

**PROBLEMS OF BUSINESS EXPANSION IN SMALL COUNTRIES****BIZNESĀ PAPLAŠINĀŠANĀS PROBLĒMAS MAZĀJĀS VALSTĪS**

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**Introduction**

The widely known statement from economic theory suggests that there are two main reasons for businesses to expand their activity abroad: one is to avoid placing all eggs into one basket, in other words, to spread the risks, and the second, to reduce production costs by economies of scale, accordingly, ensuring the necessary sales. A specific feature of all the small countries – is a limited market, which holds companies within a certain borderline of intense competition with a strictly predefined demand. The creation of the internal market is one of the European Union's (EU) important achievements, which brings a significant contribution to the simplification of commercial affairs between the member states. The opened borders to domestic markets of 500 million consumers and the possibility to operate on the same set of rules throughout the Community without discrimination on national considerations create excellent opportunities for the business expansion, being particularly beneficial for companies originating from small countries.

Statistics show, that the majority of Latvian businesses choose to limit their activities to 2.3 million customers, sharing them with foreign investors, who have stepped into the Latvian market with the EU expansion, and not taking advantage of existing possibilities in the EU. The Latvian government cannot keep the local market intact by applying protectionism measures, which is against the EU principles. The only way for entrepreneurs to hold back the external pressure is to be active and spread operation in other countries.

## Pros and cons for doing business in small countries

There exist different measures to define the "smallness" of a country, and the most frequently used are population size, land area, and gross domestic product (GDP). Population and land area can both be deemed to reflect the size of an economy's endowments. GDP is a frequently used measure for market size, as it displays domestic demand. The three measures have in common that smaller values imply stronger limitations to diversify production. The smaller the economy's endowments (labour and land), the more difficult it is to produce a large variety of products. The smaller a country's market (GDP), the lower the probability of profitable production of goods subject to economies of scale [1].

The authors believe that in order to overcome the sheath of tight local potentials, smaller economies have to look wider and focus their attention more on cross-border trade. In conformity with natural laws, the openness of countries decreases with their economic size. The statement is proved by statistics for a 20 year period, and is clearly demonstrated in Figure 1. The ratio of trade to GDP in countries with population less than 1.5 million more than twice exceeds the same indicator in countries with population more than 25 million.

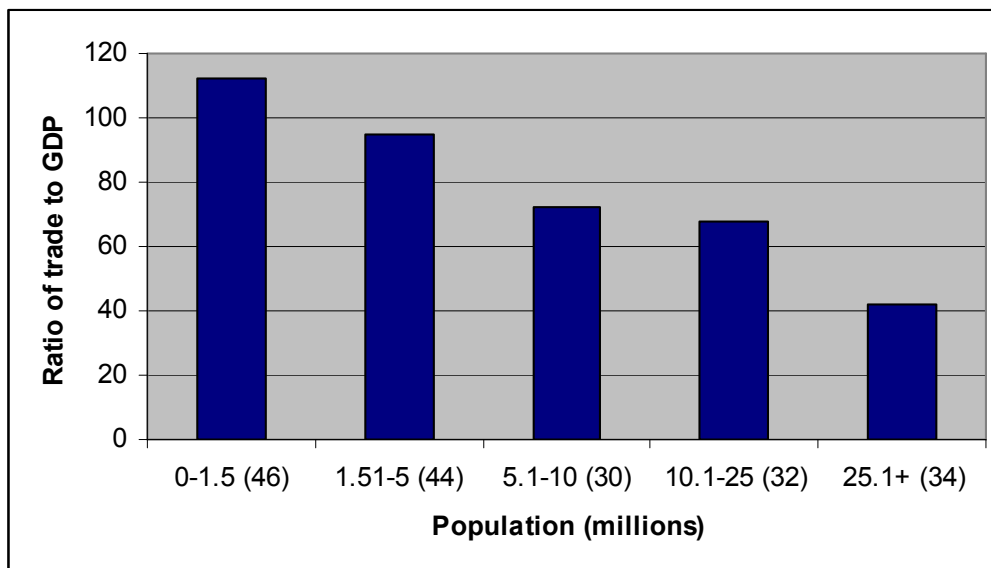


Figure 1. Small economies' reliance on trade, averages 1980-2000 [1]

The Figure 1 verifies that smaller economies therefore have to rely more heavily on external trade and foreign investment to overcome their inherent scale and resource limitations. However, a high degree of openness brings real benefits that accrue from trade – consumers in small states are able to obtain a greater variety of goods at lower cost than if their choices were confined to domestically produced goods only. Additionally, producers in small states can sell on world markets, earning more than if they were confined to meeting limited domestic demand. Participation in the world market also helps to channel new ideas and information about opportunities to firms and consumers in small states [1]. The mentioned above advantages delivered by cross-border trade, have played the crucial role for Latvia when taking the decision on joining the European Union.

The authors do not doubt the statement from the theory of microeconomics, which asserts: the bigger the market is, the lower costs an economy can enjoy. However, open borders mean not only attractive opportunities for businesses in other countries, but also new competitors coming to a domestic market. For this sake, the gains from enlarging fall

disproportionately on small countries, because the entry of new members diminishes the importance of the local market and, at the same time, improves the small countries' relative competitiveness. The empirical analysis of trade flows of different countries can show mixed results. The evident example is when after the entry of Spain and Portugal into the European Community in 1986, France and the United Kingdom appear to have lost market shares relative to the small countries in the European Community, but the same is not true for Italy nor, to a lesser degree, for Germany. [2] It means that much depends on the activities performed by governments – the business processes shouldn't be left to take a free course, but carefully steered by the European Community and Member States.

The four freedoms insured within the European Union (free movement of goods, services, people and capital) foster the development of perfect competition. With reference to macroeconomics and international finance theory, the authors affirm that the most important factors affecting international trade include market conditions in the destination market, the extent to which exporters' costs are affected by currency exchange rate changes, and the monetary policy environment in the import market. [3]

Due to the model of perfect competition, profit maximization implies that price equals marginal cost:

$$P_i = C_i \quad (1)$$

where,  $P_i$  is the price of the  $i$ th good. If the good is traded internationally, the price in foreign currency,  $P_{i(inter)}$  is as follows:

$$P_{i(inter)} = \frac{C_i}{S} \quad (2)$$

where  $S$  is the domestic currency price of foreign exchange. With constant marginal cost, pass-through, i.e., the elasticity of foreign currency price with respect to the exchange rate ( $d \ln P_{i(inter)} / d \ln S$ ), is equal to one (in absolute value). Thus, in a small country, perfect competition benchmark, local currency import prices fully reflect exchange rate changes. [3] However, perfect competition exists only in theory, so the price condition must include a mark-up ( $\lambda$ ) [3]:

$$P_{i(inter)} = \frac{\lambda C_i}{S} \quad (3)$$

Trading goods across borders within the EU still remains more costly and complex than doing business within a Member State. When selling abroad, companies sometimes have to have their products re-tested or even modified in order to meet local requirements. The intensity of controls and market surveillance varies from Member State to Member State [4]. Big countries-exporters take advantage of economies of scale, when local activities have smaller transportation costs and no cross-border complications, such as exchange rates. Currently, the Latvian currency the Lat (LVL) is attached to the single European currency – Euro (EUR), consequently exchange rate fluctuations tend to zero. As Latvia is to join the Euro zone in the close future (the official date was January 2008, but the authors pessimistically bet for 2010), the domestic currency price for European trade partners disappears.

Under these circumstances, the authors hold a view that already initially the survival conditions for local firms in small countries are extremely tough, and they cannot be directly affected by government, as discrimination-based protectionism measures are not allowed

within the EU. For this sake the success of small-country-businesses depend on the level of entrepreneurial activity.

Investigations and public inquiry organised by the Ministry of Economics have identified that considerable obstacles in Latvia for domestic business expansion abroad bring such factors as lack of qualified personnel and specialists with the knowledge of foreign languages, differences in legislation, low recognition of Latvian production (marketing), and possible discrimination on national considerations. However, as the main reason for companies' reluctance to expand abroad is mentioned lack of information and fear to face trade barriers [5]. Latvian entrepreneurs have little confidence in the opportunities provided by the EU. Such facts as that with joining the EU the number of required business licenses in Latvia has reduced from 118 to 67, quantitative restrictions on imports and exports of goods are prohibited, customs barriers (tariffs, quotas) are removed, and products can be freely sold in any EU member state are just often ignored. It is ensured that products legally produced in EU member states or Turkey or in EFTA countries are mutually recognised; the regulations requiring local registration for certain kinds of business have been withdrawn. Service providers are empowered to set up a business or a branch in other EU Member State for a permanent operation on the same conditions as the domestic companies and are authorised to provide temporary services without a local establishment. The profession qualifications are also mutually recognised within the EU. Some restrictions in service sectors still exist, but they have to be justified for reasons of public policy, public security, public health or the protection of the environment and notified to all the Community [6, 7].

### **Stimulation of business expansion in small countries**

With the increasing of the EU in size and diversity after enlargement, confidence in the operation of the existing legal framework for the free movement of goods, services, people and capital needs to be further strengthened. This can best be done by putting in place a number of disciplines which will make the rules more transparent and more predictable, and which will encourage national authorities to have more trust in each other's methods and assessments. The public authorities have to keep it in mind when working out new regulations in order to foster intra-Community trade and harvest the advantages of economies of scale and specialisation. [4]

The authors consider that another necessary block of activities for stimulation of business expansion in small countries aims to enhance the activity of private sector. As it was already mentioned, Latvian companies have little confidence in the opportunities provided by the EU. So they need governmental support and step-by-step backup to commence a wider cross-border operation. There are various organisations assisting companies in cross-border activities. One of the most efficient of them is the Investment and Development Agency of Latvia. The Agency provides information about business opportunities in other EU countries, relevant legislation, the taxation system, the national economy and external trade, and promotes and facilitates cooperation between Latvian and foreign companies. Entrepreneurs assess as very beneficial the so-called business-stock-exchanges, when for a company there are organised from ten to fifteen meetings with potential business partners from the same sector. There are various agencies, chambers, associations and other bodies, which help to solve the problem of small-countries-markets: institutions promoting activities in the particular sphere, for example, the construction association, structures facilitating entrepreneurship in a certain region, e.g., representatives of states and municipalities, or standing up for the interests of companies with common features – the Small and Medium-sized Business Confederation. Numerous web sites on the Internet provide information of

different quality – usable and useless, up-to-date and obsolete. Consequently, the vagueness stuns the users; they are not ready to waste time, money and other resources for getting inappropriate information.

As an outcome from the evaluation of the current situation, the authors have come to a conclusion that there is a logical need for a centralised information system, and the government should take the helm for its creation. The point of single contacts (PSC) defined by the recently adopted Service Directive (2006/123/EC) is an ideal tool to make the idea breathe. According to the Directive, such PSCs are to be established in each member state by the end of 2009. They should ensure an access through a single gate to exhaustive information on the requirements for service provision applicable in other Member States. In the PSC any service provider should be able to easily complete all procedures and formalities necessary for the access to and exercise of his activities by electronic means [8]. In a like manner, according to the *Regulation of the European Parliament and of the Council laying down the procedures relating to the application of certain national technical rules to products lawfully marketed in another Member State and repealing Decision 3052/95/EC*, a similar PSC is to be established for mutual recognition of goods lawfully marketed in other Member States [9]. As it is absolutely up to each Member State to decide how the PSC will be organised, in Latvia the authors propose creating one united PSC converging all the existing official websites and business assistance portals of non-governmental bodies and public authorities.

The authors propose that financing for the project could be attracted from the resources of the E-government development programme 2005-2009, which aims to create a body for coordination of state institutions' and local authorities' operation, as well as stimulate their mutual assistance and administrative cooperation [10]. The institution will also supervise the quality of internet-provided services, registration of formal electronic activities, etc. Another resource which can be involved in the process of business facilitation is co-financing for the creation of informative portal [www.latvia](http://www.latvia). The mentioned portal could be used as a base and a gate to different kind of information required for business expansion.

The authors are convinced that realisation of the proposed activities will ensure that companies would take advantage of other markets, preparing themselves for fair competition under the same rules, no matter where a company is established or located.

## Conclusions

A specific feature of all the small countries – is a limited market, which holds companies within a certain borderline of intense competition with a strictly predefined demand. Smaller economies, therefore, have to rely more heavily on external trade and foreign investment to overcome their inherent scale and resource limitations. Nevertheless, open borders mean not only attractive opportunities for businesses in other countries, but also new competitors coming to a domestic market. For this sake, the gains from the enlargement of the common market fall disproportionately on small countries, and much depend on the activities performed by governments.

Investigations and public inquiry have identified that the main reason for Latvian companies' reluctance to expand abroad is the lack of information and fear to face trade barriers. Latvian entrepreneurs have little confidence in the opportunities provided by the EU single market.

Much has been done by the European Community in order to ensure the four main freedoms, but anyway some sectors still need better regulation and new proposals for legislative acts. Another vital moment is the necessity to raise the activity of the private sector. Companies need state support and step-by-step backup to commence a cross-border

operation. The business assistance agencies, chambers, associations and other bodies could be bunched to a centralised information system. The PSC should be established for ensuring an access to exhaustive information on the requirements for business performance in other Member States, as well as providing a possibility to electronically complete all the necessary procedures and formalities. The creation of two separate PSCs for service provision and trade of goods is defined by the European directives. The convergence of both the PSCs into one interactive portal, supplementing it with links to all the existing high-quality official websites and business assistance portals of non-governmental bodies and public authorities will break the sheath of unawareness in the business community about the existing opportunities and, thereby facilitate business expansion in small countries.

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### ***Starčenkova O., Gaile-Sarkane E. Biznesa paplašināšanas problēmas mazajās valstīs***

*Mazo valstu specifiskā īpatnība – ierobežots tirgus, kas tur uzņēmumus sīvas konkurences uzliktajos rāmjos ar strikti noteiktu pieprasījumu. Līdz ar to mazajām valstīm ir jāliek lielāks uzsvars uz starptautisko tirdzniecību un ārējām investīcijām. Tajā pašā laikā atvērtas robežas nozīmē ne tikai pievilcīgas iespējas citās valstīs, bet arī jaunu konkurentu ienākšanu vietējā tirgū. Valdības nevar nosargāt savu valstu iekšējos tirgus, īstenojot protekcionisma pasākumus, kas ir pretrunā ar ES principiem. Vienīgais veids, kā uzņēmēji var cīnīties ar ārējo spiedienu – pašiem būt aktīviem un paplašināt darbību uz citām valstīm. Galvenais iemesls, kāpēc uzņēmumi*

nevēlas paplašināties uz ārvalstīm, ir informācijas trūkums un bailes piedzīvot tirdzniecības barjeras. Kā risinājumu šai problēmai, autori izvirza priekšlikumu Latvijā izveidot vienotu interaktīvo portālu, kas nodrošinās augstas kvalitātes valsts institūciju un nevalstiskā sektora atbalsta pakalpojumus, kuru mērķis ir veicināt biznesa

**Starckenkova O., Gaile-Sarkane E. Problems of business expansion in small countries**

*A specific feature of all small countries is a limited market, which holds companies within a certain borderline of intense competition with a strictly predefined demand. Smaller economies therefore have to rely more heavily on external trade and foreign investment. However, open borders mean not only attractive opportunities for businesses in other countries, but also new competitors coming to a domestic market. Governments cannot keep the local market intact by applying protectionism measures, which is against the EU principles. The only way for entrepreneurs to hold back the external pressing is to be active and spread operation throughout the other countries. The main reason for companies' reluctance to expand abroad is lack of information and fear to face trade barriers. As a solution, the authors propose to create in Latvia a single interactive web portal, providing high-quality support services of non-governmental bodies and public authorities, aiming at facilitating business expansion in small countries.*

**Старченкова О., Гайле-Саркане Э. Проблемы расширения бизнеса в малых странах**

*Особенность всех малых стран заключается в ограниченности рынка, который держит предприятия в определенных рамках жесткой конкуренции со строго предопределенным спросом. В связи с этим, маленькие страны вынуждены больше полагаться на международную торговлю и внешние инвестиции. В то же время, открытые границы для предпринимателей означают не только заманчивые возможности в других странах, но и появление новых конкурентов на домашнем рынке. Правительство не может сохранить местный рынок нетронутым, применяя меры протекционизма, что противоречит принципам ЕС. Единственный путь, как отразить внешнее давление – предприниматели должны быть активными и расширять деятельность в другие страны. Главный сдерживающий фактор компаний для расширения деятельности зарубежом – недостаток информации и боязнь столкнуться с торговыми барьерами. В качестве решения проблемы авторы предлагают создание в Латвии единого интерактивного портала, предоставляющего высококачественные услуги государственных институций и частного сектора, благоприятствующие расширению бизнеса в малых странах.*