The Aspects of Entrepreneurship and Innovation Development of SMEs

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Abstract

Development of business activities is in accordance with economic priorities of state, formulated into the frames of long-term strategy of economic of Latvia. The problem of innovative development and growth is actual for small and medium sized enterprises. Skills and innovation have been the Latvian government's priority for the past few years, giving SMEs opportunities to fund creation of new products and services, up-skill and re-skill labour force and transfer knowledge and technologies from scientific institutions to SMEs. An increase in the number of young companies with a high level of growth potential, as well as the development of an entrepreneurial environment and a startup ecosystem will play a significant role in the development of small and medium-sized businesses. The purpose of this article is to show the state of innovative development of small and medium-sized enterprises in Latvia through the dynamics of the innovation index in the context of the EU. According to the European Innovation Scoreboard, Latvia is among the countries that have made progress from modest innovators in 2011 to moderate innovators in 2017. Latvia showed positive dynamics and growth of the total innovation index from 48 points in 2011 to almost 66 points in 2018.

Keywords
business environment, entrepreneurship, innovation, SMEs, startup

1. Introduction

The experience of countries with developed market economies shows that solving socio-economic problems depends largely on the level of development of SMEs. Development of business activities is in accordance with economic priorities of state, formulated into the frames of long-term strategy of economy of Latvia. National competitiveness is formed by competitive businesses whose success depends on the factors of entrepreneurship environment. SMEs are crucial for a healthy dynamic market economy (Hillary, 2004). Innovation and innovation environment take place within multiple business environment factors. Business environment is characterized by the prevailing economic and political climate, legal, socio-cultural, technological, geographical, ecology situation, as well as the state of institutional and information systems. Innovation, skills, has been the Latvian government's priority for the past few years, giving SMEs opportunities to fund creation of new products and services, up-skill and re-skill the labour force and transfer knowledge and technologies from scientific institutions to SMEs.

And despite this, the problem for Latvia lies in skills and innovation. The objective of this article is to show the state of innovative development of small and medium-sized enterprises in Latvia through the dynamics of the innovation index in the context of the EU, based on EU statistics. The focusing on productivity growth and expanding export opportunities will be crucial to the development of the Latvian economy, where innovation plays a significant role in a strategic perspective. The object of the research is innovative development of SMEs in Latvia. The methodological basis for the article is made up of bibliography review, methods, regulations of the EU, supplemented by national and international reports, scientific publications of foreign authors, and comparative analysis and methods of statistical analysis. It should be noted that the crisis in the sectors of the national economy caused by the global coronavirus pandemic will negatively affect the positive dynamics of indicators of innovative development. The consequences of this crisis have yet to be analysed and assessed, but it

is clear already today that the world has changed, the business environment has changed, 2020 will be a tragic year for many enterprises, especially for SMEs.

2. Literature review

The concept of "entrepreneur" and "entrepreneurship" was used for the first time in the modern sense by the English economist Richard Cantillon (Blaug, 1994). Cantillon first introduced the scientific use of the term "entrepreneur" as denoting the person buying goods for a known price, and selling for an unknown price, and therefore someone who is taking a risk. The most popular theory of the basic concept of entrepreneurship is that of Schumpeter, combining economic assessment of the entrepreneurial function with an attempt to display a psychological portrait of the entrepreneur and entrepreneurship as a process of "creative destruction." "Entrepreneurs we call business entities whose function is the implementation of new combinations and who act as active subjects of the enterprise." Schumpeter identified three main groups of motives: the desire to be the absolute owner of one's enterprise; the desire to prove its own consistency; the ability to realize oneself, the ability to do things you love and achieve concrete results on one's own; the joy of creation, which makes for an independent business activity (Schumpeter, 1982).

According to Daniel Isenberg, entrepreneurship is an ecological system that demonstrates the interdependence of environmental factors and is composed of many elements with complex relationships. The interdependence of ecosystem factors is the nature of complex cause-and-effect relationships; the interaction between the factors is influenced by the entrepreneurial activity in the region. Due to the complexity and combinations of ties, their successful interface requires supportive policies; markets; capital, skills and abilities of the people; the culture of entrepreneurship; supporting tools. Each element contributes to the development of the entrepreneurship ecosystem. Sustainable development and growth of entrepreneurship is ensured by a combination of all these factors. The complexity and uniqueness of the conditions existing in each country, region cause the need to study the factors that influence the creation of a favourable business environment as an ecosystem (Isenberg, 2011). Researches show that the main drivers behind a successful innovation ecosystem are favourable administrative requirements, government incentives, available financial resources, academic-industry collaborations, research and development, commercialization, market dynamics, entrepreneurial culture. (Ratanova, Voroncuka, 2019). Enterprises are relatively stable organizations and institutions of the economy – the host in different countries and periods of history, various legal forms, especially ownership – which, thanks to their many potentially autonomous abilities (goals), provide households with higher long-term utility owned by them (human, tangible, monetary, intellectual, social capital) than they themselves could achieve by their own management in a market economy, the state, or any thereof mix (Noga, 2009). The nature of the market interaction and competition can influence the firm's innovative capability, allowing the firm to adapt to its local market and its competition (Bao, Chen, Zhou, 2011; Martinez-Roman, Gamero, Tamayo, 2011). Firms of different sizes face market competition differently. Market concentration and innovation activity can either coevolve or be simultaneously determined (Salavou, Baltas, & Lioukas, 2004). The business environment and the specific configuration of its factors have a direct impact on the innovation intensity and activity of the firms.
The Small Business Act (SBA) is an overarching framework for the EU policy on small and medium-sized enterprises. It aims to improve the approach to entrepreneurship in Europe, simplify the regulatory and policy environment for SMEs, and remove the remaining barriers to their development. The SBA review, published in February 2011, is a major landmark in tracking the implementation of the Small Business Act. It aims to integrate the SBA with the Europe 2020 strategy. 6 of the 7 Europe 2020 flagship initiatives will help SMEs achieve sustainable growth. Main priorities of the SBA are:

- Promoting entrepreneurship
- Less regulatory burden
- Access to finance
- Access to markets and internationalisation.

A company operates in a specific business environment, which has an impact on all of its activities. Many SMEs fail in the short term due to already existing problems such as little or no investment in improvements and/or knowledge of the market, lack of formal planning and demand forecasting, lack of managerial and technical skills, and limited economical resources. These features make the SMEs more vulnerable to internal and external events such as: critical employee quitting his/her job, a decline of financing options, and reduction of demand due to a competitor entering the market (most of SMEs are within very competitive markets) (Eggers, 2020). The business environment is characterized by the current economic and political climate, legal, socio-cultural, technological, geographical environment, the environmental situation and the state of the institutional and information systems (Figure 1). The economic situation determines the income and purchasing power of the population, the level of unemployment and employment, the degree of economic freedom of entrepreneurs, investment opportunities, availability and accessibility of financial resources and other economic factors. The political situation depends on

the goals and objectives of the government in power. Through the economic policy, the government can influence entrepreneurial activity in specific sectors or regions. The legal environment is characterized by a system of laws and regulations governing trade, business, industrial, financial, tax, investment, and innovation areas of a company. The level of legal framework for entrepreneurship largely determines the stability and sustainability of an enterprise.
Geographical environment determines the natural environment in which the business operates, such as availability of raw materials, energy, climate and seasonal conditions, availability of highways, railways, sea and air routes. Geographical factors are taken into account for the supply of raw materials, finished good's distribution, etc. Ecological situation reflects the state of the environment, the degree of environmental risk, elaboration of monitoring and enforcement measures on businesses that pollute the environment. These and other environmental factors are taken into consideration when choosing a company of a certain technology, the raw materials used or the type of products. The institutional environment is characterized by a variety of institutions (organizations), with the help of which a range of commercial transactions, business relationships are established. Such institutions include banks, insurance companies, stock exchanges, companies that provide a variety of professional services (legal, accounting, auditing, etc.), advertising agencies, employment agencies, etc.

According to the Small Business Act of 1953 in the United States, a small business is one that is independently owned and operated and not dominant in its field of operation. The act also authorized the Small Business Administration to develop a more detailed definition that takes criteria as sales volume and the number of employees in the firm. It is also important to acknowledge the qualitative factors that distinguish a small business from a large firm into account. The Committee of Economic Development has outlined four characteristics that describe the domain of small business:

- Management is independent, since the manager usually owns the firm.
- Capital is supplied and ownership is held by one individual or a few individuals.
- The area of operations is primarily local, although the market isn't necessarily local.
- The firm is small in comparison with the largest competitors in its own industry.

Taken together, these characteristics provide a qualitative description of small business. However, it is important to consider both the quantitative definitions and the qualitative factors when trying to define small business (Hodgetts, Kuratko, 2002). Robert Hisrich gives the most concise definitions of the essence of entrepreneurship: the process of creating something new, something that has value, and entrepreneur – a person who spends all this necessary time and effort, assumes all financial, psychological and social risk, receiving in reward the money and satisfaction from achievements (Hisrich, 1995).

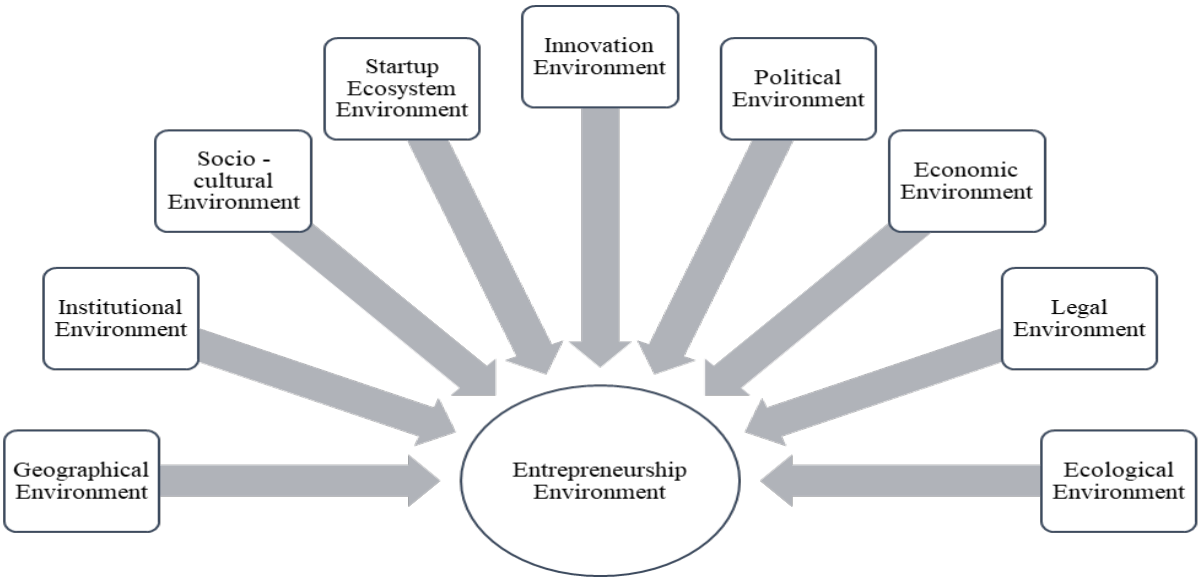

Figure 1. Factors of business environment

Each economy has its own specific entrepreneurship profile in terms of activity rates across various phases of the entrepreneurship process, characteristics of entrepreneurs and their businesses, and the attitudes and perceptions people hold toward this activity. The entrepreneurship environment in which entrepreneurs operate has its own

profile, containing strengths entrepreneurs can leverage and constraints they must overcome in order to start their business. Change is an inherent feature of the economy, economics and management sciences. Traditional methods of market activities, based on a disciplined approach to planning and forecasting, and based on complex rules and forecasts, have lost their battle against the market and the chaos that currently prevails (Eisenhardt, Sull, 2001). A few decades ago, Ansoff came up with the concept of a turbulent (highly volatile and complex) environment. On the one hand he pointed out the multifaceted nature of the disturbances occurring in the business environment, on the other, the need to include such changes in strategy building (Ansoff, 1984).

A key indicator of EU innovation leaders is the effective commercialization of their technological innovations. The set of business environment factors and their interaction are creating favourable conditions for the innovation of the entrepreneurship.

3. The SMEs innovation development indicators of Latvia

In Latvia, the SMEs play a significant role in the building of the gross domestic product (GDP) and the labour market. At the legislative level, a SME is governed by the Commercial Law, and the Civil Law. In Latvia, just as elsewhere in Europe, SMEs form a major part of the national economy and play a significant role in building the GDP and in employment. The definition of SME is stipulated in the Law on Control of Aid for Commercial Activity, Cabinet of Ministers Regulations No. 964 on Declaration Procedures of Commercial Companies According to Small or Medium-sized Commercial Company of 25 November 2008, and Commission Regulation (EC) No. 800/2008: medium-sized enterprises (number of employees: 50–249; annual turnover does not exceed EUR 50 million; total sum of annual balance is under EUR 43 million); small enterprises (number of employees: 10–49; annual turnover does not exceed EUR 10 million; total sum of annual balance is under EUR 10 million); micro enterprises (number of employees: 1–9; annual turnover does not exceed EUR 2 million; total sum of annual balance is under EUR 2 million) (Table 1).

Table 1. SMEs classification

SMEs category	Number of employees	Annual turnover, million, €	Total sum of annual balance million, €
Micro	1–9	>2	>2
Small	10–49	>10	>10
Medium	50–249	>50	>43

According to the information of the Small Business Act for Europe (SBA, 2019), by the estimate for 2018, there were 114,326 economically active individual merchants and commercial companies in Latvia in 2018 (excluding farms, fish farms, and self-employed persons involved in economic activity), 99.8% of which belonged to the category of SME. The proportion of economically active SMEs in Latvia is the following: micro-enterprises 91.6% (104,705), small enterprises 7% (7,976), medium enterprises 1.3% (1,450), large enterprises – 0.2% (195) (Table 2).

Table 2. SMEs in Latvia, 2018 (NFBS sectors)

SMEs category	Number of enterprises	Share	Number of persons employed	Share	Value added, Billion €	Share
Micro	104,705	91.6%	217,364	33.2%	2.7	21%
Small	7,976	7.0%	158,454	24.2%	3.1	23.9%
Medium	1,450	1.3%	153,879	22.0%	3.4	26.3%
Total	114,326	99.8%	519,697	79.4%	9.3	71.1%

In 2018, there were slightly more than 25 million SMEs in the EU-28, of which 93% were micro-SMEs. SMEs accounted for 99.8% of all enterprises in the EU-28 non-financial business sector (NFBS), generating 56.4% of value added and 66.6% of employment in the NFBS (Annual Report on European SMEs, 2019). Overall, the NFBS represented 54.5% of EU-28 GDP and 61.4% of total EU-28 employment. Of the whole SME population in the EU-28 NFBS in 2018, 28.4% were active in the knowledge-intensive services industries and 1.0% in high-tech industries.

Innovation, skills and R&D have been the Latvian government's priority for the past few years, giving SMEs opportunities to fund creation of new products and services, up-skill and re-skill the labour force and transfer knowledge and technologies from scientific institutions to SMEs. And despite this, the challenge for Latvia lies in skills and innovation. The difficulties in accessing bank finance for SMEs, also the lack of private investment in research and development, are hampering economic development in all sectors. The focusing on productivity

growth and expanding export opportunities will be crucial to the development of the Latvian economy. It is necessary to develop a National Educational Strategy for Entrepreneurship covering all levels of the education system. Across Europe, startups contribute to make countries economically and socially vibrant by redefining the technological landscape and creating the markets of tomorrow (European Startup Monitor, 2019). Eight of the top 30 startup ecosystems in the world are in the EU. Startups are a critical element for the economic vitality of any country. They also are the pipeline for SMEs and future high-growth firms. Young businesses may have important effects on the macroeconomy in the medium and long runs. A fall in the number of startups directly reduces the number of new jobs created by startups. This 'lost generation' of firms then creates a persistent dent in aggregate employment as subsequent years are characterised by a lower number of young firms (Gourio et al. 2016, Sedláček 2019).
Leading scholars (van Stel et al.,2007; Acs et al., 2009; Storey and Greene, 2010) maintain that innovative SMEs, frequently operating in advanced or cutting-edge service sectors, are the companies with the highest probability of expanding rapidly, creating net employment, favouring the change in productive specialisation in their countries and supporting access to that quaternary sector of the economy more compatible with sustainable development principles. Business dynamism is the private sector's capacity to generate and adopt new technologies and new ways to organize work, through a culture that embraces change, risk, new business models, and administrative rules that allow firms to enter and exit the market easily. An agile and dynamic private sector increases productivity by taking business risks, testing new ideas and creating innovative products and services. Innovation capability, the quantity and quality of formal research and development; the extent to which a country's environment encourages collaboration, connectivity, creativity, diversity and confrontation across different visions and angles; and the capacity to turn ideas into new goods and services. Countries that can generate greater knowledge accumulation and that offer better collaborative or interdisciplinary opportunities tend to have more capacity to generate innovative ideas and new business models, which are widely considered the engines of economic growth (Global Competitiveness Report 2018).

The Global Competitiveness Index (GCI) rating, published annually by the World Economic Forum (WEF), is a globally recognized tool for measuring a country's competitiveness. Despite various methodological shortcomings, the GCI rating provides valuable information to policy makers and allows identification of areas where Latvia lags significantly behind other countries. In 2019, in the new WEF Global Competitiveness Index (GCI 4.0) Latvia ranked 41st among 141 countries of the world (Estonia – 31st, Lithuania – 39th) having moved up one position compared to the evaluation of 2018. The index is composed of 12 pillars characterising business environment, human capital, market (products, labour, financial) and innovation ecosystem. Taking into account the growing impact of digitalisation on the development of competitiveness, the new GCI methodology was changed and is named GCI 4.0. The performance of the previous year was also recalculated according to it. It allows to evaluate the changes that have taken place during the year, which can be characterised by the evaluation (compared to the leading country) and by the change in the place during the year. The progress of Latvia in competitiveness shows that the evaluation of the "Financial system" pillar improved the most affected by the evaluation of SME funding and venture capital availability. At the same time, it should be noted that despite the improvement in the evaluation, the place obtained in "Innovation capacity" pillars have worsened, because progress of other countries was more rapid (The Global Competitiveness Index, 2019). European economy shows growth potential in 2018, especially in terms of innovation environment (9% compared with 2017 and 58% compared with 2011) and business expenses for research and innovation (8% compared with 2017 and 19% compared with 2011). Twenty-four Member States showed improvement, with Estonia being the most pronounced (24% per year and almost 17% over the past eight years), followed by Portugal, Finland and Greece. Although the process of rapprochement between Member States continues, albeit at a slower pace, as a result of faster growth of less innovative economies amid slower improvements by innovation leaders.

To achieve a high level of innovation performance, countries need a balanced innovation system performing well across all dimensions. They need an appropriate level of public and private investment in education, research and skills development, effective innovation partnerships among companies and with academia, as well as an innovation-friendly business environment, including strong digital infrastructure. These key areas correspond largely to the dimensions and indicators used for the European Innovation Scoreboard.

According to the European Innovation Scoreboard, Latvia is among the countries that have made progress from modest innovators in 2011 to moderate innovators in 2017 (Figure 2).

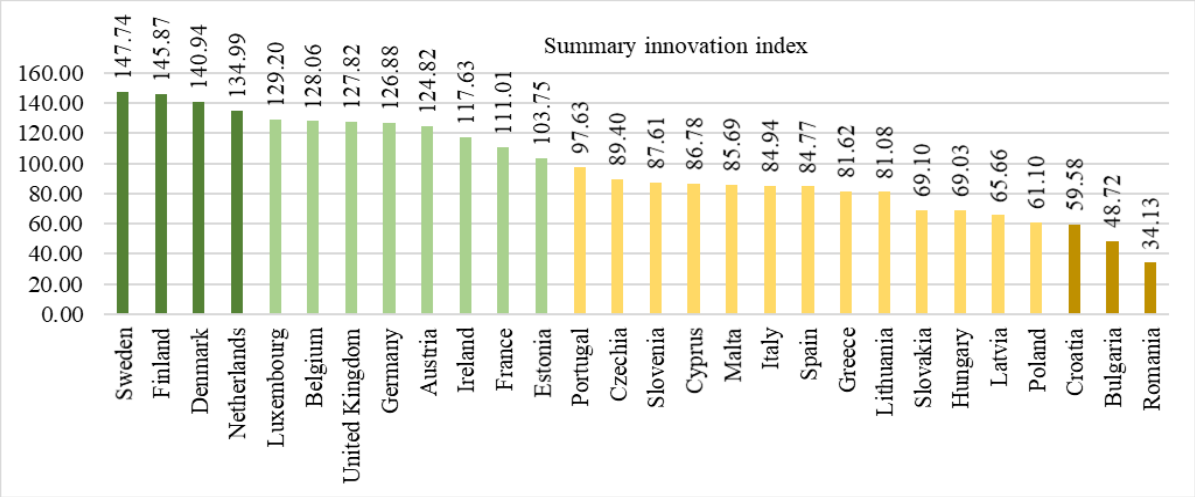

Figure 2. Summary innovation index (EU 28), 2019

Estonia is among the countries that have made progress from moderate innovators in 2011 to strong innovators in 2017, while Lithuania is showing steady growth in the moderate innovators group of EU countries.

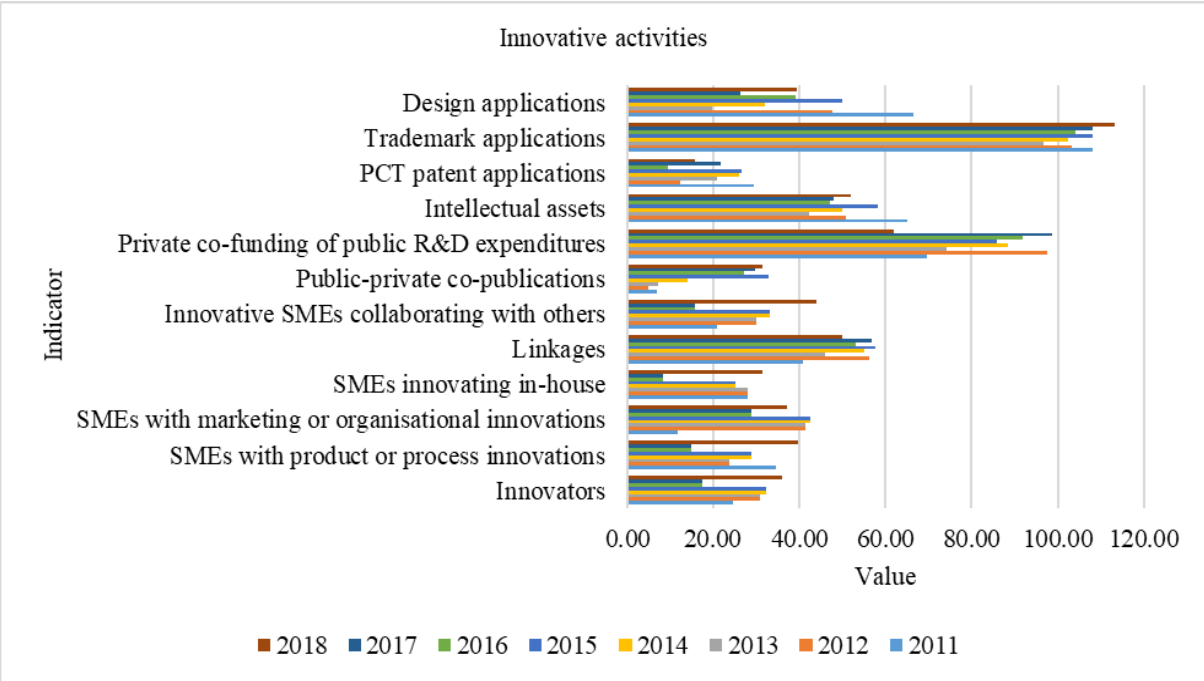

Figure 3. Innovative activities (2011–2018)

Innovation activities capture innovation efforts at company level, covering three dimensions: innovators, linkages, and intellectual assets (Figure 3).

Table 3. Changes in the innovative activities index of Latvia (2011–2018)

Indicator	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
Innovators	24.65	30.96	30.96	32.27	32.27	17.41	17.41	36.09
SMEs with product or process innovations	34.45	23.61	23.61	28.90	28.90	14.96	14.96	39.81
SMEs with marketing or organisational innovations	11.65	41.35	41.35	42.66	42.66	28.76	28.76	37.04
SMEs innovating in-house	27.89	27.89	27.89	25.17	25.17	8.41	8.41	31.36
Linkages	40.72	56.20	45.91	54.98	57.54	53.16	56.89	49.82

Innovative SMEs collaborating with others	20.94	29.95	29.95	33.27	33.27	15.82	15.82	44.11
Public-private co-publications	6.85	4.83	7.12	13.92	32.73	27.02	29.60	31.40
Private co-funding of public R&D expenditures	69.77	97.52	74.30	88.54	85.99	91.75	98.70	61.93
Intellectual assets	65.08	50.78	42.22	49.94	58.20	46.97	48.10	52.04
PCT patent applications	29.50	12.26	20.87	25.89	26.67	9.34	21.86	15.86
Trademark applications	108.25	103.39	96.70	102.29	108.23	104.15	107.98	113.35
Design applications	66.56	47.56	19.75	31.99	49.89	39.12	26.25	39.31

Table 3 shows changes in the innovative activities index of Latvia by innovation activities from 2011 to 2018.

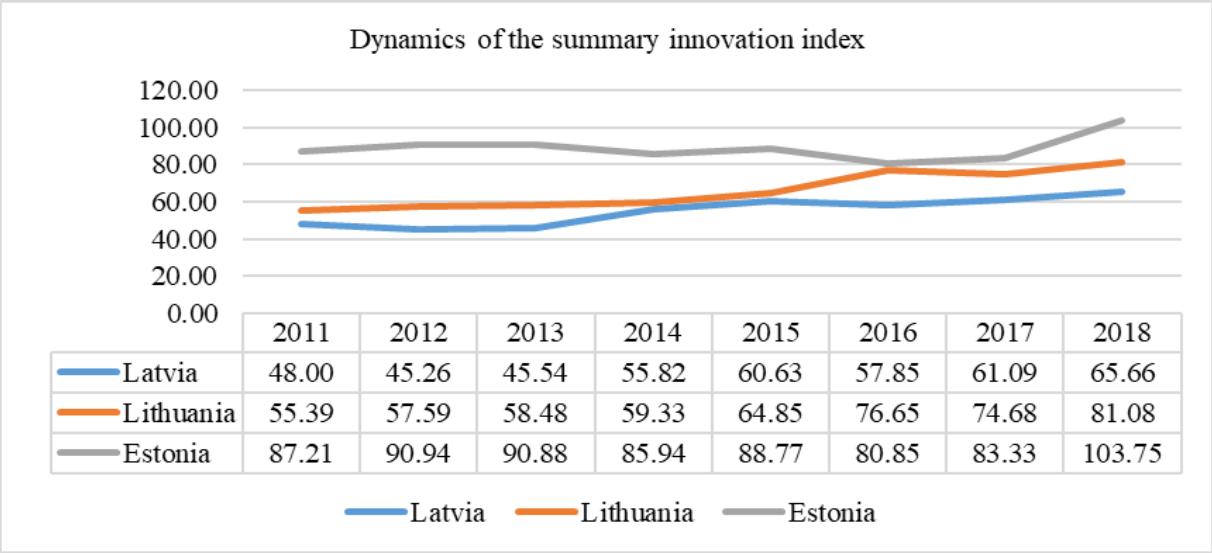

Figure 4. Dynamics of the summary innovation index: Latvia, Lithuania, Estonia, (2011-2018)

As the data show, Latvia shows positive dynamics and growth of the total innovation index from 48 points in 2011 to almost 66 points in 2018 (Figure 4). It should be noted that among the three Baltic states of Latvia, Lithuania and Estonia, Estonia is in the lead. While in 2011 Estonia had scored 87 points, it achieved an 104 points in 2018. Lithuania ranks second between Estonia and Latvia and has managed to increase its number of points from 55 in 2011 to 81 points in 2018.

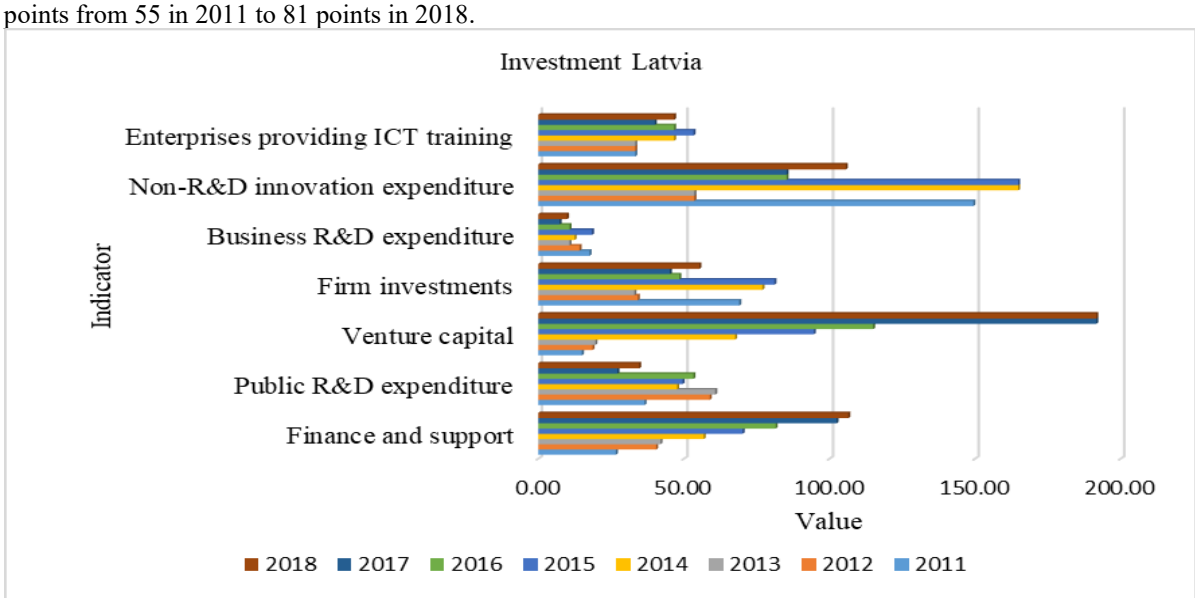

Figure 5. Investment index of Latvia, (2011–2018)

Investments include public and private investment in research and innovation, distinguishing between external finance and support, and own-resource investments. Table 4 shows changes in the investment index by individual indicators.

Table 4. Dynamics of the investment index of Latvia (2011–2018)

Indicator	2011	2012	2013	2014	2015	2016	2017	2018
Finance and support	26.66	40.49	41.96	56.81	70.19	81.53	102.4	106.47
Public R&D expenditure	36.50	58.91	60.78	47.71	49.58	53.31	27.17	34.64
Venture capital	14.99	18.64	19.64	67.61	94.62	114.98	191.6	191.62
Firm investments	69.02	34.17	33.04	76.99	81.09	48.45	45.19	55.31
Business R&D expenditure	17.61	14.17	10.74	12.46	18.46	10.74	7.31	9.88
Non-R&D innovation expenditure	149.41	53.61	53.61	164.78	164.78	85.29	85.29	105.59
Enterprises providing ICT training	33.33	33.33	33.33	46.67	53.33	46.67	40.00	46.67

Figures 6 &7 demonstrate a fairly strong positive relationship between variables. Finance and support, venture capital these are indicators that, if increased, will have a positive effect on the summary innovation index.

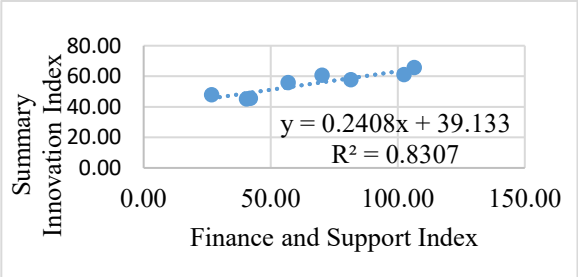

Figure 6. Finance and Support Index Correlation

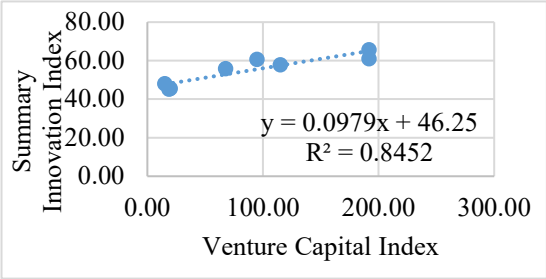

Figure 7. Venture Capital Index Correlation

The value of the Summary Innovation Index is determined by a number of indicators that affect its increase. The transition of the country from moderate innovators to strong innovators will require serious efforts from the state. Improving the business climate, improving innovation and startup ecosystems requires both government measures in this area and the efforts of entrepreneurs. Financial support and venture capital have a significant impact on the development of innovative entrepreneurship.

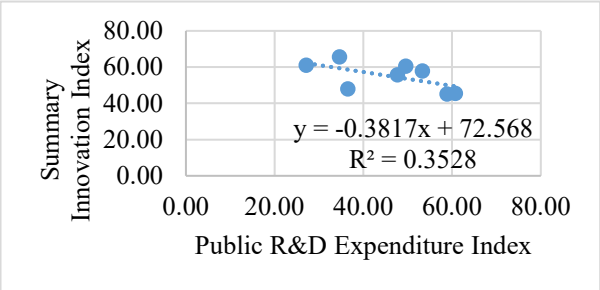

Figure 8. Public R&D Expenditure Index Correlation

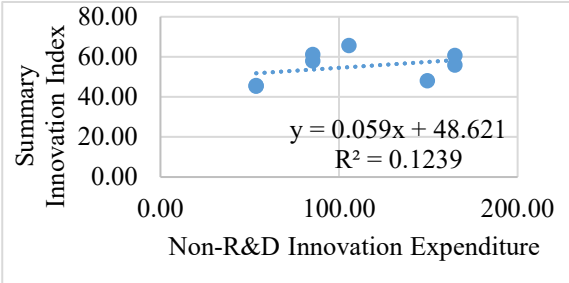

Figure 9. Non-R&D Innovation Expenditure Correlation

Research and development R&D shows a positive, but weak relationship between the summary innovation index (Figure 8). Perhaps because the results of research and development are not commercialized in aim to create added value. Non-R&D expenditure index dynamics given in the table shows a high level in comparison with other indicators in the group (Table 4). It should be noted that the high index of non-R&D innovation expenditures showed less correlation with the summary innovation index (Figure 9). This mean that it is necessary to revise the structure of these costs, to make an audit of activities and to develop a strategy aimed at improving the result.

Conclusions

A combination of various factors creates an innovative business environment. The interaction of these factors creates its own profile of the business environment as an entrepreneurship ecosystem, taking into account the specifics of each country. Startups are a critical element for the economic vitality of any country, they create an opportunity field for SMEs and future high-growth firms. In Latvia, SMEs play a significant role in the creation of the gross domestic product and the labour market. Further research is also needed because innovation, technology and startups are factors of the entrepreneurial environment that influence the innovative development of SMEs and the competitiveness of a country.

The relationship between the entrepreneurship environment and activities of SMEs is complex, and it is important to understand how the environment affects the quality of entrepreneurship. As research shows, the dynamics of the index of expenses not related to R&D showed less correlation with the Summary Innovation Index. This means that it is necessary to revise the structure of these expenditures, conduct an audit of an activities and develop measures aimed at increasing the efficiency of the use of investments of SMEs.

The set of factors of the business environment and their interaction create favourable conditions for business innovation and motivation of entrepreneurs. To achieve a high level of innovation, each country needs a balanced innovation system that works well across all dimensions. According to the authors, it is necessary to study the influencing factors of the innovative environment, the relationship between the influential factors themselves and determine their priority. For a country's transition from moderate to strong innovators require serious national efforts. Improving the business climate and innovation ecosystem requires both government action in this area and the efforts of entrepreneurs.

The crisis caused by the global pandemic Covid 19 in the sectors of the country's economy will negatively affect the dynamics of indicators of innovative development. The consequences of this crisis have yet to be analyzed and assessed, but it is already clear today that the business environment has changed, and 2020 was a difficult year for many companies, especially for SMEs.

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