New Challenges of Economic
and Business Development – 2013

May 9 - 11, 2013, Riga, University of Latvia

BUSINESS ENVIRONMENT FACTORS CONTRIBUTING TO THE DECISION ON THE LOCATION OF A FIRM IN LATVIA

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Regional development imbalances limit the potential gain of a national economy in general and give a negative impact on an international reputation of the state.

Defining the key elements for a business environment contributing to such differences is an ambiguous issue. Mostly researchers tend to focus on the resulting factors (GDP, economic activity, number of enterprises, etc.), not on the initial ones. According to this report the decision on the location of a firm is treated as a prime factor attributing to the level of the development of the specific region in Latvia if all other factors are believed to be constant in a moment of time.

The main purpose of this report is to go even deeper – namely, to make a research on a list of sub-factors of the business environment contributing to the decision on the location of a firm in Latvia. Different levels of regional competitiveness within a country, its ability to maintain high rates of economic growth and attract investors- those are the results of the specific composition of the business environment.

After statistic data analyze (regression and correlation analyze) and research (study of the literature, expert interview method) on the general elements of the business environment in the world and in Latvia, as well as research on competitiveness elements, this paper reveals some crucial aspects for an average decision on the location of a firm; characterizes the overall set-up and offers a list of suggestions to solve the problem of imbalances.

The scope of the issue of the business environment and its separate factors is broad and multifaceted; this paper presents a brief insight by the authors and the corresponding research is aimed to be continued.

Key words: *regions, business environment, firm location*

JEL code: R12

Introduction

Over the last two years Latvia has gain a lot of international interest as a “success story” after the deep recession caused by the financial and economic crisis that shocked the whole world. Nevertheless, the story is not as unequivocal as it may seem at the first sight. According to observations by the authors in the international media many economic and political experts have fiercely argued against the, so called, success. The explanation for such a dispersed range of views is quite simple: the classical understanding of “growth and development” (based on pure numbers- factors (GDP, productivity, export rate,

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innovations)) starts to lose its adherents. The key element of the public debates now more often is the overall state of welfare (sub factors – economic inclusion, income distribution, motivation, inner stability).

The objectives of the paper is to explore different approaches and methodologies of measuring competitiveness of a country and to discuss the adjustments needed to project those approaches and methodologies to a regional level within a country (in case of Latvia). This paper identifies factors for further research, which is in a scope of another paper.

From the classical point of view, the situation in Latvia is promising. Structural reforms have increased competitiveness of Latvia and facilitated integration with the world's economy. Reforms to business laws and regulations have substantially improved the investment climate. Since the late 1990s governments have held a regular dialogue with the private sector and international organizations to identify and implement ways to streamline business registration, improve the tax system and increase the efficiency of international trade, among many other such reforms (Doing Business, 2012).

The authors emphasize (see Table 1) that despite the prevalence of different technological adjustments, incredible mobility of information and relatively small territorial distances in Latvia, there is a permanent tendency that comparatively rich regions get richer and the poor tend to lag behind. On the other hand the aforenamed tendency is typical for whole world. Albeit, globally the poor are expanding in numbers while in Latvia the poor, low-middle class and middle class – all together are migrating away.

Table 1

Example of regional disparities

Indicator	Best	Weakest	Difference in times	Compared to previous period
Population change,% 2007-2012	Riga region -0.7	Latgale -6.7	9.6	No information
Population density People/km^2 (2012)	Riga region 104.6	Vidzeme 15.0	7	Increasing
GDP per capita (2010)	Riga region 10201	Latgale 3228	3.2	Increasing
Unemployment rate (2012)	Riga region 6.7	Latgale 15.2	2.3	Increasing

Source: Central Statistical Bureau of Latvia; Development of Regions in Latvia 2011 by Ministry of Environmental Protection and Regional Development (State Regional Development Agency)

Over the last decades, firm location has been a focus- study in field of economic geography (e.g. Krugman, 1991; Fujita et al., 1999; Baldwin et al., 2003). The main focus of economic geography is whether firms agglomerate or disperse as a result of the movement of labour.

Business environment components contributing to the decision on the location of a firm usually are quite constant, but the composition of the respective business environment is the one that varies significantly over countries and even regions within one country. The ambition is to treat the decision on the location of a firm more scrupulously; as some people start up and practice business where they actually live, but other ones may examine resources existing within specific area first and then choose location with a special intent.

Another aspect of respective decision making is the business industry a firm is going to perform in. In service industry, traditionally, firms can provide their services only in the markets in which they are located (this statement is related to business where physical presence is needed for both- service suppliers and service buyers). In this case two factors have significant effect on decision regarding firm location in the service industry. The first factor is market size. Markets with large populations attract more firms than those with small populations; this is because there is more demand in the former. At the same time, however, large markets also experience severe competition among firms. The second factor is the strategic interaction among firms as a result of location choice. Subsequently, when each firm chooses its location, it must take into consideration the location of rival firms. This implies that location choices made by firms generate strategic interactions among them (Kurata, 2011).

Today improvements in information, communication, and logistics technology allow firms to serve many markets from a distance, spread discrete activities around the globe, and coordinate them in a global system (Porter and Rivkin, 2009).

Business may face a necessity to make a decision on a firm location even several times per business life circle. Fair enough to mention that this paper gives more intention to an initial decision (ID) than on a secondary decision (SD). Naturally, there is no motivation to change business location (incentive for SD) if such an action does not promise a certain rise in profits or some cost reduction for the firm.

Research results and discussion

Business environment competitiveness among regions within a country can be measured by the ease of doing business. On a general level it shall be possible to face business environment competitiveness within several regions of the same country the same way as if a private investor would assume an international competitiveness.

Table 2

Business environment indicator overall adjustment

Indicators determining ease of doing business	Projection to a national level	Additional comments
Starting a business	Possible	Even though the Procedures (4 procedures) are equal, there might be variation in time among regions. Assessment: taking into account the average level of legal income, the value of the cost and minimum capital differs from region to region.
Dealing with construction permits	Not required	Assumption
Getting electricity	Not required	Assumption
Registering property	Not required	Assumption
Getting credit	Possible	Assessment of possible differences in financial service infrastructure and creditworthiness of the business in regions
Protecting investors	Not required	Assumption
Paying taxes	Not required	Assumption
Trading across borders	Possible	Assessment of possible influences by the neighbouring countries
Enforcing contracts	Possible	Assessment of possible business culture and counterparty competence level differences
Resolving insolvency	Not required	Assumption
Employing workers	Possible	Assessment of labour cost and competence level differences

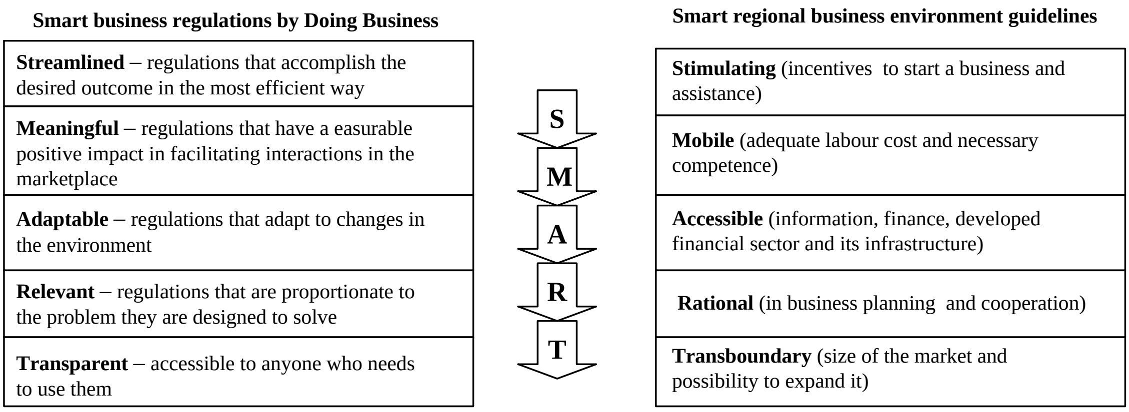
Source: author’s assessment based on factorial framework by doing Business 2013

Several rating agencies (Rating and Investment Information Inc, Standart&Poor's, Fitch Ratings, etc.), indexes, reports work for an international investment location choice. Though, none of those undoubtedly considerable as universally bundled. Besides, what work well for an identification of the competitiveness of the country may not work the same way on the regional level. Therefore, the paper shall be continued by an attempt to make a projection of a world widely used approach to sum up business environment factors on a national level.

For instance, Doing Business does not measure the full range of factors, policies and institutions that affect the quality of the business environment in an economy or its national competitiveness. It does not capture aspects of security, the prevalence of bribery and corruption, market size, macroeconomic, the state of the financial system or the level of training and skills of the labour force, etc.

Nevertheless, Doing Business covers 11 areas of a company's life cycle through 11 specific sets of indicators (Doing Business, 2012); in Table 2 overall regional adjustment results are provided.

According to Table 2, 5 out of 11 indicators can be projected to a national level in order to discuss business environment factors contributing to decision on the location of a firm in Latvia. That is to say, the set of these identified indicators (if communicated in a systemically coordinated way) can form a brand new broader view of what is "SMART" business environment (see Figure 1).



Source: author's assessment based on SMART model by doing Business 2013

Fig. 1. **Smart regional business environment guidelines**

Analysing business environment factors and its possible total or partial projection to a national level is just one side of the "iceberg". Composition of business environment factors can be the same in two regions A and B, but somehow it doesn't guarantee the same level of development. Business environment shall not be analysed as a static space (or at least if not assumed so in purpose of research). Another crucial aspects is business environment factor dynamics (factor competitiveness) in terms of structure, development of individual parameters or even groups of parameters, etc., furthermore, all that in the context of political decisions. Measuring competitiveness puts another issue on the table, that is to say, highlights the need for a methodology.

For example, since 2005, the World Economic Forum has based its competitiveness analysis on the Global Competitiveness Index (GCI), a comprehensive tool that measures the microeconomic and macroeconomic foundations of national competitiveness. Competitiveness is a set of institutions, policies, and factors that determine the level of productivity of a country. The level of productivity, in turn, sets the level of prosperity that can be earned by an economy. The productivity level also determines the rates of return obtained by investments in an economy, which in turn are the fundamental drivers of its growth rates. In other words, a more competitive economy is one that is likely to sustain growth. The concept of competitiveness thus involves static and dynamic components. Although the productivity of a country determines its ability to sustain a high level of income, it is also one of the central determinants of its returns to investment, which is one of the key factors explaining an economy's growth potential (WEF, 2013). There are 12 pillars of competitiveness and 3 stages of economic development (global competitiveness index framework) as shown in Table 3.

Table 3

The global competitiveness index framework

Basic requirements subindex	Efficiency enhancers subindex	Innovation and sophistication factors subindex
Pillar 1. Institutions Pillar 2. Infrastructure Pillar 3. Macroeconomic environment Pillar 4. Health and primary education	Pillar 5. Higher education and training Pillar 6. Goods market efficiency Pillar7. Labor market efficiency Pillar 8. Financial market development Pillar 9. Technological readiness Pillar 10. Market size	Pillar 11. Business sophistication Pillar 12. Innovation
Key for **factor-driven** economies	Key for **efficiency-driven** economies	Key for **innovation-driven** economies

Source: WEF "Global competitiveness report 2012-2013"

To build up regional competitiveness it is important to stress pillars of the second column, mostly Pillar 7, Pillar 8. Efficiency pillars will contribute in both directions: social infrastructure and intelligent business models and innovation.

Discovered business environment factors shall be transformed into sub factors and statistically tested in order to set a model of decision on a firm location.

For example, in assessing financial market development (Pillar 8) as a sub factor, presence of a bank unit can be treated as an indicator for a regional competitiveness. Financial services are not available or available in a limited way in less developed areas of Latvia. People are not motivated or even afraid to use the latest products, computer software, electronic billing, and advanced payment. By the way people in less developed areas sometimes even cannot afford remote financial services (cost of equipment; internet coverage). In rural areas of Latvia, where different remote financial services are less available or scarcely used, it is common to use postal services or operations in cash.

Even though it appeared to be possible to make a supposed projection of an international approach to the national level, significant uncertainties still are persistent. Setting up a firm location model in respect of the regional development level, shall introduce an emotional factor of choice as well. That is to say, that the decision on a firm location will change in accordance with the emotional factor of the owner. The emotional factor shall be defined as a complex index (as a function from owner's income level, property, age, family status, risk aversion index, etc.). The emotional factor is supposed to influence the owner's total location decision utility negatively, in case previously mentioned index elements present bigger value than the gain from higher comfort from a firm location.

A group of firm location choices influenced by the emotional factors makes the business environment inclusive. That is to say: a choice of one person proves that the quality of the territory is appropriate for setting up business. Similarly as the mass effect works in stock markets, so called price (emotion value) of a region can be pushed or pulled by the originator. Even though such a rise in value can be "bubbled" at the first time, after all, it will turn to a real rise in regional competitiveness. Fair enough to mention that economically weaker regions on average tend to have smaller firms and bigger risk aversion. For instance, in Latgale, which is considered to be the weakest among regions, share of small business is close to 90%. According to the local research by Silineviča the main obstacles influencing development badly are: increase in taxes, lack of current assets, lack of management skills, lack of project management skills, uncertainty in state policy (Silineviča, 2011).

Every location decision reflects into jobs, investments, tax revenues, and regional development. Therefore it is hard to say which is first: well developed and competitive business environment in the region motivates for a higher rate of endogenous activity or higher rate of endogenous activity makes business environment competitiveness. In this respect further investigation is needed.

When seeking to bring capital, jobs, and expertise into a region, policy makers resort to large tax breaks and cash incentives. In using subsidies as the primary strategy to attract a company's activities, policy makers "train" business leaders to think of locations as interchangeable, and they draw to their regions the companies that are least likely to put down deep roots. Local leaders should aim to attract businesses not by outbidding rival locations on tax subsidies but by offering a compelling value proposition, such as access to talent, technological knowledge, supporting institutions, or a local market that fits the firm's strategy and cannot be matched elsewhere. Incentives should focus on investments in local infrastructure, in workforce training, and in other assets that will be valuable to other firms and citizens even if particular companies relocate system (Porter and Rivkin, 2009). So far regional disbalance is obvious; see Table 4.

Table 4

Gross domestic product by statistical region 1999-2008, share (%)

Region	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Riga	55.3	55.4	54.5	57.7	56.1	58.1	57.3	55.3	54.4	54.1
Pieriga	10.1	10.2	10.3	10.1	10.1	9.7	11.1	13.1	12.3	12.7
Vidzeme	6.3	6.1	6.0	6.2	6.4	6.4	6.2	6.6	6.7	6.6
Kurzeme	12.5	13.1	12.6	11.2	11.9	11.9	10.7	10.3	10.3	10.4
Zemgale	7.5	7.3	7.1	6.9	7.2	6.5	7.0	7.2	8.0	7.6
Latgale	8.2	7.9	9.4	7.8	8.3	7.4	7.6	7.4	8.2	8.4

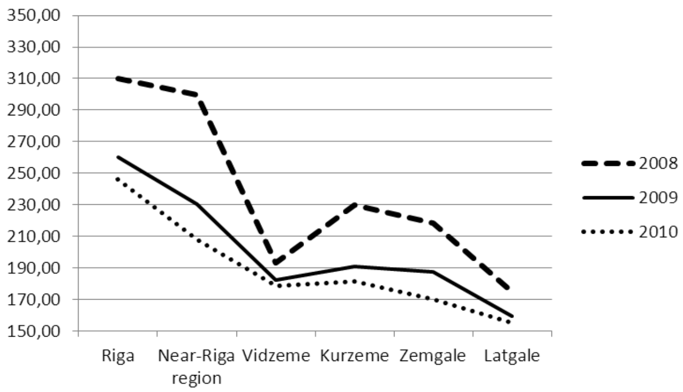
Source: Central Statistical Bureau of Latvia

As seen from the Table 4, since 1999 more than 65% to almost 70% of GDP has been produced in Riga and Pieriga regions, proving those to be the most active in economical sense. Densely populated central regions at the same time appear to be the biggest internal markets with greater capacity not only to investments and other positive impacts, but also to some negative aspects and risks. Risk aversion in economically active regions is much higher on the average, therefore more incentives to start business as well.

Companies can achieve practical use and benefits employing the concept of clusters, stimulating competitiveness, export and innovation capacity, that is to say, a cluster is a platform for interaction (Liela and Zeibote, 2010).

For a given output, amore risk-averse firm operating with an uncertain output transport rate will locate closer to the output market (Tan 2001).

Taking into account the territory and population, Latvia should not be going through radical structural differences of the economy; however, in spite of the low capacity of the national market, there is a significant qualitative disproportion in regional development. Theoretically, less developed regions are more attractive in attracting mobile investments, because of the higher profit expectations. In Latvia, later idea does not work because of the low domestic demand, especially after economic crisis and thus overall decrease in income as shown in Figure 2.



Source: Author's construction based on data by Central Statistical Bureau of Latvia.

Fig. 2. **Average monthly disposable income for one household member during 2008-2010 (Ls)**

The global crisis brought Latvia's economic growth to a halt. The growth, mostly driven by increased domestic demand and strengthen by foreign capital inflows, turned into a deep recession starting in 2008. The aforementioned drop in the average disposable income across the regions is directly related to the demand level within specific region. Emigration influences the demand level negatively as well. Clear enough, every customer is a value for business itself and business has to take the most of the location costs. Therefore, firm location is more important to producers than to customers. Firms tend to concentrate in larger regions, even though, an increase in the firms' concentration is unwanted for business, but it is welcomed by the consumers and the overall national economy.

It seems that regions that are in a better economical position will have both: because of the higher local income (savings to transform into investment) better capitalized firms (bigger firms, more sophisticated business) and higher endogenous activity to start business.

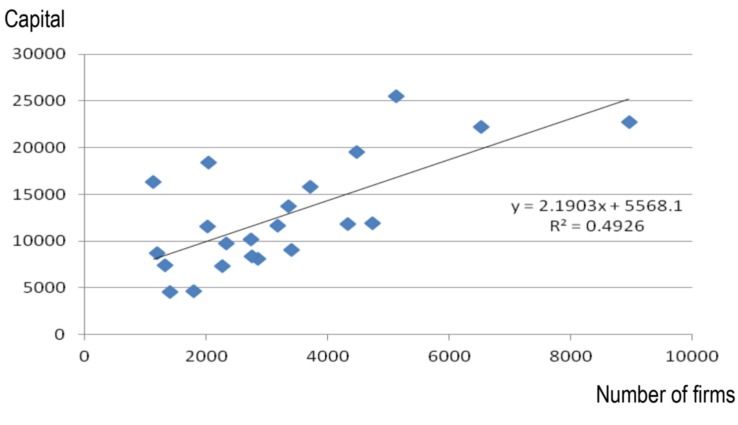


Fig. 3. **Average registered capital and number of firms**

As mentioned in the introduction of this paper, after an identification of the sub- factors, further statistical testing will take place (in a scope of further research). Nevertheless, a brief example of rational of statistical testing is presented below. In order to have an overall prove of the statement, statistical data set was tested in a linear regression model. Data from 23 territorial units was used. An average registered firm capital considered as independent variable. The rationale behind this assumption is that the capital represents a part of income (surplus) that was transformed into business incentive. The number of registered firms is considered as a dependent variable. That is to explain, the endogenous activity (number of firms) grows, if income (surplus) is higher. The diagram is shown in Figure 3.

From Figure 3 it is concluded that there is a moderate positive correlation level between capital and number of firms. Unfortunately, from the overall analyse it is not possible to conclude the origin of the capital, thus it is still uncertain, who was the real decision maker (is there any influence from emotional factor, etc.).

More detailed individual business environment factor analyze in a systemic context is planned to be taken in nearest future.

To sum up the research and discussion part of this paper, any investor (local or foreign) assess the strengths, weaknesses, risks and gains of the territory before choosing it for setting up business (SWOT).

Conclusions, proposals, recommendations

In spite of the low capacity of the national market in Latvia, there is a significant qualitative disproportion in regional development.

Densely populated central regions at the same time appear to be the biggest internal markets with greater capacity not only to investments and other positive impacts, but also to some negative aspects and risks.

Regions that are in a better economical position will have both: because of the higher local income (savings to transform into investment) better capitalized firms (bigger firms, more sophisticated business) and higher endogenous activity to start business.

It appeared to be possible to make a supposed projection of an international approach to the national level. The decision on a firm location and competitiveness of this region works vice versa.

Setting up a decision model of a firm location in respect of the regional development level, shall introduce an emotional factor of choice as well index (as a function from owner’s income level, property, age, family status, risk aversion index, etc.). The emotional factor is supposed to influence the owner’s total location decision utility negatively, in case previously mentioned index elements present bigger value than the gain from higher comfort from a firm location.

Business may face a necessity to make a decision on a firm location even several times per business life circle. Setting up a decision model of a firm location, it is important to identify: is this a first or second location decision; the origin of capital; the business industry a firm is going to perform, etc.

The corresponding research is aimed to be continued.

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