

# PRICE-SETTING SPECIFICS IN LATVIAN ENTERPRISES

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## Abstract

Prices are one of key economic indicators and tools for influencing economic processes. In Latvian market, the sensitivity of price continues increasing determined by the variable and unpredictable tax system, as well as the effects of the reforms being implemented. Still, for the establishment of competitive prices stable economic environment is needed. Therefore the evaluation of the price-setting specifics gains utmost importance. By evaluation price-setting and identifying existing regularities, by developing methodological approach to targeted price-setting management process, it is possible to promote the implementation of the competitive advantages of price-setting. Latvian market is characterized by changing prices with a strong upward trend. Though the scientific literature increasingly accentuates the science-based price-setting, Latvian enterprises have little experience in this field and this important and complex process is given undeservedly little attention.

*Keywords:* price-setting, factors influencing price-setting, problems.

*JEL Classification:* M21.

## Introduction

Although price-setting is one of the most important management functions, it is still insufficiently understood and also one of the least-controlled functions in many companies. At the same time, price-setting is a very sensitive tool available to managers for influencing the profit. Price-setting contains a huge potential, implementation of which can ensure the increase in the company's operational efficiency and gaining the competitive advantage. Advances in information technologies and increased competition in the global economy raise the question of price-setting for each and every business, as most companies have used the simplest performance optimization tool – cost reduction. But the competition continues to increase, demand in some markets to decline, buyers are better educated and informed, which is contributed to by the dynamic environment of the Internet. All this provides the topicality of high-quality price-setting as a management tool. Price-setting policy development issues and the choice of the right prices always remain important to every company. Especially in the current situation, it is important for the Latvian enterprises to promote the successful marketing of their products, as the level of competition is increasing, and one of the basic prerequisites of the success is the price - as a tool to ensure competitive advantage. For successful solution of the problem there is needed continuous improvement of the price-setting methods and forms. Price-setting improvements should be scientifically justified, based on well-established methodology, as the creation and implementation of optimal price-setting policy lies at the very basis of commercial success.

The objective of the research is to identify the price-setting specifics and problems in Latvian enterprises.

To reach the objective there will be characterized the nature of the price-setting process, establishing the main elements and stages, analyzed the price-setting practices in Latvian enterprises, based on the opinion of the entrepreneurs and experts.

Research methodology, will be used: logically constructive approach - making judgments and results analysis; synthesis method - to combine the elements of a single system; social research methods – questionnaires and interviews – to obtain the primary information and to carry out its verification.

## The Nature of the Price-Setting Process

Price-setting takes place in real market conditions and, though this process may be subjective, it has objective basis, to provide the company with the opportunities of reproduction and further operational development.

Price setting is one of the most important decisions made by the company. Still, the weak application of the price-setting advantages in the enterprises is determined by the following factors:

1. In the conditions of high demand and fast decrease in expenses, there is no motivation to use price-setting to increase profits;

2. The enterprises have no belief in the management possibilities of the price-setting process, thinking that the price is determined by the market, consumers or reckless competitors;
3. Indicators needed for the price-setting decision making are not available or are out-dated;
4. Price differentiation and other price-setting activities are regarded as illegal, which limits internal price-setting process;
5. Difficulties in establishing price-setting errors;
6. Price setter has no stimulus to fight for the increase in profits;
7. Enterprise managers seldom take active part in the process of price setting (Marn *et.al*, 2004).

Agreeing with the opinion expressed above, there should be mentioned that for every enterprise it is important to gain price advantage, though there exist many real problems, which again reaffirms the price setting importance in each enterprise.

Within the price setting process in the company there is used a complex of measures – different methods and strategies. The complex of measures or price-setting policy is the sum of all measures and conditions, which are needed to establish the price for the goods in the appropriate way and amount.

There may be distinguished several basic reasons for the application of the price-setting policy decisions (Bruh, 1997; Meffert, 1980; Tarasevich, 2003):

1. Demand-related reasons; demand-based price-setting;
2. Trade-related reasons: promotion of the trade by reducing prices, discounts;
3. Company-related reasons: changes in price structure, especially growing supply and personnel costs, introduction of new goods;
4. Competition-related reasons: changes in competition prices, involvement of new competitors;
5. External environment-related reasons: price influencing laws; trade barriers;
6. Reasons related to the commencement of entrepreneurship: introduction of new products on the market, beginning of new type of operation, accessing new markets.

To reach the price-setting policy targets there are applied various instruments, which are interconnected and the application of which requires the coordination of the activities. There may be distinguished strategic and operational-tactical instruments (Gerasimenko, 2005). It is important to mention following instruments: the amount of price, discounts (rebates, bonuses, amount discounts), terms of delivery, terms of payment, guaranties (Bruh, 1997). Consequently, to reach the targets there is used not only the price-setting itself, but other components related to it, as well. While summarizing the opinion of several authors (Preisner&Engel, 1994; Gerasimenko, 2005; Marn *et.al*, 2004; Machado, 1998; Tarasevich, 2003) the price-setting process and its composing elements may be represented in the price-setting policy element model. See Figure 1.

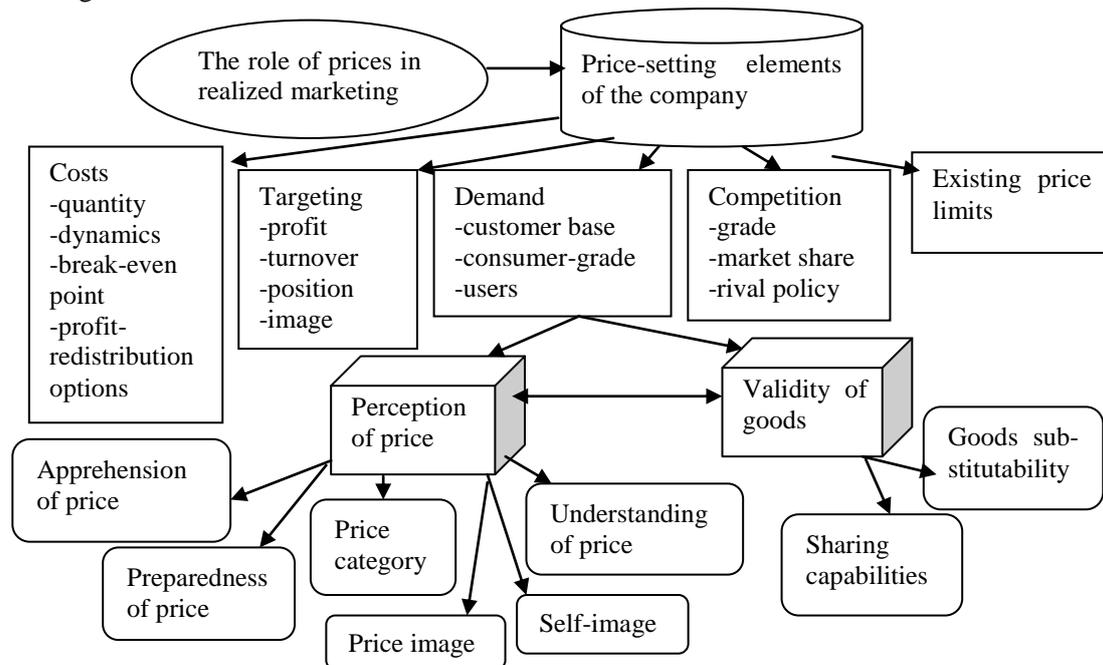
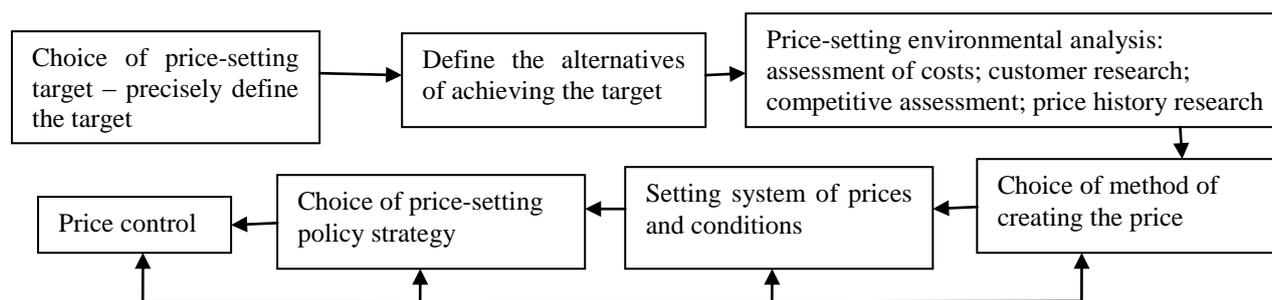


Figure 1. Company's price-setting policy element model

Firstly, the price setting in the company is directly influenced by expenses, competition and demand, but it will be hard to establish price without setting own targets and without taking into account the country's limitations and the specifics of the applied marketing, which may strengthen the overall role of the price-setting policy within the organization of the company's operation within the particular market conditions. There should be mentioned that the elements forming price-setting policy should be regarded as a whole system, within which the company will operate and the influence and correlation of which it will feel both directly and indirectly.

Further, approximating the nature of the price-setting process, there should be mentioned that the literature (Preisner&Engel, 1994; Gerasimenko, 2005; Armstrong *et.al*, 2010) though depicts with unanimity the price-setting process regarding the main stages of the process (target, research, choice of methodology, price setting), there exist different weighting of the importance of the corresponding stages, as well as there can be observed flaws (incomplete regard or even ignorance of particular stages). Describing own opinion of the price-setting process, the authors have established the chain of the price-setting process stages. See Figure 2.



**Figure 2.** Chain of the price-setting process stages

Consequently, the most important stage of the process is defining the target, which will be supplemented by approximation of the alternatives, followed by superficial examination, during which parallel to the classic value expenses (allowing to approximate the lowest price limit and future prospective), demand (allowing to understand psychological aspects, the highest price limit), competition (allowing to approximate the pricing risk and the highest limit, as well as alternatives), there is reviewed the pricing history which is an important aspect of setting the optimal price. The research may include different aspects, historic experience of price-setting, price level and specifics within the previous periods. Summarizing the results of the analysis allows making a choice approximating the most suitable methodology and market price strategy, while at the end of the process the control should be implemented. It is important to sustain the feedback loop among the process stages.

Further, there will be reviewed the price-setting methods. There should be mentioned that in some sources (Preisner&Engel, 1994; Machado, 1998; Gerasimenko, 2007 Armstrong *et.al*, 2010) most often there are mentioned price-setting methods, which are based on three principles: cost, demand, and competitiveness; while the other sources (Tarasevich, 2003; Alistarhova, 2000, Diderih, 2002, Magidenko, 1997; Kuyumcu, 2007) indicate the possibilities and the need of the application of economic analysis in the price-setting. Therefore, the authors believe that the price-setting methodology should be based on four principles: 1) Cost; 2) Value; 3) Competitiveness; 4) Economic analysis.

Consequently, there may be distinguished three groups of price-setting methods:

- 1) Expense-related methods – total expenses, return on investment, coverage amount, structurally similar methods;
- 2) Market-related methods – consumer evaluation, prestige, following the leader, competition, auction methods etc.,
- 3) Economically-analytical methods – specific indicators, regression analysis, aggregates, economic advantage, expert, consumer testing methods etc.

Price-setting methodology is wide and complex, especially with regard to the economically-analytical group of methods. Most commonly used are the expense-related and market-related methods (based on the principles of competition and value), the application of which is determined by the specifics of the particular field of national economy. At the basis of the expense-related methodology lies the principle of the need to cover the expenses, methodology allows for the regressive and progressive calculation (the basis of full or partial expenses). Due to the amount limitations, the methodology will not be reviewed in detail.

Concluding this part of the research, there may be concluded that the price-setting process in the company is a complex, yet important process. The prices set accordingly to the particular conditions of the national economy will provide the company with (price) advantages which is substantial for the conditions of increased competition. Price-setting is relatively free as it will always be influenced by the targets to be met and a wide range of factors.

### Price-setting Practice in Latvian Enterprises

Latvian economy is characterized by changing prices: rapid price increase trend is until the year 1997, which gains a faster pace again from 2004 to 2009 (while there is a significant decrease in the gross national product, consumer prices still increase by 3.5%, though in some other places there is still a negative inflation trend, in 2010 the deflation is 1.1%, changed by increase in prices of 4.4% in 2011 (CSB, 2012). According to the research of the specialists of the Bank of Latvia (Benkovski *et.al.*, 2011) in Latvia there is monitored a larger price flexibility than in euro-zone, persistence period is 3.5 months, 28.7 % of prices are changed monthly, the most flexible prices are in the sector of energy, while the most stable are in the sector of services; furthermore, these frequent changes mostly are expressed by the growth in prices, which is larger than in euro-zone, while the decrease in prices is short-term and seasonal.

Latvian price changeability and the broad range of influencing factors is a substantial commercial activity risk factor, which does not promote competitiveness; frequent changes in the economic environment (both extraordinary and planned) do not promote stability and optimism, consequently, hinder the price-setting for the goods, though the prices are one of the competitiveness factors (Bruksle&Gode, 2011). To be able to evaluate the price-setting process in the Latvian business environment, establish the main principles and possible deficiencies, there was carried out a research by gathering primary data. During the research on price-setting process in the business environment there was used a several method approach – combined survey strategy:

- 1) the direct company survey by questionnaires with personal delivery to gain the primary information on the price-setting organization in different companies, influencing factors and perception of price administration;
- 2) the structured interview to verify obtained primary information and clarify additional issues that had arisen;
- 3) the expert survey to specify the obtained results and to supplement the interpretation of the gained results.

During the survey (taking into account the specifics of the research topic and the nature of the information to be obtained) there were personally addressed the representatives, owners, financial directors and price-setting specialists of different companies (to gather the primary information as relevant as possible); of 300 addressed people, 155 agreed to participate in the survey. For the data processing there was used the programme SPSS Statistics 17.0. For the verification of the primary information and the clarification of the ambiguous issues the interviewing of 15 entrepreneurs was carried out. In the expert survey participated 11 (out of 17) experts whose duties are connected with the analysis of economic processes and prices – representatives of the Bank of Latvia, Board of Statistics, Board of Competition, Public Services Regulator, Academy of Science, commercial banks, as well as of Latvian Association of Economists.

Evaluating the gathered information, there should be noted that respondents have operational experience in different areas, most of them represent the companies of commercial sector (43.71%), the second largest group is involved in the production sector (33.11%), the proportion of the consulting and financial enterprises is comparatively small (9.27% and 8.61% respectively), a very small part of the enterprises (5.3%) operates in several sectors. The operational experience has formed over a larger period, the most of the companies (76.77%) operate on the market for more than 5 years, while 10.32 % even more than 15 years; correspondingly, they operated also during the time when in Latvia rapid inflation took place (1993 - 1998). Furthermore, it is important that respondents represent different categories of the companies, of the surveyed companies 84.31% correspond to the small and medium enterprise category, of which the largest part (35.29%) is the small enterprises, followed by micro-enterprises (27.45%). Further, there are highlighted the most important findings, resulting from the summary of the survey results, on the price-setting in different Latvian companies.

1) Price-setting targets. In the companies, while developing price policy, most often (55.85%) there are set several targets at a time, two – 30.52% of respondents, three – 14.29%, four or more – 11.04%. The

most often mentioned target is the opportunity to gain maximum profits (20.18 %), followed by ensuring of average profit level (17.7%). Yet, for the group of respondents stating 2 or 3 targets, the most often mentioned is the increase of the market share (21.60%), followed by the opportunity to gain maximum profits and sustain client loyalty (16.05%), ensuring of average profit level (10.49%). There should be noted that this highlights the first substantial problem characteristic for the price-setting in the companies – setting of several targets at a time does not allow establishing the optimum price as each target requires an individual and different price-setting approach.

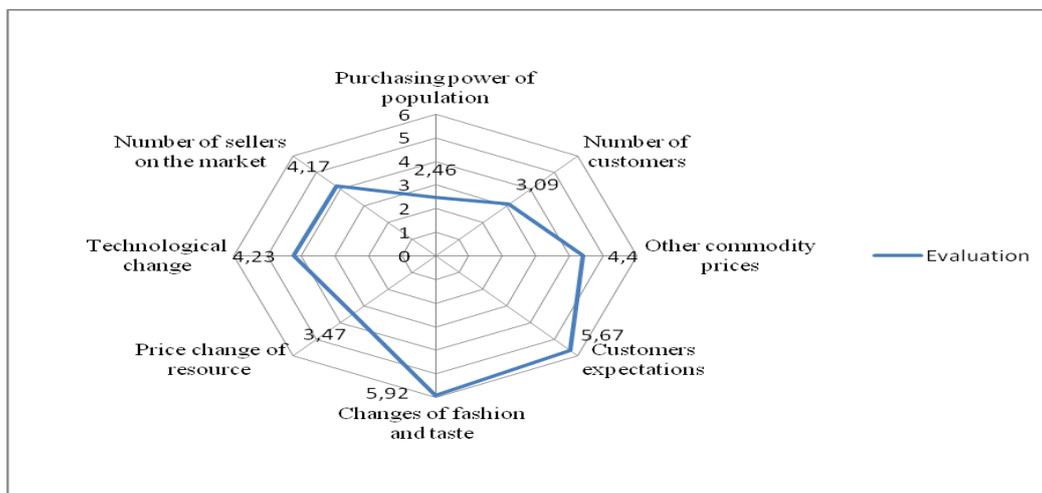
2) Price-setting principles. During price-setting companies mainly apply the combination (87.50% of respondents) of principles (expenses, competition, value). A very small part (7.24%) bases the price-setting on only the principle of expenses, and more than a half of these enterprises are with a large operational experience (10 to 15 years). The trend to combine price-setting principles can be seen in all groups of enterprises. There should be noted that combining principles during price-setting is a successful approach which allows establishing the most appropriate price for the particular market conditions; still with the prerequisite of not the following sequence: on the basis of the full expenses and approximating competitors' prices, establishing own price which does not differ from the competitors', as such price-setting will not ensure gaining the price advantage. While combining principles, it is important to pay more attention to the economic analysis (approximation of economic advantages, consumer testing, regressive analysis, etc.).

3) Price-setting strategy. Companies prefer the flexible price strategy (59.67%) followed by the average price strategy (22.97%), and the high price strategy (10.81%). Most seldom is used the low price strategy (3.39%), and there should be noted that this strategy is most often applied by small companies and those operating on the market for 5-10 years. By preferring the flexible strategy, the companies try to adapt to the changeable Latvian market environment; as there was mentioned before, Latvian price flexibility is higher than in the euro-zone.

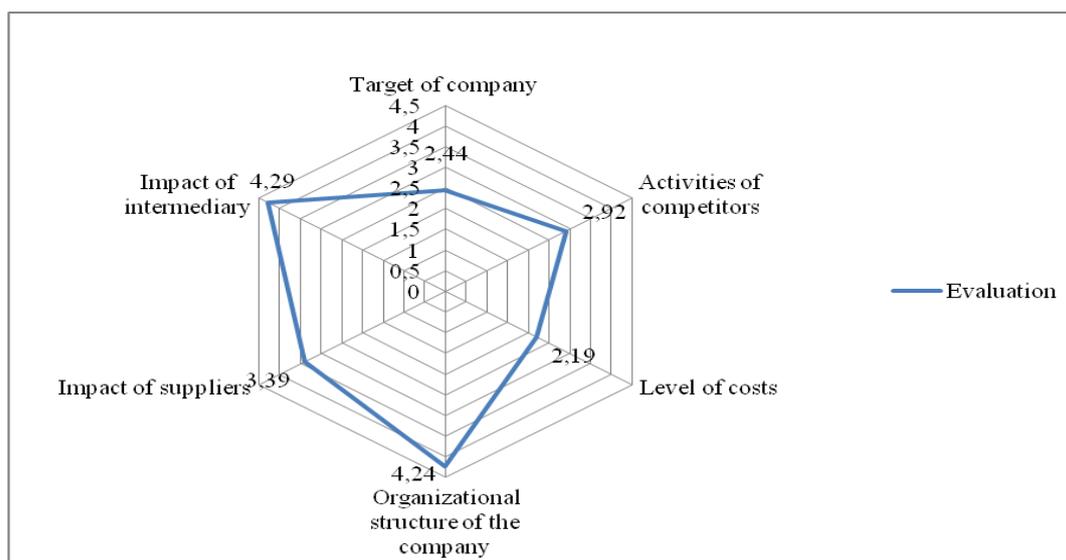
4) Application of discounts. Discounts are applied widely with only 12.99 % of the respondents stating that they do not use them, while 16.88% state that apply them once a month, 14.29% - once a season, and 14.94% apply them for individual clients. The reasons mentioned most often are: the purchase of goods in bulk (27.78%), and the reward for loyalty (21.43%). The amount of discount seldom exceeds 20%, most often they are up to 10% (35.94%), up to 5% (23.44%), or up to 20% (18.75% of respondents).

5) Influence of the public price regulation. More than a half of the respondents are not influenced by the public price regulation, while part of them are influenced due to the price regulation on raw materials (22.15%), or indirect regulation (7.86%). Yet, there are enterprises (17.86%) that within their operation encounter price regulation (fixed prices, amplitudes, setting price ceiling). Consequently, the influence of the state can not be perceived as insignificant factor.

6) Factors influencing price-setting. Respondents had to evaluate macro- and micro-environmental factors and their influence on setting prices. The gathered information allows concluding that the most significant influence has the purchasing power of the inhabitants, the amount of buyers and the changes in the prices of resources (macro-environmental factors), as well as the level of expenses, the company targets and the competitors' activities (micro-environmental factors). See Figure 3 and Figure 4.



**Figure 3.** Macro environmental factor impact assessment on price-setting (from 0 – most influence; to 6 – no influence)



**Figure 4.** Micro environmental factor impact assessment on price-setting (from 0 – most influence; to 6 – no influence)

Summarizing the findings it is possible to conclude that Latvian entrepreneurs mainly set the prices themselves, most often it is the owner-manager of the company, setting the profit margin takes into account the main trends in the field with basis on the average price (significant aspect is the specifics of operation). Prices are reviewed at least once a year and according to the possibility or the necessity adjusted, which is influenced by the changes in the supplier prices. As a significant hindrance in price-setting there is mentioned the continuous price changeability in Latvia, especially on the basic raw materials, which hinders planning of operation and increases risk. As the most important state activities for the promotion of the competitiveness and stable prices, there are mentioned:

1. Clear and predictable taxation policy;
2. Stable legislation;
3. Fighting the shadow economy;
4. Allowances for the small enterprises.

There should be noted that the price-setting in the companies is organized comparatively simply, without paying it much attention.

The experts evaluate Latvian price changeability as rapid and often unpredictable, and point out that the main conditions for price-setting are expenses, based on the expense principle or the combination of several principles. As the main price-setting influencing factors are mentioned production expenses and purchasing power, correspondingly, the experts' opinion substantiates the results obtained in the survey and interviews. There are mentioned several substantial problems hindering the competitive and stable prices in Latvia, which can be divided into three categories: market situation, economic policy, operation of the companies. See summary in the Table 1.

**Table 1** Factors promoting price instability – summary of experts' opinion

Market situation	Economic policy	Company operation
1) Insufficient competition; 2) Small market; 3) Open market; 4) Lack of local raw materials; 5) Large dependence on the raw material price fluctuations; 6) Dependence on the changes in the global economy; 7) Changeable total price level.	1) Inefficient state taxation system; 2) Government decisions are not development-focused; 3) Lack of a real long-term economic development plan; 4) Monetary policy is focused on currency not price stability 5) Striving to level off prices in the EU	1) Improper approximation of the demand – small production amount and too high expenses; 2) Insufficient production amount and efficiency in comparison with foreign competitors; 3) Lack of company strategy

Within the price regulation, the experts state the necessity to apply a well thought-out indirect administration approach, and as a substantial factor for the formation of competitive prices mention the adjustment of legal environment, predictable, stable, and transparent taxation policy, defining of clear view of development. Consequently, the opinion of experts supplements the ideas stated by entrepreneurs.

### Conclusions

Developing the price-setting policy, there should be established the pricing targets, carried out the pricing environment analysis, approximated the price with the means of the chosen pricing methodology and strengthened the pricing strategy which had been highlighted at the beginning. There can be set different targets, applied different price-setting methods (based on the principles of expenses, value, competition and economic analysis), and chosen different price-setting strategies according to the set targets and carried-out research.

Latvian entrepreneurs carry out price-setting mostly by themselves. Usually it is done by the owner – the manager of the company. Price-setting is based on expenses. Though entrepreneurs try to combine principles (by estimating demand, consumer needs, and competitors' prices), surcharge is created in line with the trends existing in the branch and with the focus on the average level there (therefore more important become specifics of operation). Price-setting in the companies is organized in a relatively simple way, without paying much attention to it.

Substantial hindrance in price-setting is the continuous price fluctuation in Latvia, which interferes with the operation planning and increases risk. The state regulation in price-setting is felt mostly indirectly through taxation policy.

The most important state activities, that would promote creation of competitive and stable prices, are a clear and predictable taxation policy, stable legislation, tax reductions for small enterprises.

Price regulation needs a sound indirect administration approach, and a substantial factor for competitive price-setting is the adjustment of legislative environment and definition of clear vision of development.

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