

## Competition and SMEs front informal economy - Case of Kosovo

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### Abstract

This study aims to raise a discussion in order to raise awareness of the population about understanding the problems that informality brings. In general, the study has the potential to not only affect economic development, but also to set up a socio-political agenda that will benefit the citizens of Kosovo. Informality is a globally widespread phenomenon, which has become a feature of developed and developing countries. Despite the global reach, and despite the adverse effects it has, informality still remains the term that causes many disagreements, which are directly related to its definition, classification and measurement. This study aims to present the real picture of informality in Kosovo; The size, the determinants, and the economic consequences that this phenomenon may cause. In this study, informality is defined as a phenomenon that describes all the economic activities that are secretly developed by the state and which do not neglect the rule of the state. As such, it includes concepts such as tax evasion, informal employment and undersigning employee salaries.

**Keywords:** Competition, SMEs, informality, labour market, economic development, strategies, long term, the government.

### Introduction

The purpose of this research is to provide a conceptual framework for understanding economic informality in Kosovo as an input for further analysis and policy formulation that address informality. The bulk of informal economic activities in Kosovo, some data include about half of the workforce, is quite worrying due to possible irregularities occurring in the informal sector due to lack of protection for workers operating in informal enterprises, but also due to possible disparities between tax collection and the use of public goods and services. Informality is a widespread global phenomenon that has become a feature of developed and developing countries. Despite the global reach, and despite the adverse effects it has, informality still remains the term that causes many disagreements, which are directly related to its definition, classification and measurement. This study aims to present the real picture of informality in Kosovo; The size, the determinants, and the economic consequences that this phenomenon may cause. Kosovo is located in the central part of the Balkan Peninsula in Southeast Europe. It borders with Serbia, Montenegro, Albania and Macedonia.

Kosovo's surface is 10 908 km<sup>2</sup>, the total resident population is 1.804.944 inhabitants, the population density for 2013 was 166.9 inhabitants per km<sup>2</sup>, the total number of households is 297 090, the total number of dwellings 412 884, of which 71% used, about 61% of the population living in rural areas, the average size of households is 5.85 people. Unemployment rate in total 30.0%, unemployment rate in males 26.9%, female unemployment rate 38.8%, youth unemployment rate (aged 15-24) 55.9%. As far as the land surface is concerned, 53% of Kosovo's land is agricultural, 41% of Kosovo's land is forest land, 1% of Kosovo's land is water surface, 5% is the other area (traffic land, urban, and other). This study is also intended to stimulate discussion in order to raise awareness of the population about understanding the problems that informality brings. Overall, the study has the potential to not only affect economic development, but also to set up a socio-political agenda that will benefit the citizens of Kosovo. In 2014, Gross Domestic Product (GDP) in Kosovo was EUR 3,084 million, with a real increase of 1.2%. Kosovo is an important place for business development and offers a number of business-friendly advantages such as: young and well-qualified population, natural resources, favourable climate conditions, new infrastructure, fiscal policy and more tax Low tax rates in the region, geographical position with access to the CEFTA regional market and that of the European Union. Kosovo in June 2009 is a member of CEFTA, the International Monetary Fund, the World Bank and the European Bank for Reconstruction and Development, and aspires to other powerful mechanisms such as the World Trade Organization (WTO). SMEs, apart from their own resources, provide access to finance from microfinance institutions and credit lines of commercial banks, which are still expensive, with a slower pace of improvement but are often very bureaucratic. Kosovo's economy since 1999 has been largely supported by international aid, public sector and remittances (BB, 2010). The role of the private sector, especially of SMEs, has been relatively weak. Despite this, Kosovo is still in the transition phase where entrepreneurship and the creation of small businesses are expected to play an important role in the path towards a modern free market economy and thus towards growth. Kosovo suffers from a negative balance of payments where imports (€ 2,538,337 thousand) dominate exports (€ 324,534 in thousands of euros). This is mainly due to the fact that Kosovo's SMEs are not so competitive at the international level. Poor, non-competitive exporting SMEs impede further SME inputs into GDP, job creation and overall economic growth. SME development and entrepreneurship should be the basic generator of economic growth. This development should be based on the priorities that need to be further developed and the obstacles and weaknesses that, with strategies and measures of economic policy, need to be overcome and relativized.

### **Definition of informal economy**

The concept of informality is complex and has spurred deep and controversial debate in the academy. Due to complexity, the definition of the concept varies greatly and there is no consensus on what we really understand with informality. Therefore, this section will give a summary of the different definitions and approaches related to informality and then describe informality in the form as presented in this report

(Riininvest, 2014, 9). In this study, informality is defined as a phenomenon that describes all the economic activities that are secretly developed by the state and which do not neglect the rule of the state. As such, it includes concepts such as tax evasion, informal employment and undersigning employee salaries. The term "informality" for the first time was used in 1970 to describe economic activities that ran out of state order. However, the social phenomenon of informal employment existed even earlier. Although non-formal labour relations were not criticized at the time, there were some social researchers who - in their reports - wrote about non-formal economic activities, citing, for example, street entertainers, traders, or workers through some factories. We have grouped three sets of thoughts or concepts outlining the relationship between formal and informal economy.<sup>1</sup> In current debates, some argue that the role of the informal economy can be positive, for example: stimulating the growth of the market economy, promoting a flexible labour market and absorbing the surplus of the workforce from the formal sector. Consequently, the increase of informality is interpreted as an economic failure and informal employment is considered as imposed on the individual. Supporters of the other perspective claim that informal activities have become the appropriate instrument that follows the global agenda of privatization and liberalization. According to the authors, both attitudes can be accurate and can be applied in the same state. The same difference is noted by Kucera and Roncolato (2008), who concentrate on the fact that there is a distinct difference between voluntary and involuntary informal employment. As they say, the difference depends on the state development stage. According to them, developed countries have greater social security and "open unemployment can be the best option than involuntary informal employment in the event of loss of employment" (Kucera and Roncolato 2008).

### **Empirical research in the Republic of Kosovo Informal economy and front**

The overall aim of the competition policy, but also of the law in general, is to maintain and promote the effective competition in the market, aiming at achieving the most efficient allocation of resources. Kosovo's competition law in principle is in line with European Community competition legislation, but the implementation of competition rules in us is much more difficult because we are dealing with a much wider scope of the informal economy. The reasons for the growth of the informal economy may be numerous, but it is worth noting that the policy of constraints on entering the formal economy, institutions not so attractive as well as the demand for products and services at the lowest prices. The informal economy actually contributes somewhat to the reduction in the level of unemployment as well as in special cases and to the reduction in prices but still its presence in the market brings a number of negative effects on the size of the country's economy, such as: reduction of state revenues, protection of market participants, protecting consumers, protecting sound products, and creating a climate with unfair and unjustified competition. Other negative effects generated by the informal economy are the concealment of profits, various

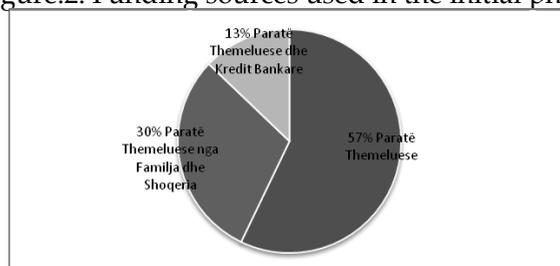
<sup>1</sup> Chen M et al, Supporting Workers in the Informal Economy: a Policy Framework, 2002.

unlicensed activities, then the lack of formal trade instruments such as contracts and formal credit operations. Analyzing fairly this aspect, as a negative phenomenon of informal economy in markets characterized by competition, the share of informal businesses thus avoiding taxes and duties, prices and other contributions in fact represent an incentive to date the formal economy to sink on a different level of informality. Realistically though, although the size of informal businesses in Kosovo in the long term does not restrict competition, it is still a growing trend and that this concept should be considered a major challenge for training all economic regulators to control the competition and its relevant actors.

### Not formal businesses in Kosovo<sup>2</sup>

A major obstacle to increasing budget revenues is the spread of the informal economy and the Republic of Kosovo needs a reliable financial system as well as a viable and functional market economy. It is therefore important to find effective methods to prevent the informal economy. Different authors and publications have estimated that the informal economy of Kosovo is estimated to be between 40% - 60%, using indicators such as the number of employees in the formal and informal economy, the number of enterprises working in the formal and informal sector as well as the comparative figures of other countries<sup>3</sup>. SMEs represent the largest vehicle for economic growth. Given the importance of funding and its input into the company's strategy and spending, it aims to observe the formal and informal sources of SME funding in the Republic of Kosovo through the SME's research through a questionnaire. The structure of the SME surveyed corresponds to the real economic situation in the country with regard to employees, main businesses and the city of origin. The collected data enables us to make a solid basis for statement directions that are common to entrepreneurs in a particular country. The initial funding analysis during the start-up phase of SMEs is presented in Figure 2.

Figure.2. Funding sources used in the initial phase



Source: Ministry of Trade and Industry, Private Sector Development Strategy 2013-2017

Figure 2 shows clearly that almost 90% of all new companies have just started working with 3F money. Almost 60% of entrepreneurs are relying solely on their money. These results show that banks are not so interested in supporting and working with SMEs. For this reason, a new company can rely mainly on informal sources of funding, more

<sup>2</sup> Ministry of Trade and Industry, Private Sector Development Strategy 2013-2017.

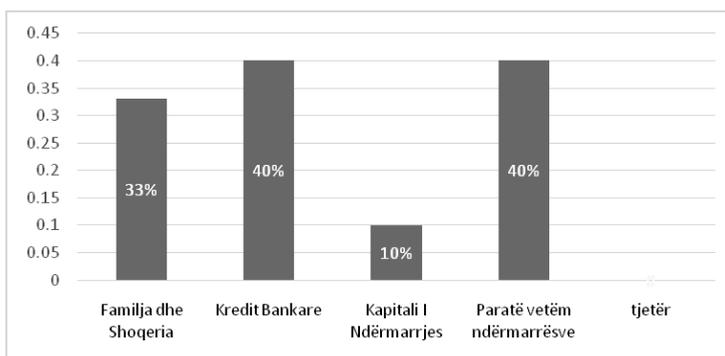
<sup>3</sup> CBK, Annual report 2016.

specifically in 3F (Founder, Family and Friends). Analysis of different sources used by SMEs is represented in Figure 3.

**Significantly increase the number of SMEs to enter the formal sector**

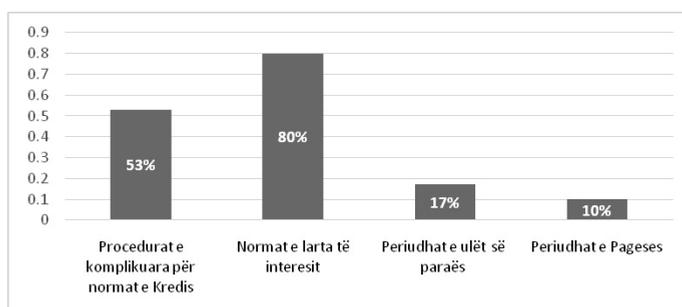
By introducing outlined regulatory business procedures, a greater number of SMEs will be encouraged to enter the formal economy. This should provide the SME with greater opportunities for access to credit and financing resources and in resolving commercial disputes while on the other hand to contribute to the overall development of the market economy and the creation of sustainable Work in the SME sector. Financing sources used by SMEs and which can be used in the Future

Figure 3.1 Funding sources used by SMEs (Shiroka, 2013)



The results show that 40% of all SMEs in Republic of Kosovo, only use their money. This gives us a clear foundation that many entrepreneurs are strictly traditional, but at the same time their companies do not have the potential for growth above the average. However many of these entrepreneurs have not applied for bank loans, not because they do not need it, but because of high interest rates. We have also come to the conclusion that 40% of SMEs have received bank loans at least once in their lifespan. This could also be the determination as a relatively low participation of all formal sources of funding. Business capital almost does not exist. From the data we can conclude that SMEs in the Republic of Kosovo in the upstream stages of development rely only on money and bank loans. To understand how entrepreneurs look at different sources of funding, we were asked what they would do more if they needed additional funding in the future (Figure 4). Floods of SMEs in the Report with Banks

Figure 5: Major Banking Shortcomings highlighted by SME (Komoni, 2008)



Taking into account the need for additional financial capital that enterprises need, according to this table we can see why only 40% of enterprises use bank loans as additional financial capital. Kosovo is still the country with the highest interest rates in the banking sector, and there is still no mechanism limiting these norms to create a favourable business environment by synchronizing the development and further advancement of enterprises and generally stimulating economic growth. High interest rates can be estimated to be one of the barriers leading to great difficulties and which may be contributory factors to bankruptcy or the creation of difficulties of many enterprises, whether small, medium or large.

### **Interest rates\***

Average interest rates on loans and deposits were characterized by a downward trend during 2013. The average interest rate on loans declined to 12.4% (13.4% in 2012) (Komoni, 2015), while deposits declined to 3.4 percent (3.6% in 2012). Consequently, the difference between interest rates on loans and deposits in 2013 was 9% compared to 9.8% in 2012. The average interest rate on corporate loans decreased to 12.4 percent in December 2013 from 13.2% in December 2012. Investment loans were characterized by lower interest rates (12% in 2013, 12.9% in 2012) compared to other business loans, which average interest rates during 2013 were 13.6% (14.6% in 2012). The decline was also recorded in the average interest rate on household loans, which was reduced to 12.1% from 12.5% in 2012. The average interest rate on corporate deposits dropped from 3.3% in 2012 to 2.8% in 2013. Meanwhile, the average interest rate on household deposits declined to 2.7% in December 2013 compared to 3% in December 2012. As regards the maturity, the average interest rate on deposits of enterprises decreased in all categories of deposits Of enterprises except deposits in amounts over 250 thousand euro with a maturity over 2 years, with the average rate reaching 3.8% from 3.2% in 2012. Average interest rates on household deposits fell in all categories by the maturity of maturity. In order to increase the transparency and support of economic development policies, GAP Institute has published today the 8th "Bankometer", which aims to fill the information vacuum facing citizens and businesses in Kosovo regarding the system Banking. The GAP Institute estimates that enforcing regulations that increase transparency in the banking system may have an effect on lowering interest rates and tariffs for banking products and services. This institute recommends commercial banks to initiate the publication of effective interest rates as soon as possible so that customers can get acquainted with the real cost of the loan or real return on deposits, otherwise the CBK will take steps in accordance with the approved regulations. GAP also recommends that the CBK publish aggregated data from commercial banks regarding tariffs and interest rates so that citizens can easily compare them. "With regard to interest rates, compared to 2009, on average, interest rates on loans and deposits have decreased slightly. Meanwhile, compared to 2011, on average, personal and business loan rates have increased, while those for auto loans, homes and deposits have declined," GAP report said. The GAP Institute estimates that the increase in competition between commercial banks in Kosovo would impact the more substantial reduction in interest rates on loans. Regarding

developments in the banking system for 2009-2013, Banker's findings over the years have shown that interest rates on loans remain high due to many factors such as the informal economy, problems with the cadastral system, dysfunction of the courts, impossibility Of the CBK to inject liquidity etc. "We have noticed that not all banks have applied tariffs for the same products; e.g. Cash withdrawals at the counter, depositing on behalf of third parties, national transfers between branches of the bank, student fees on the branch, "says GAP report. Based on these indications, the GAP Institute estimates that there may be room for more favourable prices on fees and commissions offered by commercial banks. Positive news regarding the increase of transparency in the banking system, according to GAP, is that the Central Bank Board, on November 29, 2012, has approved the regulation on disclosure of the effective interest rate by the banking, microfinance institutions and financial non-banking ones. "The highest interest rates on business loans were in 2009 with 13.8%, while the lowest in 2010 with 12.7%.

As shown by the tables, the average decrease was mainly due to lower interest rates by banks with the lowest share of assets in the commercial banking system such as BPB and NLB, "said GAP. Regarding 2013, NLB has the lowest interest rate with 12.5 percent, while the highest interest rate on average was in 2009 with 10.3 percent, while the lowest in 2013 with 9.8 percent. "With regard to 2013, the lowest interest rate has marked BKT with 9.5%. On household loans we see that 2009 has marked the highest interest rate with 11.1%, while 2013 with 9.9%. This trend has come as a result of the deduction of this rate at all banks.

### **Financial sector**

Total financial sector assets totalled 4.2 billion euros, marking an annual growth of 10.5%. Growth is mainly attributable to the growth of pension fund assets and commercial banks and partly to the slight increase of insurance companies. Meanwhile, the assets of microfinance institutions and financial auxiliaries decreased compared to the previous year. The financial system assets structure in 2013 was similar to previous years. Regarding the number of financial institutions, the only changes were made to financial aids, with their numbers rising to 39% (38% in 2012). Regarding sector participation in total financial system assets, the banking sector continues to represent the bulk of the asset structure. However, compared to the previous year, the share of assets of all sectors, with the exception of pension funds, decreased. Pension funds were the only sector that increased participation in 2013 to 21.7% from 19.5% in 2012. A considerable part of the financial system's assets continues to invest in foreign markets. The Net Asset Value (NAV) in December 2013 amounted to 2.56 billion euros, marking an annual growth of 9.5% (13% in December 2012). The highest share of total NPAs continues to have NDAs CBK. The only segment that scored the negative balance of AJNs was that of microfinance institutions, mainly as a result of the high support of these institutions in financing from abroad in the form of credit lines. Claims on the external sector in December 2013 amounted to 3 billion euros, marking an annual growth of 8.7% (13.4% in December 2012). The demand structure is driven by participating deposits of 37.9%, followed by securities other than shares with a share of 27.2% and other equity and equity holdings of 21.6%. Within 2013, the largest

annual growth recorded investments in securities with 68.4% and loans with 37.8%, while cash held at institutions abroad marked an annual growth of 11.6%. Downturns were characterized by foreign currency deposits denominated in foreign currency (decline of 9.3%), monetary gold and DST (decline of 5.9 percent), and the IMF (4.2% drop). Increased investment in instances such as investment in securities and loans is an indicator of investment orientation in instruments that bring higher return on assets. Total liabilities to the external sector in December 2013 amounted to euro 455.6 million, recording an annual growth of 4.4%.<sup>\*</sup> The structure of liabilities is driven by IMF obligations with 34.2%, followed by loans with 31.9%, deposits with 19.9 percent and DST allocation by 13.6%. The increase of liabilities to the external sector is mainly a result of the growth of loans that commercial banks in the country have received from the external sector and partly the deposits of non-residents in the banking sector in Kosovo. Exposure of the financial system to the external sector remains relatively low both in terms of assets and liabilities. Moreover, the banking sector's exposure to the external sector remains low. Investments abroad account for 24.5 percent of total banking sector assets, while only 5.7 percent of liabilities are to the external sector.

## Conclusions

Kosovo is still in the transition phase where entrepreneurship and the creation of small businesses are expected to play an important role in the path towards a modern free market economy and hence towards sustainable development and growth. In order to achieve these goals, it is necessary to develop the private sector and particularly small and medium enterprises (SMEs) in order to make efforts to increase employment and reduce poverty. However, the role of the private sector, especially the SMEs, has been relatively weak. The reason lies in the fact that even though small and medium enterprises have contributed more to employment in relation to large enterprises, they have not managed to offer stable and stable employment. SMEs in Kosovo faced many difficulties, such as the High Credit Line, the lack of government support, which has led to a lot of stagnation from passing a category (e.g. from small business to small enterprises) into one other category, but also in their closure. These difficulties have mainly come as a result of the funding difficulties that came first from the lack of commercial banks and other financial institutions (after the war) and later by the high interest rates held by these banks and other institutions. SME with large percentages of informality, the stagnation of tax declarations such as: VAT, non-exporting, non-competitive employees, prevents the SME's contribution to GDP, i.e. the creation of new jobs and economic growth in general. Venture capital in the Republic of Kosovo is almost completely lacking, so it once again shows the role played by 3F "money" and bank loans when it comes to external financing sources for Businesses in the country. Almost 90% of all entrepreneurs start their own enterprises with their own funds or through loans from family and friends. Lack of formal sources of funding is particularly true at the stage of establishing new enterprises. In the later stages of increased participation of formal sources of this apparent financing development, more bank loans, more reasonable interest rates, Government support for SMEs, because 95% of the RKS market is part of SME.

## Recommendations

It is strongly recommended that the strategy 2013 - 2017 intensifies to develop the implementation plan, monitoring and evaluation of the 'realization' of the goals of this strategy, which goals can be listed as follows:

- Increasing Formality in Kosovo Businesses
- Orientation in the industry sector by giving priority to production and export
- Continuous support to the development of economic, technical and managerial skills.
- Protection of Industrial Property
- Establish cooperation with the business community - EA
- Increase of activities in promoting investment in and out of the country
- Protecting and attracting Foreign Investors, etc.

Organizations supporting the activity of SMEs in Kosovo should apply selective policies and simpler procedures for selecting the enterprises and projects they will support in order to motivate SMEs for a continuous cooperation with them such cooperation will provide the best economic and financial effects. The role of finance is of great importance for the development of SMEs. Owners and business managers need to apply more quality policies in the sense that financial funds are not spent on land, objects and machinery alone, but the emphasis should also be on quality production that companies can compete in foreign markets. SMEs need to use and use different kinds of loans. Domestic and foreign banks operating in Kosovo, including microfinance institutions, should apply better credit policies to help expand economic activity. Criteria for defining the creditworthiness of enterprises should be reconsidered and mitigated relatively so that a number of enterprises can make use of bank loans. In this sense, the valuation of assets that can be used as mortgages and collateral should be more realistic, then Implementation and Effectiveness of Implementation of the Legal Framework to regulate the legal system in terms of health insurance etc.

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