 4, 2004 the second EIC in Latvia was opened under the supervision of the Latgale Regional Development Agency.

Entrepreneurs also have a chance to receive consultancy services that are partly financed by the national government or the European Union. At the end of 2003, the Ministry of Economy implemented "The Consultative Support Program for Starting Businesses" aimed at consulting with small and medium-sized enterprises which have been operating for less than 2 years after their registration, in the areas of financial issues, preparation of business plans and market research, mandatory and voluntary EU quality requirements, etc. Similar opportunities are now provided to companies within the framework of EU Structural Funds.

2.2 Procedures for setting up business in Latvia

On the 1st of January 2002 the new Commercial Code came into effect and it is believed that the new code will improve the legal framework for business activities by eliminating some inconsistencies in existing laws and streamlining registration procedures. For example, the number of possible business forms was reduced to only five (from 17 previously). The minimum requirements for start-up capital are still relatively low. In order to register, limited liability companies are required to have an equity capital of 2,000 LVL and joint stock companies are required to have 25,000 LVL. Approximately 75% of all companies are limited liability companies.

The World Bank's "Doing Business Database" indicates that in Latvia, entrepreneurs have to go through 7 steps to launch a business over 18 days (on average), at a cost equal to 17.6% of gross national income (GNI) per capita. They must deposit at least 41.4% of GNI per capita in a bank in order to obtain a business registration number. A comparison with the registration procedures in neighbouring countries and the OECD average is provided in Table 2.

Country/region	Number of procedures	Number of days	Cost (% of GNI)	Min. deposit (% of GNI)
Latvia ¹⁹	7	18	17.6%	41.4%
Lithuania	8	26	3.7%	62.8%
Estonia	6	72	7.5%	49.7%
Europe & Central Asia	9	42	15.5%	51.8%
OECD	6	25	8.0%	51.8%
USA	5	5	0.6%	0.00%

Table 2: Comparison of business registration procedures

Source: World Bank Doing Business data base, 2004

A survey carried out by Latvijas Fakti, a survey firm, found that registering a business at the Register of Enterprises takes on average 24.9 calendar days, while registration with the State Revenue Service takes on average 10.8 calendar days.²⁰ The survey uses different procedures than the World Bank survey, so the two are not directly comparable.

¹⁷ OECD, Latvia Country Assessment 2003, p.28

¹⁸ The European Charter for Small Enterprises. Questionnaire 2003. Answers of the Republic of Latvia, p.11

¹⁹ The World Bank study assumed that one of the procedures, obtaining registration certificate with the Register of Enterprises, would take 3 days at a cost of 300 LVL. This is the so-called accelerated procedure. While it could also be the case that entrepreneurs could use the ordinary procedure, which would mean that obtaining the registration certificate would take 14 days at a cost of 100 LVL. Such change would increase the average time of registration in Latvia to 29 days and decrease the cost of registration.

²⁰ Regulatory and Administrative Costs Survey, Latvijas Fakti, November 2003 – January 2004, p.46

2.3 Availability of financial resources

Nearly all the studies on enterprise development in Latvia emphasize access to finance as a serious obstacle to entrepreneurship in Latvia. For instance, a survey carried out for the purposes of the preparation of Latvia's report for the European Charter for Small Enterprises indicates that "the main obstacles in developing business are high taxes (45% of all respondents), lack of working capital (27%), lack of start-up capital (23%), lack of investment finances (20%)"²¹. Yet these subjective perceptions of entrepreneurs must be interpreted with some caution. It is natural for a borrower to desire that the cost of funds be lower than what was charged by a bank. From the entrepreneurs' point of view, when banks refuse to issue credit, even for perfectly sound reasons, it is "lack of startup capital", and it is a barrier to their business.

A recent study by the World Bank provides a different angle for evaluating whether or not finance is a problem. It examines the degree to which collateral and bankruptcy laws facilitate lending (Legal Rights Index), the quality and accessibility of credit information available (Credit Information Index), and the cost to create and register collateral. The results for Latvia and some other countries of interest are presented in Table 3.

Country/region	Cost to Create Collateral (% of income per capita)	Legal Rights Index	Credit Information Index
Latvia	1.5	8	4
Lithuania	4.1	4	3
Estonia	n/a	n/a	5
Europe & Central Asia	7.6	5	2
OECD	5.2	6	5
USA	0.1	7	6

Table 3: Comparison of aspects related to getting credit

Source: World Bank Doing Business data base, 2004

According to those indicators (higher indexes mean better access to capital), at least in theory, credit should not really be a problem in Latvia. The problem, of course, is that this view flatly contradicts the perceptions of entrepreneurs. Since there is not enough empirical evidence to vindicate either of the views, it cannot be ruled out that access to capital is, indeed, a problem. We therefore briefly outline some traditional explanations of why access to capital might be a problem for the start-ups.

One commonly held view is that collateral demands by banks pose a serious barrier to potential entrepreneurs. The general practice in Latvia is that banks issue loans as 70-80% of the collateral value and entrepreneurs are required to invest 20-30% of the project value themselves; loans for working capital are usually available for up to 50% of the capital required.

Another problem is that from the perspective of the banks, the benefits of dealing with small businesses may be outweighed by the costs. According to a representative of the Mortgage and Land Bank, banks are not particularly interested in issuing credit to micro- and small enterprises because

these companies usually require relatively low loan amounts²². If the fixed costs of administering loans are relatively high, it might be unprofitable for banks to issue credit to small firms. There is, therefore, a case for using taxpayers' money to help jump-start some of the very small businesses. Again, although the argument is theoretically sound it does not follow that the government should get involved into large-scale loan subsidies to small businesses. Latvia's financial sector is still relatively young, and it lacks the depth and breadth of banks in developed countries. As banks build their expertise and competition forces them to look for new profit opportunities, we may expect that credit to small firms becomes more widespread. What government may do (and what it has already done) is to channel some cheap funds, earmarked for small firms only, through the private banks. The banks would thus be alerted to new profit opportunities (if there is any) and be able to build the necessary technical expertise.

The entrepreneurs themselves are sometimes to blame. Many loan requests are turned down because of inadequate business plans and a lack of credit history. The low quality of business plans can be partly explained by the fact that most entrepreneurs do not have formal business educations and public business advisory services are very limited. Therefore, in order to prepare a good quality business plan, entrepreneurs often use private consultants that increase their start-up costs.

As regards the insufficient collateral, entrepreneurs can use the guarantees provided by the Latvian Guarantee Agency (LGA). The LGA was established in 2003, and its goal is to support the development of the business activities of small and medium-sized enterprises by issuing medium-term and long-term loan guarantees in its name to financial institutions registered in Latvia or abroad that are financing these enterprises. However, it is difficult to judge whether the guarantee amounts provided by the LGA are sufficient, as the amount of support for one project can be up to 50 thousand LVL. During the first four months of 2004 seven projects amounting to 221 thousand LVL were financed using the support of the LGA. More projects have been financed with funding from EU Structural Funds, which in the period up until 2006 would allow the issuing of guarantees to entrepreneurs for the amount of approximately 25 million LVL.

Entrepreneurs also have the option of using non-traditional financial instruments - venture capital and business angels - as a source for financing their businesses. There are a number of venture capital funds operating in the country; the Baltic American Enterprise Fund, the Baltic Small Investment Fund and the Norwegian Latvian Fund are the most active. As regards the business angels, currently very little evidence is available on the use of this source of financing in Latvia.

The Government of Latvia has also developed a support scheme aimed at improving SME access to finance. The SME Development Lending Program was established in 1999 and within its framework Mortgage Bank (previously Mortgage and Land Bank of Latvia) works on providing credit for the development of small and medium-sized companies to help those entrepreneurs who have prospects of successful development but who cannot expect financing from commercial banks because of a lack of collateral and credit history.

²¹ The European Charter for Small Enterprises. Questionnaire 2003. Answers of the Republic of Latvia, p.11

²² The European Charter for Small Enterprises. Questionnaire 2003. Answers of the Republic of Latvia, p.13

According to information provided by the Latvian Mortgage Bank, through this program, starting from the year 2000, Mortgage bank has borrowed funds from foreign banks. These funds have been used for on-lending to SMEs. From 1 January 2000 until 30 June 2004, 1,128 loans totaling EUR 55.2 million have been issued, with an average interest rate of 6.9%. The breakdown of loans by industry is as follows:

Industry	Percentage of loans
Agriculture, forestry	9%
Fishery	2%
Processing industry	29%
Trade	26%
Hotels, catering	11%
Transport	9%
Electrical energy, gas, water	2%
Services	11%
Construction	1%

Table 4. Breakdown of loans to SMEs by industries

Source: Latvian Mortgage Bank

On 1 May 2004 Latvia joined the European Union (EU) and now EU Structural Funds resources are available for the priorities defined by the Single Programming Document (SPD). The second priority of the SPD provides for the establishment of three national programs that will be financed by the Republic of Latvia and the European Regional Development Fund, and will be aimed at improving financing for SMEs:

- Risk Capital Financing²³ – is aimed at the establishment and development of venture capital funds in Latvia and establishment of the fund-of-funds, which would invest into new venture enterprises,
- Development of the Loans Guarantee System²⁴ – aimed at promotion of the loan guarantee system granting financing to a Guarantee Fund, thus developing and expanding the existing guarantee system by enabling differentiation of risk between SMEs, banks, and guarantee funds.
- Loans (including micro-credits) to Support Business Start-ups – this program foresees the granting of financing of 20-25 million Euro to a state bank (Mortgage Bank), which will be used for lending to SMEs on favorable terms.

At the moment, insufficient evidence is available to evaluate the impact of those programs on access to finance for start-ups and SMEs, and a detailed survey would be required once the programs have been up and running for a sufficient period of time.

²³ <http://www.em.gov.lv/em/2nd/?cat=4086>

²⁴ http://www.esfondi.lv/image/upload/ak-ES_strukturfondi_no_A_lidz_Z/242.pdf

3. Environment for further growth of businesses

This section examines the operating environment of companies (especially SMEs) in Latvia and covers a number of aspects that have considerable impact on the development of the company. We focus on the regulatory environment and access to human resources.

3.1 Regulatory framework for business development

According to a World Bank sponsored survey, entrepreneurs in general are rather critical of the regulatory environment: 41.9% of the surveyed companies said they were “rather unsatisfied than satisfied”; 15.7% were “relatively unsatisfied”; and 5.1% said they were “very unsatisfied” (World Bank and Latvian Development Agency, 2004). Only 31.3% of the companies provided positive feedback. Tax rates and the unpredictability of changes in laws and regulations were named as the major obstacles for business development by more than two thirds of the respondents. As regards laws and regulations, 49% of the companies rated this obstacle as “high” or “very high”.²⁵ Indeed, it is estimated that since 1991 more than 250 new laws and 350 new regulations have been issued each year, which is high by any standards (OECD, 2003). This section therefore focuses on taxation and contract enforcement, which is considered to be very important to growing businesses.

Taxation policies

It seems natural for businesses to complain about taxes being too high. 57.3 percent of all Latvian companies in the above survey mentioned tax rates as a “major obstacle for development” and 57 percent indicated that tax laws and tax administration are a “significant problem”. Some observers have argued, however, that the tax burden on private enterprises in Latvia is relatively low. For example, the corporate income tax rate in Latvia is a mere 15 percent, which is one of the lowest in Europe.²⁶ As noted in one OECD study, “Latvia has succeeded in achieving a relatively modest total tax burden equivalent to approximately 36% of GDP, significantly below EU and OECD European averages” (OECD, 2003, p.26).

One can make the case that the tax burden on individuals is very high, which also has an adverse effect on small enterprises. The social payroll tax rate is 33.09%, of which employers are liable for 24.09% and employees must pay the remaining 9%. Combined with the personal tax rate of 25 percent, the social tax creates a tax wedge of almost 50%, which is excessive by any standards (Figure 5).²⁷ Employees and employers may therefore find it mutually beneficial to evade income and social taxes through ‘wages in envelopes’. According to anecdotal evidence, it is common among small businesses to set minimum official wages and pay the rest of the wage in an envelope, i.e. not paying any taxes on it. Although tax evasion may seem like an appealing solution for the entrepreneurs because of cost savings, ‘wages in envelopes’ may also represent a barrier to their subsequent growth. Firstly, for a large enough enterprise ‘wages in envelopes’ represents too much of a risk because of increased attention from the State Revenue Service.²⁸ This creates a trade-off between growth (i.e. becoming ‘large’) and the benefits of tax evasion. Secondly, enterprises with ‘wages-in-envelopes’

²⁵ Regulatory and Administrative Costs Survey, Latvijas Fakti, November 2003 – January 2004

²⁶ Of course, what matters are effective, rather than statutory tax rates. Even so, however, it would seem that the corporate tax burden in Latvia is rather small.

²⁷ The difference between workers’ take-home pay and what it costs to employ them—the so-called “tax wedge”—consists of income tax and the social-security contributions of employees and employers.

have a cost advantage compared to law-abiding firms, which creates unfair competition. All in all, the above reasoning implies that excessive personal taxes contribute to a vicious circle in which law-abiding firms are driven out of business and growth is sluggish because becoming large may not pay off. This is consistent with the evidence from the aforementioned survey, in which 40.4% of the respondents name competition with the grey/shadow economy as a very high or high obstacle for development of their business (World Bank and Latvian Development Agency, 2004).

Obviously, the solution is a combination of reduced tax rates and improved enforcement. However, social tax rates and by extension the social security system, are politically sensitive and, thus, difficult to reform.

In regards to tax administration, an issue that is often raised is that tax legislation is interpreted differently by businesses and by the State Revenue Service, which can result in severe penalties for businesses. The penalties are “100% or even 200% of the outstanding tax amounts. For comparison, similar penalties in Sweden are 40% for income tax and 20% for social tax and VAT (OECD, 2003, p.27).”

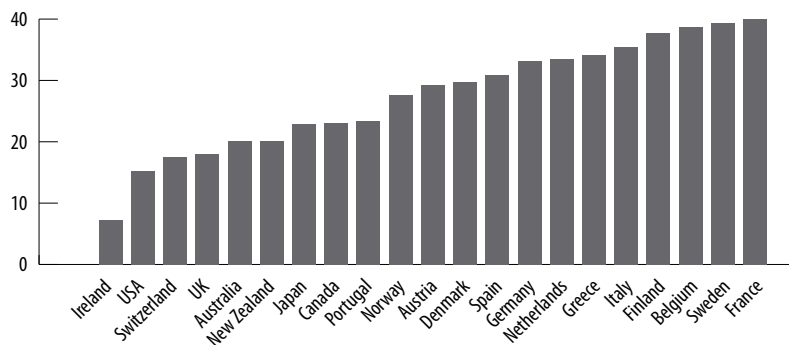


Figure 5: Household tax wedge, 2003

Source: The Economist Intelligence Unit

²⁸ Large enterprises may prefer to avoid wages in envelopes for a number of reasons. First, there are risks that some dissatisfied employee will expose the scheme to the tax authorities, which would result in huge fines. Second, wages in envelopes can only be paid if there is a corresponding inflow of ‘black cash’, implying that the enterprise would also need to evade value added taxes. This may not be attractive to large enterprises because of a more complex organizational structure. This reasoning is supported by anecdotal evidence that suggests that providing wages in envelopes is rarely practiced in large firms.

Enforcement of commercial contracts

Issues of contract enforcement have been under the scrutiny of academics and policy-makers.²⁹ It can be suggested that better enforcement of contracts leads to more favorable conditions for the growth of new businesses.³⁰ Based on what little evidence there is, it appears that enforcement of contracts is not a particularly sensitive issue in Latvia, as a number of market-based solutions have emerged to help businesses to better screen and evaluate their risks.

World Bank’s “Doing Business Database” provides some evidence on the time involved and the costs of enforcing commercial contracts in Latvia. Three indicators are reported in Table 4: the number of procedures counted from the moment the plaintiff files a lawsuit until actual payment, the associated time and the cost (in court and attorney fees), and this result expressed as a percentage of debt value. Thus, the World Bank’s findings suggest that the costs of contract enforcement in Latvia are not high, compared with OECD countries and the USA.

Country/region	Number of procedures	Time (days)	Cost (% of debt)
Latvia	23	189	11.0%
Lithuania	17	154	14.1%
Estonia	25	150	10.6%
Europe & Central Asia	29	412	17.6%
OECD	19	229	10.7%
USA	17	250	7.5%

Table 5: Comparison of procedures for enforcement of commercial contracts

Source: World Bank Doing Business data base, 2004

Another indicator of contract enforcement, reported by the World Bank, is the time and cost associated with completing an insolvency case (Table 5). The estimated time required to complete an insolvency case in Latvia is 1.1 years. The pecuniary costs of insolvency cases (e.g. court costs, lawyers’ fees) are reported in the third column of the table. The recovery rate, expressed in terms of how many cents on the dollar claimants are expected to recover from the insolvent firm, is reported in the fourth column.³¹ Again, the findings suggest that, compared with other countries, completing insolvency cases in Latvia is relatively cheap and a very high proportion of the losses can be recovered. On the other hand, one may argue that the World Bank’s findings should be viewed rather cautiously because they are based on lawyers’ estimates, rather than on real-world data.

²⁹ See Messick (1999) for an overview of the issues.

³⁰ In an influential study, Johnson et al (2002) found that more trust in the effectiveness of courts (better enforcement) is associated with greater willingness to extend trade credit or accept an offer from an unknown but cheaper supplier.

³¹ To estimate insolvency costs the World Bank’s researchers created a fictional case of building a hotel and submitted it to a number of law offices in different countries. The reported findings are based on estimates of the lawyers surveyed on how long, on average, it would take to solve the fictional case.

Country/region	Time (years)	Cost (% of estate)	Recovery rate (cents on the dollar)
Latvia	1.1	4.0%	85.0
Lithuania	1.2	8.0%	52.4
Estonia	3.0	8.0%	40.0
Europe & Central Asia	3.3	13.1 %	30.5
OECD	1.6	6.8%	72.2
USA	3.0	8.0%	68.2

Table 6: Estimated time and costs of completing an insolvency case

Source: World Bank Doing Business data base, 2004

For example, a survey carried out by Creditreform Latvia in May of 2004 paints a less rosy picture of contract enforcement in Latvia. It suggests that delays in payments of invoices are widespread, which can be interpreted as evidence that contract enforcement is not very effective. Creditreform's findings indicate that that only 45.6% of all invoices are paid on time, and this number has increased compared to the previous years (in 2001 it was 41.4%, and in 2002 it was 41.3%) and, on average, payment of invoices is delayed by 18.4 days (Table 6).

Delay	% of invoices
Paid on time	45.6
Delay up to 7 days	17.0
Delay of 8-14 days	11.5
Delay of 15-30 days	10.7
Delay of 31-60 days	6.8
Delay of 61-90 days	4.6
Delay of more than 90 days	2.9
Not paid	0.9

Table 7: Delay periods in payment of invoices

Source: Creditreform Latvia

It should be noted, however, that a number of market-based solutions have emerged to help enterprises deal with enforcement of contracts and other risks of entrepreneurship. For example, Lursoft offers information on all registered enterprises in Latvia, which improves the entrepreneurial environment by enabling entrepreneurs to quickly assess the reliability of their potential partners. Also, more firms are using the services of professional debt-collection agencies such as Creditreform.

3.2 Administrative procedures

According to the survey carried out by Baltijas Datu Nams, 17% (or 144) of the respondents reported that the procedure for registering a title transfer in the Land Book is the most time-consuming of all the administrative procedures. According to the survey's findings, it required 74 calendar days on average, while official information provided by government officials stated that the maximum processing time is 30 days (by law).³³ These findings may indicate some broader problems with registering property in Latvia.

We therefore also report the findings of the World Bank Doing Business Database that are related to procedures for registering property (Table 7). The number of days it takes to register a property are shown in the second column of the table, the number of procedures required to transfer a property title from one owner to another are in the third column. Pecuniary costs of the title transfer as percentage of property per capita value are shown in the last column.³⁴ The reported findings confirm that, compared with many countries, registering property in Latvia is a very time consuming and expensive process.

Country/region	Number of procedures	Time (days)	Cost (% of property per capita)
Latvia	10	62	2.1%
Lithuania	3	3	0.9%
Estonia	4	65	0.5%
Europe & Central Asia	6	133	3.0%
OECD	4	34	4.8%
USA	4	12	0.5%

Table 8: Comparison of procedures related to registration of property

Source: World Bank Doing Business data base, 2004

A survey carried out by Latvijas Fakti also indicated that the main administrative procedure required before one could start using purchased property is registration of the title in the Land Book and valuation of the real estate (every 5th respondent mentioned this procedure). The respondents said that the procedure required, on average, 52 days although the responsible institution said that it could be done in 34 days.³⁵ According to the survey, the procedures related to real estate also involve considerable payments including official fees and payments to lawyers and consultants.

When carrying out procedures related to registration and valuation of real estate and construction, each enterprise on average spent 681 LVL in official fees. Enterprises that used outside consultancy paid on average 163 LVL. It also has to be mentioned that these procedures are also characterised by the fact that bribes are given to either speed up the process or to achieve a more favorable solution. According to the survey, in the case of companies that gave bribes, each paid on average 120 LVL.³⁶

³³ Self-Assessment of Administrative Barriers in Latvia, FIAS/World Bank, 2002, Chapter III, p.125

³⁴ <http://rru.worldbank.org/DoingBusiness/ExploreEconomies/BusinessClimateSnapshot.aspx?economyid=10>

³⁵ Regulatory and Administrative Costs Survey, Latvijas Fakti, November 2003 – January 2004, p.89

³⁶ Regulatory and Administrative Costs Survey, Latvijas Fakti, November 2003 – January 2004, p.103

3.3 Employment issues

With regard to employment issues, there are two main questions concerning its impact on the level of entrepreneurial activity – the ease of firing and hiring employees, and the ability of employers to find a qualified workforce. Employment laws in Latvia are regulated by the new Labor Law, which came into effect in June 2002 and has been developed in accordance with EU standards. All in all, employment regulations (including the regulations on wage setting) in Latvia are relatively liberal (OECD, 2003). The minimum wage is quite low as compared with the average wage. According to recent Eurostat statistics, Latvia has the lowest minimum wage among those EU Member States that have such a mechanism and the highest proportion of employees receiving the minimum wage – 15.4%. The OECD study concludes, “The predominant form of wage setting in Latvia appears quite flexible and capable of responding to changing market conditions”.³⁷

The World Bank’s Doing Business database looks at the difficulty of hiring and firing workers as one of the aspects affecting business development using three indices, which measure how difficult it is to hire a new worker, how rigid the regulations are on working hours, and how difficult it is to fire a worker. The indices are developed taking into account such issues as the availability of part-time and fixed-term contracts, working time requirements, minimum wage laws, and minimum conditions of employment. Each index assigns values between 0 and 100, with higher values representing more rigid regulations. The World Bank also calculates the overall Rigidity of Employment Index, which is the average of the three above-mentioned indices.³⁸ The table below summarises the above indices for Latvia and provides data about other countries and regions.

Country/region	Difficulty of Hiring Index	Rigidity of Hours Index	Difficulty of Firing Index	Rigidity of Employment Index
Latvia	78	20	50	49
Lithuania	33	60	30	41
Estonia	11	80	40	44
Europe & Central Asia	31	51	42	41
OECD	26	50	26	34
USA	0	0	10	3

Table 9. Comparison of employment indices

Source: World Bank Doing Business data base, 2004

There is no evidence available in the form of a survey of enterprises to find out how employers in Latvia see the new Labor Law and to explain why there are differences between OECD and World Bank studies, with the OECD stating that regulations are liberal, but the World Bank study indicating that Latvia actually does have more rigid labor regulations compared to the OECD countries.

Coming back to the second question, posed at the beginning of this section, it has to be noted that the lack of a qualified workforce is a concern for Latvian companies. The OECD study refers to 2001 data, in which the difficulty in finding qualified workers was rated as the seventh most serious obstacle for business development and indicates that “although 60% of the labor force has a secondary-level education, the majority have out-dated vocational skills which are over-specialized and unsuited to current patterns of demand in the economy”³⁹.

³⁷ OECD, Latvia Country Assessment 2003, p.16

³⁸ <http://rru.worldbank.org/DoingBusiness/ExploreEconomies/BusinessClimateSnapshot.aspx?economyid=10>

³⁹ OECD, Latvia Country Assessment 2003, p.15

Conclusions

We find that the level of entrepreneurship in Latvia is very low, as compared with many developed and developing countries, but generally on par with transition countries such as Slovenia and Poland. This result suggests that the present rate of economic growth in Latvia may not be sustainable in the long run.

A typical entrepreneur in Latvia is a male, 39 years old, and ethnic Latvian. Compared with other countries, entrepreneurs in Latvia are somewhat older, and there are very few entrepreneurs in the younger age brackets. There is substantial gender imbalance amongst entrepreneurs, with women accounting for only 35 percent of all entrepreneurs in our sample.

Most entrepreneurs work in the trade or services sector. Entrepreneurial activity in the manufacturing sector is rather small. Only about 30.4% of new firms had long-term loans from banking institutions. It is likely that about 28.4% of entrepreneurs financed their businesses from their own savings or through informal loans from friends or relatives. Our best guess is that from 2.8 to 6.9 percent of all entrepreneurs in our sample received substantial formal equity investment.

Our review of existing studies indicates that there are few significant institutional barriers to the development of entrepreneurship in Latvia. The tax burden is relatively low, companies are easy to set up and labor markets are flexible. However, problems still remain in some areas, such as administrative excesses in the registration of property.

It would be worthwhile to research the effect of informal institutions, such as 'entrepreneurial culture' as these are likely to be responsible for the very low observed level of entrepreneurship in Latvia.

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Appendix 1: Empirical Methodology

In this section we outline how GEM uses adult population surveys to estimate the level of entrepreneurship and to extract information about important characteristics of entrepreneurs. We then explain how we used data from the enterprise register to produce similar estimates and discuss the compatibility with the GEM studies.

The Global Entrepreneurship Monitor Program is one of the most comprehensive efforts in the world to understand the impact of entrepreneurship on economic development, using cross-country data. The most visible aspect of GEM is the adult population surveys, completed in each participating country to provide estimates of the level of entrepreneurial activity. These surveys involve locating a representative sample of the adult population to create measures of entrepreneurial activity that represents the entire country. The best-known indicator produced by GEM is the Total Entrepreneurial Activity (TEA) index that reflects the prevalence of individuals that are engaged in new business creation. GEM defines entrepreneurs as adults in the process of setting up a business they (partly) own and managing an operating young business (Reynolds 2004, p. 9). Two early stages of entrepreneurial activity are distinguished: (i) a nascent entrepreneur who is involved in setting up a business, and (ii) an owner-manager of a new firm, which is less than 3.5 years old. From 1999 to 2003 over 350,000 individuals in 41 countries were interviewed about their participation in and attitudes toward entrepreneurial activity. To ensure comparability of results across countries the same methodology is used for all countries and a coordination team at London Business School supervises the survey process.

The challenge was to produce GEM-compatible estimates of entrepreneurial activity in Latvia for the year 2003 without an adult population survey. Fortunately, we were able to take advantage of a comprehensive data set from the Latvian Enterprise Register, maintained by Lursoft Ltd. Using this data, we were able to determine the number of individuals that qualified as new firm entrepreneurs according to the GEM criteria (i.e. individuals that were both owners and managers of firms less than 3.5 years old). Our sampling frame was defined to consist of individuals who met the following criteria:

- Owned fully or partially a company that was registered within the last 3.5 years.⁴⁰
- Had the right to sign business documents for that company (i.e. could be considered also managers of the company).
- The company was operational in 2003⁴¹

Thus, our definition of the sampling frame closely corresponds to the GEM working definition of new firm entrepreneurs. Moreover, we know there were precisely 12,377 new firm entrepreneurs in 2003. That is, our finding is a population parameter rather than its estimate. We then drew a simple random sample of 2,000 individuals from the above sampling frame.⁴² The data obtained covered some personal characteristics of new firm entrepreneurs, as well as some characteristics of their companies.

⁴⁰ The reference date was January 1st, 2004.

⁴¹ A company was defined as operational if it had received any revenue from its main activities during 2003

⁴² This is also a typical sample size in GEM adult population surveys. Note, however, that the sample is not adjusted for age, gender and other known population characteristics, as is the case in the GEM surveys. Nonetheless, our findings should be rather reliable because the sample size is relatively large.

An entrepreneur's age was extracted from his or her personal code.⁴³ Obtaining information on entrepreneurs' gender and ethnicity was more difficult because the Enterprise Register does not collect such data. Our approach was to infer gender from the endings on the first and last names.⁴⁴ While gender could be inferred using a specially written computer program, the ethnicity of entrepreneurs had to be identified manually, by checking whether a particular name looked 'Russian' or Latvian.⁴⁵ Since this process is relatively expensive and time consuming, the sample size for ethnicity is fairly small – only one hundred observations, randomly drawn. Data on selected company characteristics was obtained from annual balance sheets submitted for the year 2003. A complete list of the variables obtained and their summary statistics can be found in Table 8 in Appendix 1.

Thus, our study population is very similar to the new firm entrepreneurs as defined in the GEM program, which makes it possible to make meaningful cross-country comparisons.⁴⁶ An important limitation of our study is that we could only identify the individuals that were owner-managers of registered businesses. That is, our methods do not allow us to estimate the prevalence of nascent entrepreneurs, who are involved in the conception of a yet unregistered new business. However, we think that this drawback does not diminish the implications of our findings. According to GEM data, the number of nascent entrepreneurs for most countries in most years is larger than the number of new firm entrepreneurs. If most nascent entrepreneurs successfully made it into the new firm stage, we would expect to see substantial growth in the number of new firm entrepreneurs over time. However, we do not see it in the GEM data for most countries. This suggests that the prevalence rate of new firm entrepreneurs seems to be a more reliable estimate of the real extent of entrepreneurial activity in a country.

Another drawback is that the amount of information we were able to obtain from the Enterprise Register is very modest compared to what would be possible with a survey of adult population. For example, we could not determine individual backgrounds of entrepreneurs, their attitudes, etc. We hope to fill those gaps when Latvia becomes a member of the GEM consortium.

⁴³ The first six digits of a person's personal code in Latvia indicate date, month and year of birth.

⁴⁴ One advantage of Latvian language is that gender can be easily inferred from the endings on first or last names. In only 2.5% of the cases we could not identify the gender, which may imply that owners were foreign citizens. These cases were dropped.

⁴⁵ Although it is debatable whether 'Russian-looking' names belong to ethnic Russians, we only distinguish between ethnic 'Latvians' and 'Russians'. The reasons are entirely practical – it would be relatively difficult to say whether a certain last name is more characteristic of ethnic Russians or, say, Ukrainians. Thus, by 'Russians' we understand a broader group of Russian-speaking minorities living in Latvia.

⁴⁶ Note that our population is a little bit different from the population of new firm entrepreneurs defined by the GEM criteria. The GEM considers a firm to be 'born', i.e. have entered the new firm phase, when salaries or wages have been paid for more than three months. Our observations are censored, however, since we only observe whether a firm has submitted a balance sheet for the year 2003. Thus, our population may contain businesses that paid wages or salaries for less than three months and overstate the number of small firm entrepreneurs.

Appendix 2: Sources Used

The report is mainly based on the analysis of the secondary data, including the following studies on business environment in Latvia carried out during the last couple of years.

In November 2003 – January 2004 a Regulatory and Administrative Costs Survey was carried out by “Latvijas Fakti” and financed by the World Bank. The survey covered more than 500 enterprises in Latvia representing different sectors and regions. Most of the companies which participated in the survey were established during the last 4 years, and companies of varying sizes were represented – micro-enterprises (77.3%), small enterprises (18.3%), and medium and large enterprises (4.4%).

The data from the year 2004 of the World Bank Doing Business database (Snapshot of Business Environment – Latvia) have also been used. The Doing Business database provides measures of business regulations and their enforcement, which is based on research of laws and regulations carried out by local partners. In the case of Latvia, a number of law offices as well as two public institutions (the Bank of Latvia and the State Land Service) were involved in data gathering, using the standard templates provided by the World Bank.

In January 2003, the OECD, within the framework of the Baltic Regional Program published the Latvia Country Assessment – a report prepared as a part of the work of the Baltic Forum for Entrepreneurship and Enterprise Development. The report looks at the environment for enterprise development and enterprise policy in the country and includes recommendations for further improvements aimed at the development of entrepreneurship in Latvia.

In 2002 the Foreign Investment Advisory Service of the World Bank together with the Latvian Development Agency carried out a Self-Assessment of Administrative Barriers in Latvia. In the self-assessment exercise a number of specific tools were applied, including the Regulatory and Administrative Costs Survey (carried out by the Baltic Data House) and the use of procedure templates, the goal of which were to present information regarding a procedure supervised by a specific government institution. The size of the Regulatory and Administrative Costs Survey sample was 541 enterprises and covered micro enterprises (1-9 employees) – 78% of the sample, small enterprises (1-49 employees) - 18%, and medium and large enterprises (more than 50 employees) - 4%. According to the authors of the Self-Assessment “taking into consideration the sampling procedures and the data weighing procedures, the sample of the research is representative of the universe of private enterprises operating in Latvia, and the results obtained can be referred to all the private enterprises operating in Latvia”⁴⁷.

On the 23rd of April, 2002 Latvia signed the Declaration on joining the European Charter of Small Enterprises. Every year the European Union (EU) Member States submit reports to the European Commission regarding their progress in implementing the objectives of the Charter. In this report two of the reports submitted by Latvia, in 2003 and 2004, (Questionnaire 2003 and Questionnaire 2004, Answers of the Republic of Latvia) have been used. The questionnaire mainly presents the information gathered by state institutions and officials regarding the situation of the business environment in Latvia.

In addition to that, information on the situation regarding government policies, the regulatory framework, the availability of information, etc. has been collected from publicly available sources (e.g. websites of the state institutions – The Ministry of Economy, The Latvian Development Agency and others).

Appendix 3: Descriptive Statistics

Variable	Units	Number of Observations	Mean	Median	Standard Deviation	Minimum	Maximum
Ownership share in a company	percent	2000	65.37	50	32.68	0	100
Age	years	1980	39.61	39	10.39	19	82
Gender dummy variable (1 if male, 0 if female)		1950	0.65	1	0.48	0	1
Ethnicity dummy variable (1 if Russian, 0 if Latvian, 2 if 'foreign')		100	0.66	1	0.55	0	2
Share of equity capital In assets	share	2000	0.07	0.21	1.49	-29.99	1
Share of long-term loans In assets	share	1891	0.14	0	0.27	0	0.99

Table 10: Descriptive statistics and variable descriptions

Source: Lursoft

⁴⁷ Foreign Investment Advisory Service of the World Bank. Self-Assessment of Administrative Barriers in Latvia, p.10.

Appendix 4: Gender, Ethnicity, and Age of Entrepreneurs

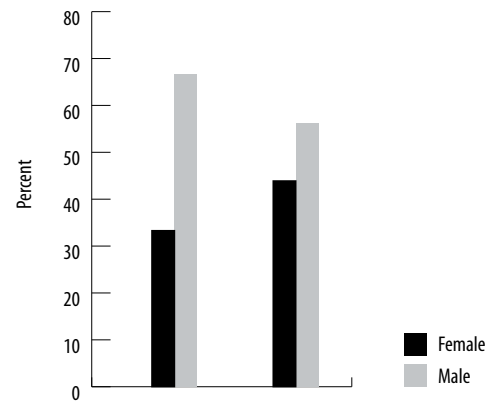


Figure 6: Gender and ethnicity of entrepreneurs – 2003

Source: Lursoft

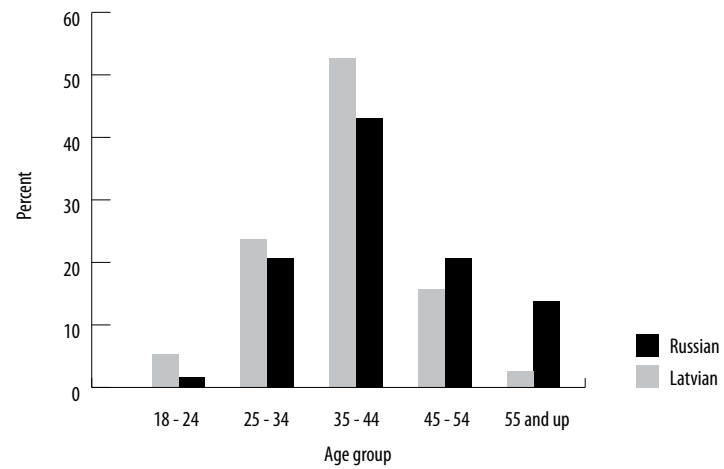


Figure 7: Age profiles of entrepreneurs by ethnicity – 2003

Source: Lursoft

TS

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