

**COMPETITIVENESS AND
THE SME DEVELOPMENT
IN ALBANIA**

Support to promotion of reciprocal understanding
of relations and dialogue between the European
Union and the Western Balkans

COMPETITIVENESS AND THE SME DEVELOPMENT IN ALBANIA

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Abstract

Albanian economy reveals a low level of competitiveness. In particular the low levels of export and the high trade deficit, point out to the need to take measures which will contribute to fostering the business environment, through promoting the private sector development and attracting Foreign Direct Investments. Micro and small or medium-sized enterprises (SMEs) make important contributions to development. The growth of a healthy, competitive SME sector will be maximized when there is a strong enterprise culture in the society at all levels; a continuous growth in the quality stock of independent business; maximum potential for growth of existing small businesses; and a highly supportive economic, social and stakeholder environment. These are the broad target areas for policy development. This paper on the competitive SME policy development describes the state of the SME sector, the level of competitiveness of the economy in general and the direction of future policy reforms.

This paper is structured as follows: (i) first it describes the role of SME in the world economy, its advantages relative to larger companies and main policy directions at the global level to promote their development and encourage entry of new firms; (ii) it follows with an evaluation of the role of SMEs in the Albanian economy, which highlights (iii) the importance of improving business conditions and the competitiveness of the economy. The paper concludes with an analysis of main policy directions which are supposed to improve the business climate for star ups, especially in the micro firms and SMEs. This is mainly focused on such areas as removing administrative barriers for the start up, training and improving skills of the labor force and improving access to financial market for the SMEs.

The role of SMEs in development and policies promoting firm creation

Small businesses play a central role in the world economy. Recent empirical studies show that SME's contribute to over 55% of GDP and over 65% of total employment in high-income countries. SME's and informal enterprises, account for over 60% of GDP and over 70% of total employment in low-income countries, while they contribute over 95% of total employment and about 70% of GDP in middle-income countries. In the European Union countries, for example, there are some 25 million small businesses, constituting 99% of all businesses; they employ almost 95 million people, providing 55% of total jobs in the private sector. Important contribution is also on exports and on productivity growth.

A detailed OECD analysis of productivity growth for the SMEs in eight OECD countries over a ten-year period showed that between 20% and 40% of total labor productivity growth can be explained by entry and exit of firms. Normally, firms that exit the market have lower productivity than their competitors and thus directly increase average productivity in the industry. Firms that enter the market have labor productivity that is around the industry average and consequently a small effect on labor productivity growth. Effects on multi-factor productivity (MFP) are different. Existing firms play a very limited role in MFP growth but entry of new firms has made a significant contribution. New firms enter with innovating organizations that make better use of factors and thus increase MFP growth.

The advantages and disadvantages of SMEs compared to their larger counterparts have often been described in the literature. The appendix 1 summarizes the main advantages of the SMEs relative to larger companies in such important dimensions as marketing, management, finance, etc.

Given this very important role the SME's play on the economic development of the countries, policies which encourage the creation of new firms is given a high priority on the development agenda.

In terms of policy actions, the governments should pay attentions to both macro economic policies as well as policies at the micro level. At the macro level, maintaining macro economic stability, characterized by stable prices and exchange rate as well as lowering the fiscal deficit and the overall public debt are important measures to ensure a stable environment for investment planning. While these are necessary conditions for growth, they are not sufficient. Factors which influence the firm's behavior rest on the micro environment.

Attempts made to compare the business environment across all countries for firm creation and entrepreneurship, suggests the most important micro-policies appear to be the following:

- *Increasing access to venture capital* by: *i)* using public equity funds to leverage private financing and targeting financing gaps; *ii)* easing quantitative restrictions on institutional investors; and *iii)* developing competent venture investors and managers.
- *Ensuring efficient bankruptcy regimes* by: *i)* reducing the time that creditors have claims on assets; *ii)* introducing tougher regimes for bankrupt parties whose conduct has been irresponsible; and *iii)* removing the state's right to recover unpaid taxes ahead of other creditors.
- *Providing entrepreneurial education* by: *i)* teaching practical entrepreneurial skills and attitudes in early education; and *ii)* integrating entrepreneurial skills in university curriculum.

Several studies and assessments also highlight additional areas which play an important role on SMEs development: loans and loan guarantees, administrative simplification for start-ups, income and capital taxation, and business services.

Growth of the micro enterprises and SME sector in the Albanian economy

Over the past decade Albania has undergone a turbulent transition, alternated by periods of relative tranquility and steady growth to major, unforeseen setbacks (IMF, 2003). Private sector development has been fairly vigorous in the recent past in Albania. GDP growth has been fairly steady at 6% per annum, fuelled by expansion in sectors such as construction, transportation and services. As a result, the share of the private sector activity is among the highest in the SEE region, at 75% of GDP.

The place and role of micro and the SME in these developments is very important; they are widespread all over the country, from the major cities to the remote areas in the villages. Therefore, neglecting their development would mean not to take into account important drives of the economic growth of the country.

As the end of 2004, micro and SME's registered and operating in the Albanian economy were about 54,596 firms, which make up to 99% of total firms operating during this year. Micro and SME's have provided employment for 56% of total employment, 65% of total turnover of the economy and 45% of total investment generated by private non agriculture sector. In particular, micro enterprises dominate with 94% of total firms operating in the country, while the Small and Medium size firms account for about 5%.

SME definition

The definition of SME is referred to Article IV of the law nr. 8957, date 17-10-2002 "On Small and Medium Enterprises". According to this law, **micro enterprises** definition embodies only the staff headcount criteria – and states that entities employing fewer than 5 persons will be classified as micro enterprises.

Small enterprises are those entities that employ 6-20 persons, and have an annual turnover that does not exceed 40 million *Leks* (around 320 thousand Euro).

Medium enterprises are entities that employ 21-80 persons; the annual turnover of the entity does not exceed 80 million *Leks* (around 620 thousand Euro) and at least 25% of the capital of the firm does not belong to an enterprise that is not small and medium.

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In particular, micro and the SME's are highly dominating in the activities of trade and services (chart 1), which alone account for 74% of total enterprises operating in the whole economy. However, in terms of employment implications, the role of micro and SME's is equally important for other sectors as well, in particular with regard to industry and construction. Data on appendix 2 gives detailed information on the contribution of SME according to the sectors of economy in employment, turnover and investment.

Chart 1: Structure of micro and SME's, % of total enterprises in the economy, 2004

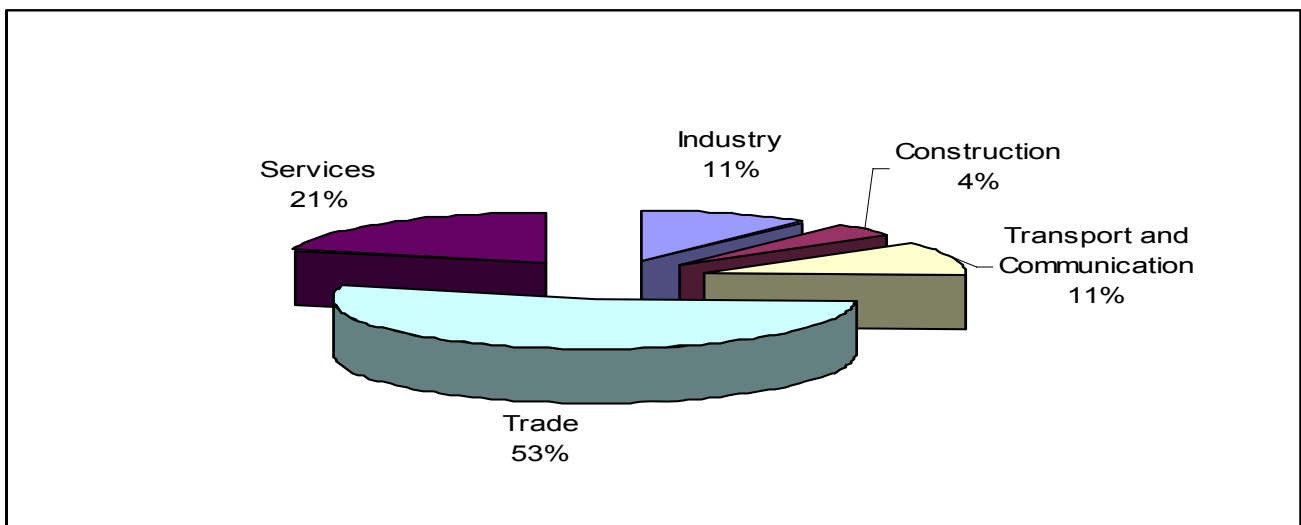
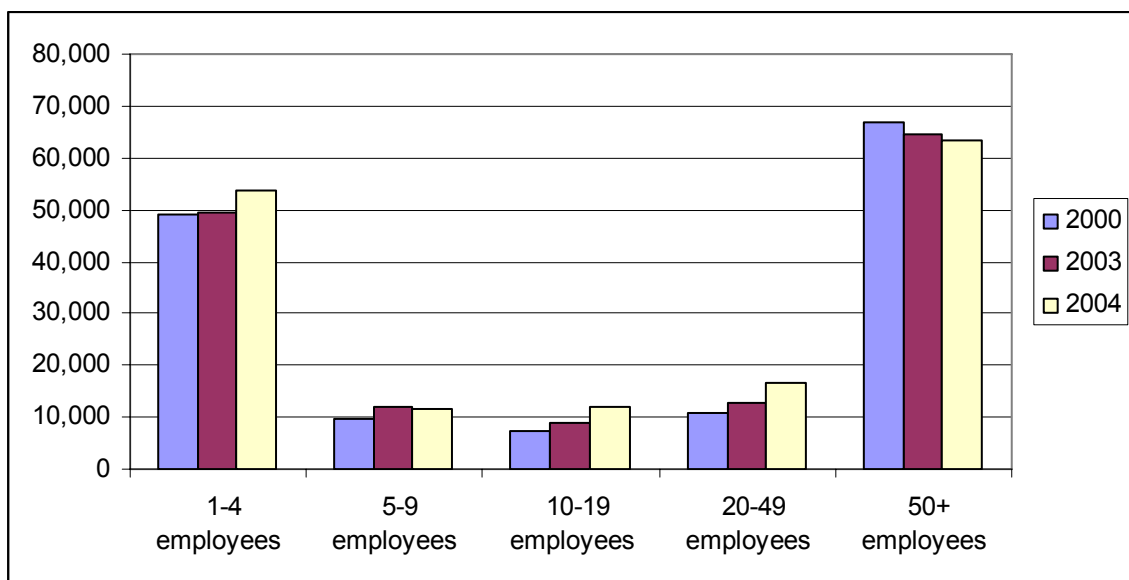


Chart 2 indicates the contribution of SME's in employment and its dynamics. As it can be distinguished from the bars, the micro and small size business have been able to increase their employment and accommodate the unemployment created by the restructuring processes of the big companies, mainly from the public sector.

Chart 2: employment by micro firms and SMEs



A detailed analysis of the distribution of SME's by sector of economy, its dynamics and contribution played in employment, turnover and investment was prepared in a background paper prepared in the framework of this project by Xhepa and Agolli (2004).

The data on SME's proves that an entrepreneurial spirit has taken root across the regions. In a regional perspective, however, distribution of SME's has a high contraction on the capital, Tirana, the central Albania and in the coastal areas, while in the highland and mountainous areas the number of companies operating is very low, with only 4.2% of total in average for the whole period. There is a strong concentration of the business activity on the Tirana-Durres corridor, which is emerging a potentially powerful economic pool. Statistical data offer clear evidences of these regional disproportional business activities. More than half of enterprises are operating in these two cities only.

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Table 1: enterprise distribution by regions

Prefectures	Micro enterprises	Small	Medium	Large
Berat	2353	74	28	9
Dibër	648	42	21	12
Durrës	6088	265	112	48
Elbasan	3576	173	56	15
Fier	5764	181	57	24
Gjirokastër	1914	71	28	8
Korcë	4729	146	66	19
Kukës	291	37	12	4
Lezhë	937	60	18	15
Shkodër	1413	107	49	13
Tiranë	19832	750	336	128
Vlorë	4148	157	57	18
Total	51693	2063	840	313

Source: Indicators by prefectures, INSTAT, 2003-2004

Creation of micro firms has enjoyed the highest rates determining the growth rate of company formation during the transition.

Table 2 Growth rates of newly created firms over the years; %

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	Average
Micro	-20.7	-27.5	9.6	-50.4	88.4	28.4	24.2	-12.2	14.9	47.2	22.7	11.3
Small	0.0	-41.4	-7.6	-44.8	47.2	-24.6	-1.4	-30.9	-38.5	-61.0	213.0	0.9
Medium	-3.5	-60.4	-3.9	-46.6	48.7	-31.0	-12.5	-20.0	-57.1	-100.0	0.0	-26.0
Large	11.7	-70.5	19.4	-62.2	0.0	-14.3	25.0	-60.0	-50.0	-66.7	0.0	-24.3
Total	-18.2	-30.8	8.2	-50.1	84.2	24.5	23.1	-12.9	13.3	45.6	23.4	10.0

The number of years with negative growth rates for micro enterprises, for example is 4 during the decade; while this number is negative for 6-8 years for other types of business measured by their size.

On the other hand, there is widespread informality on the small business side and unaccounted activities and therefore it is difficult to gauge the whole effects of the SMEs in the Albanian context. In addition to agricultural activity which remains largely unaccounted and integrated with the formal economy, petty trade, domestic services, transportation, house renting, small restaurants and cafes, in different manufacturing activities and construction etc., have become a solution as informal employment to many individuals and micro enterprises. The

typology of the informality varies, with some of them tending to increase their productivity and which potentially could grow and further be formalized, while some of them waiting for a job opportunity with the formal sector.

As the data of the following table provide, ratio of informal to formal activities are much higher in such activities as business services, transport, community works, trade, wood and paper, cereal products, etc, which are largely mirrored by the sample structure of our survey.

Table 3– Recalibrated formal/informal activity by sector – % of GVA

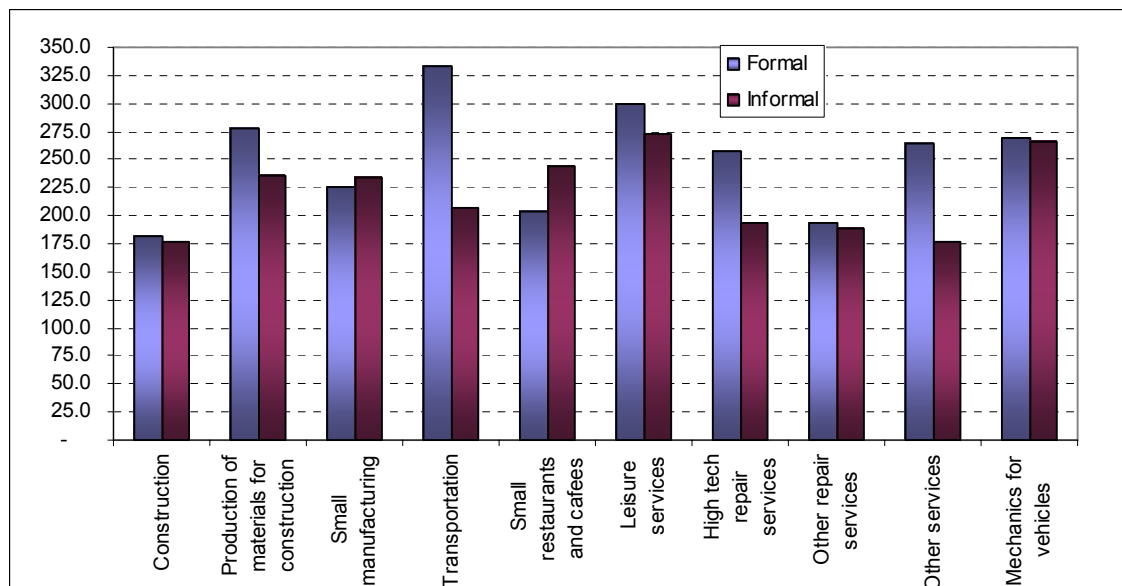
	% of GVA		Ratio: Informal – Formal
	Formal	Informal	
Cereal Products	0.2	0.4	2.2
Other food	0.4	0.6	1.4
Textiles, leather	1.0	1.2	1.2
Wood, paper, furniture	0.4	0.9	2.1
Chemicals	0.2	0.2	1.6
Non-metallic & mineral products	0.4	0.5	1.3
Metals	0.3	0.8	2.5
Machinery & equipment	0.1	0.1	0.7
Construction	3.1	5.0	1.6
Trade	4.5	12.2	2.7
Hotel & catering	0.9	1.6	1.8
Transport	1.9	6.9	3.6
Real estate, renting, business services	0.8	4.7	5.9
Other Community etc	0.6	1.9	3.2
Total	14.7	37.0	2.5

Source: OECD, 2005 “Tackling the policy challenge of dealing with the informal economy in Albania”

A study conducted on the reasons of informality in Albanian small business (ISB, 2005), reveals that businesses operating as formal have a higher level of productivity than those operating¹ as fully informal or partially informal, by 12.5% and 8.2%, respectively.

¹ Level of formalization is measured by the number of procedures respected with business registration formalities. Business registered with all the public service offices (tax office, labor, and court) are classified as fully formal; those register with none of them are considered as fully informal and those registered with at least one of them is partially informal. The level of productivity on the study is measured by the level of output per worker.

Chart 3: Productivity by degree of informality and activity



Informality is an option, sometimes a desperate one to some individuals who –in short term- have no other alternative to generate income for their families. In a sense, informality becomes a survival valve in the short run. But due to the fragility of its organizational and economic basis (low productivity, low level of technology use, low skills, little investments, etc.), the development strategy of the country can not be assumed as sound in the long run. The objective of a development strategy is to promote policies and mechanisms that create alternative ways out of this vulnerability.

In this respect, improving the business conditions and facilitating administrative procedures for business registration and lowering the costs of complying with the regulations are instrumental in formalizing the business sector and promoting new firm creation, which will contribute to growth through more productivity gains.

Economic growth, business conditions and competitiveness of the economy

Cross-country regressions provide qualified evidence that an effective business environment does cause growth. Cross-country regressions of GDP per capita growth on the business environment indicator and an array of other potential growth factors show a strong relationship between an effective business environment and economic growth (*Beck et al.*, 2004). Moreover, they show that this relationship still holds when the analysis takes into account the possibility that faster-growing countries might adopt more effective business regulations or that a third factor might drive both an effective business environment and economic growth. So, unlike for SMEs, there is evidence that an effective business environment is not just a characteristic of successful economies but also plays an important part in their success. Cross-country comparisons show that the positive relationship between an effective business environment and income growth holds as much for the lowest income quintile as for the rest of society. But there are limits: the results do not show that a good business environment has an effect on poverty reduction beyond its positive effect on GDP per capita growth.

Together, these findings have important policy implications. They suggest that rather than directly subsidizing SMEs and aiming for a large number of small enterprises, policymakers should focus on creating a business environment that allows easy entry and exit for firms and assures entrepreneurs and financiers that property rights and contracts will be enforced. In particular the performance of micro enterprises and SME's is strongly influence by the business conditions and the factors which define the competitiveness of the economy.

Improving the investment climate is, according to Stern, one of the two pillars² of economic development strategies. The author gives a broad definition of the term "investment climate", including policies, institutions and the behavior, the actual and expected one which influence the rate of return and risks associated with the investment. In this respect, Rodrik suggests that, in the conditions of limited resources available, it is better to focus on some critical issues of the investment climate and address them, rather than trying to cope with all of them at once. Prioritizing the list of issues to target first can be done in cooperation

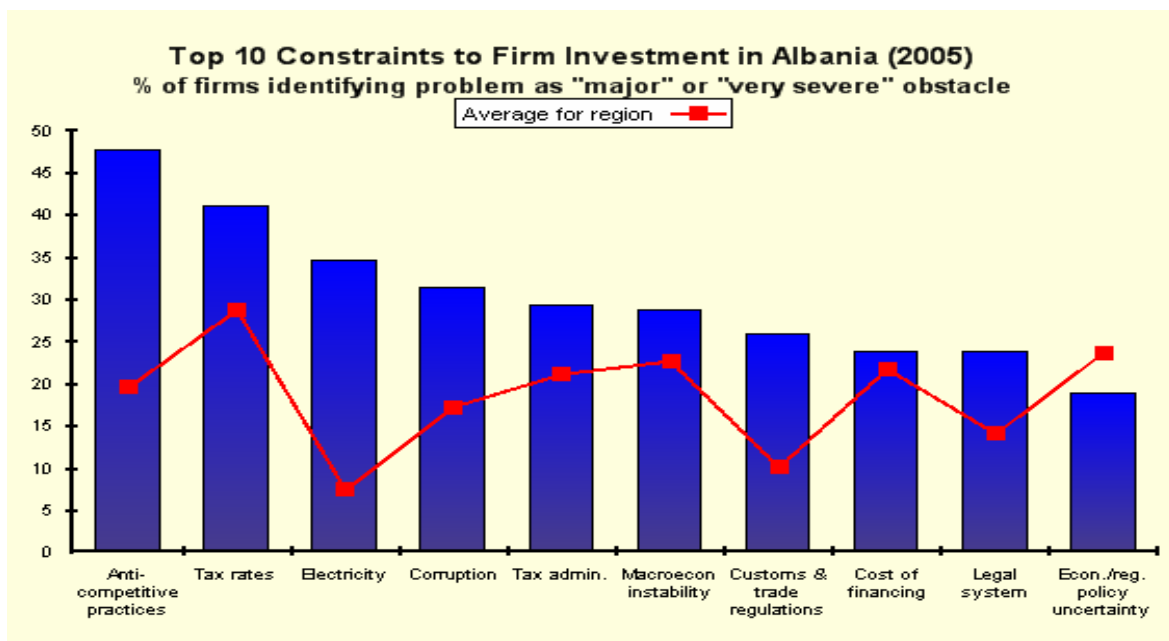
² The other pillar is empowering the people.

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with the business community, through direct interviews and studies conducted by researchers.

The World Bank “Doing business in 2005” publication ranks the major constraints to the private sector development, as indicated by chart 4.

Chart 4: Constrains to investments in Albania, 2005



Source: World Bank, 2005 “Doing business in 2005”.

The same results are achieved by a survey conducted with 800 companies (Government of Albania/FIAS, 2005) which shows that most problematic issue are the unfair practices (by 78.6% of the respondents); tax levels (72%), electrical energy (70%), corruption (69%) and frequent changes on the legislation (68%). Training and qualifies workforce is considered as a major source of constrain particularly for SMEs. The survey reveals that relations with tax and customs administration remain very problematic. The land and contraction permits are also highlighted as highly sensitive for business development.

Another way of analyzing the business conditions for private sector development is the level of competitiveness of the economy. As defined by the World Economic Forum, competitiveness is the set of factors, policies and institutions which defines the level of productivity of a country and therefore the level of prosperity an economy may achieve. During 2004, Albania was included on the World Competitiveness Report. As such, we are not able to analyze the issue on a dynamic context; however we have observed the position of our economy *vis a vis* the regional economies.

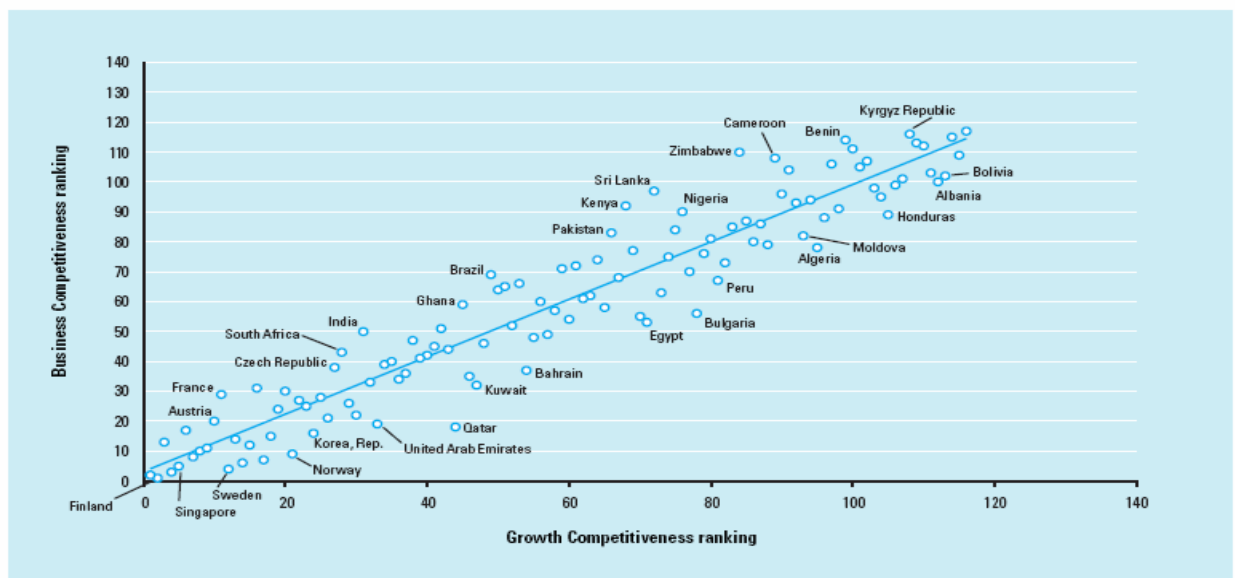
Albania ranked poor in the Growth Competitiveness Index³ (GCI): it ranked in the place 100 out of 117 countries. This ranking is 25 places below Macedonia and 38 places below Croatia. Looking at the components of this index, Albania ranks poor in the index of public institutions (in the place 102) and also in the technology index (ranking on 93).

As the following chart demonstrates, both in terms of business competitiveness and growth competitiveness indexes, Albania ranks poor compared with the countries of the region.

³ In formulating the range of factors that go into explaining the evolution of growth in a country, it identifies “three pillars”: the *quality of the macroeconomic environment*, the *state of the country’s public institutions*, and, given the importance of technology and innovation, the *level of its technological readiness*. The GCI uses a combination of hard data—e.g., university enrollment rates, inflation performance, the state of the public finances, the level of penetration of new technologies, such as mobile telephones and the Internet—and data drawn from the World Economic Forum’s Executive Opinion Survey (Survey). The latter helps to capture concepts for which hard data are typically unavailable, but which are, nevertheless, central to an appropriate understanding of the factors fuelling economic growth. Examples of the latter might include such concepts as judicial independence, the prevalence of institutionalized corruption, or the extent of inefficient government intervention in an economy. [Augusto Lopez-Claros, World Economic Forum, 2004](#)

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Chart 5: Correlation between the growth competitiveness and business competitiveness ranking



Source: The World Economic Forum, 2005 "The World Competitiveness Report, 2005"

Overall, different studies indicate the poor business environment which on the other hand correlates with the low level of competitiveness of the economy and prosperity of the population.

Efforts to improve the competitiveness position of the national economy shall be lined up in three main directions which feed the growth of the economy. In the macroeconomic policy level, maintaining and consolidation of public finance and the improvement of the expenditure management are the main policy priorities. It is also of such importance the attention of the monetary authorities to maintain a stable exchange rate which is highly correlated with the price stability.

This analysis highlights the future work needed to be done by the authorities in order to address the business constrains and improve the investment climate of the country.

Future work on promotion of SME development

In a more detailed framework, an SME “friendly” legal, regulatory and administrative environment would be characterized, among others, as one where:

- Property rights are clearly recognized,
- Contracts are easily enforced,
- A simple, transparent and low-compliance-cost tax system is operational and it is perceived as fair,
- Businesses are able to register with authorities through a simple and inexpensive system, preferably by remote access through the Internet,
- Business licensing requirements are minimized, and when they are enforced, the objective is to safeguard health and safety of consumers and labor rather than being a source of revenue for local and/or central government,
- Labor regulations are balanced and flexible, protecting the rights of labor and the firm equally,
- SMEs, whether they are exporting or importing, interact with a streamlined customs administration that is efficient, simple and transparent,
- Financial sector regulations (banking, insurance, leasing) recognize SME constraints and have introduced appropriate legal and regulatory instruments that enable commonly available SME assets to be used as collateral,
- Public administrators at local levels appreciate entrepreneurs as contributors to economic growth, treat them fairly and are committed to limiting corruption to a minimum,
- Legislation and regulation is gender insensitive, rule of law and rules of the game apply equally to men and women,
- SMEs can easily set up and join membership organizations,
- Bankruptcy legislation does not impose unduly high penalties on the entrepreneur or the SME.

Opportunities can be created, but also hampered, by regulation and entrepreneurship programs. The first policy area relates to making life easier for those who want to start a firm and for existing firms through administrative simplification. The second area related to deregulation and competition, which provides larger markets for new firms. The third area, providing access to international markets, is another possible way of creating larger markets for new firms. Fourth, spin-offs and access to licensing from public research can be an important means of access to opportunities created by public research.

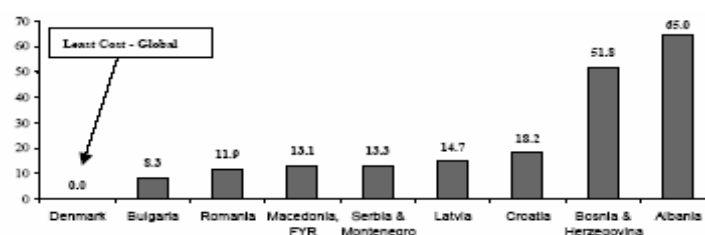
The regulatory and administrative environments profoundly affect entrepreneurial opportunities. Administrative procedures and regulations govern how companies are created and what information they must provide their governments. Owing to the fixed-cost nature of regulatory compliance, it burdens small companies disproportionately. Business establishment procedures and time affect the number of start-ups. Studies show a clear negative correlation between the quantity of administrative barriers and MFP growth (OECD, 2001a). Regression analyses performed at the indicator level and with more advanced techniques show that some aspects of simplification of the legal framework have a significant impact on entry of new firms, suggesting that they should be included among the important policy areas.

Business registration represents the beginning of an economic life cycle for entrepreneurs. Entry of new business however may be cumbersome or rather simple and a number of international studies have demonstrated that how that area is regulated does affect the entire business environment in any given country. Moreover, business registration may also provide an angle to the entire economic portrait of the country and either stimulate or deter investment.

Richer countries regulate less. So do countries in the common-law tradition. In poorer countries, market failures may be more severe, and therefore may increase the desire to correct the failures by regulating entry. The temptation should be resisted, for the costs of government inefficiency may outweigh the benefits of stricter regulation. Therefore, a stricter regulation of entry is not associated with a higher quality products, better environmental records, health standards, or greater competition. But stricter regulation of entry is associated with sharply higher levels of corruption, and a greater relative size of the unofficial economy.

Based on the World Bank (2004) study of business conditions, times and costs involved in registration procedures points out to the urgent need to reform this system, in many countries of our region, particularly in the case of Albania. Appendix 3 attached to this paper illustrates at a detailed level the business conditions as described by the World Bank (2004) report.

Chart 6: time to start a business



Source: World Bank CoDB, 2004.

Table 4: Time and costs of doing business in SEE countries; 2004

	Number of procedures	Time (days)	Cost (% of income per capita)	Minimum Capital (% of income per capita)
Albania	11	47	65	51.7
BiH	12	59	51.8	379.1
Bulgaria	10	30	8.3	134.4
Croatia	13	50	18.2	50.7
FYR Macedonia	13	48	13.1	138.4
Moldova	11	42	26.2	86.3
Romania	6*	27*	11.9	3.3
Serbia and Montenegro	10*	44*	13.3*	357.1*
Average New EU Members**	9	56	20.4	137.9

Note: These indicators measure the procedures, time, costs and minimum capital requirements to register a business formally. ** The new EU members include the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Rep., and Slovenia

Source: World Bank (2003) Doing Business in 2004. Understanding Regulation. Washington These data were based on a broad collection of indicators from consultants in over 182 countries, through cooperative partnerships involving several departments of the World Bank, donor agencies, private consulting firms and business and law associations. For more detail, consult <http://rru.worldbank.org>

In order to address the already identified constraints, government actions are planned to be taken and scheduled to be implemented in short, medium and long term. The main areas of reform program included on the government program consist of improvements in the legislation regarding the taxation system, both in terms of simplification and lowering of tax burden to business; simplifica-

tion and streamlining the business registration procedures through the application of “*silence is consent*” principle and the establishment of one stop shop services which will contribute to lowering costs of registration and shortening the time needed for that purpose; promotion of the use of new technology and modernization of operations and in particular the capacity building activities for the businessmen in management, accounting, marketing, etc.

For the purpose of this research paper, we look at more details at two important areas of improvement – training and skills improvement for labor and improving access to finance for the SMEs.

Training assistance

No variable in the growth process is more important than workforce training. Improvement in the competencies, knowledge and know-how of the entire staff is a key issue. Basic education is the first area in which government can act. Intellectual investment – schooling and higher education – must be given priority. In the long run, this is undeniably the best way to renew abilities and skills. Education is not limited to school and university; it also applies in working life. Continuing training or lifelong learning for employees enables firms to become what a study calls “learning organizations”, capable of teaching people quickly how to adjust to change. High-growth firms set great store on employee training.

International experience tells that areas in which government can act in this respect are:

- Tax incentives for supporting continuing training in SMEs and so induce businesses to invest in staff training.
- Programs and measures that encourage the supply of such training by the private or the public sector.
- Increasing ties between businesses and higher education institutions, more and more of which offer courses tailored to wage earners or continuing training curricula.
- Helping to establish high-growth employer networks for the exchange of information and experience.
- Introducing courses in entrepreneurship and knowledge of the innovation process into university education.

This analysis is also supported by the identification of the determinant factors of success, as business strongly rely on such factors as improving the quality of products and services, location of business, improving skills of management and of employees, and the purchase of modern equipment.

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Table 5: determinant factors of success for your activity

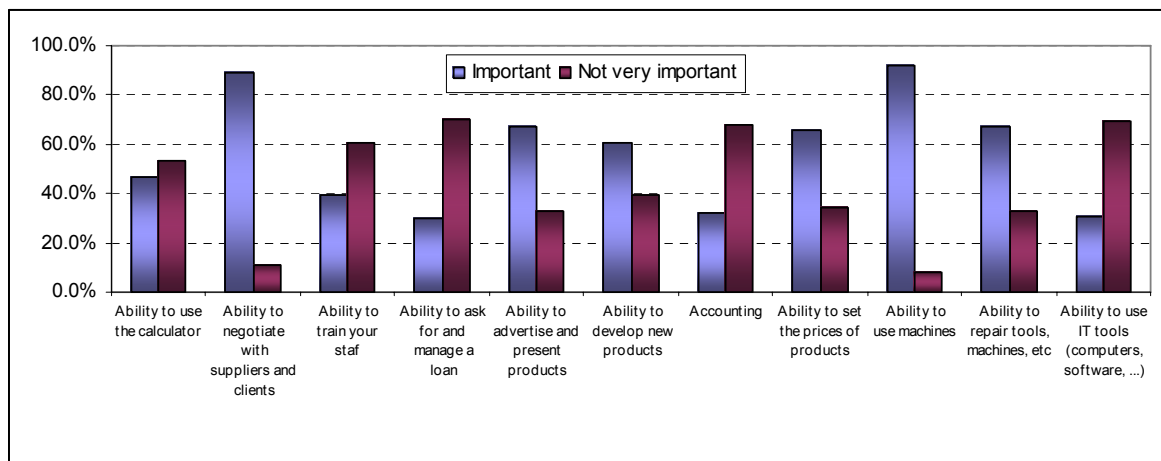
	Percentage
Access to credit	6.1%
Good business network	5.9%
Right connection in the government	1.9%
Improving my skills and/or those of my employees	15.4%
Accurate information on the market	7.7%
Improving the quality of my products and services	21.0%
Location of the business	16.5%
Modern equipment	15.4%
Good marketing	2.5%
Other	1.5%

Source: ISB, "Informal economy in Albania", 2005

Regarding the analysis of training and education, the general recognition is that improving skills is ranked at the same level of importance as improving the technology by purchase of modern equipments.

In terms of skills needed in case of micro activities, the survey conducted by the ISB (2005) confirms the needs to strengthen the technical managerial skills of the employees and of management. In particular, businesses consider as of high importance improving technical skills in using the machines and the ability to repair tools, building of negotiation skills with suppliers and clients, selling of products and services.

Chart 6: Importance of skills



Previous report on SME's (Xhepa and Agolli, 2005) identified the needs for following training courses:

- General management of enterprise
- Financial management and accounting
- Market research
- Strategic use of IT
- Human resource management
- Sales techniques and negotiations art
- Cost accounting
- International trade

In conclusion, training and improving the labor force skills can help many small firms increase their productivity and contribute to stronger economic growth.

Financing SME development

Recent cross-country papers studying the financing patterns around the world emphasize the importance of institutional differences across countries on capital structure (Demirguc-Kunt and Maksimovic, 2004). A related literature has also shown that access to external financing is shaped by the country's legal and financial environment (La Porta, Lopez-de-Silanes, Shleifer, and Vishny (LLSV), 1997, 1998). A direct implication of these studies is that in countries with weak legal systems, and consequently, weak financial systems, firms obtain less external financing and that this results in lower growth.

Beck et al (2004) study show that, even after the control for various firm characteristics and country and institutional variables, smaller firms finance a lower proportion of their investment externally, particularly because they make use of bank finance to lesser extent. Further investigating the linkages between firm size and the impact of institutional development on financing patterns, we see that small firms benefit disproportionately from higher levels of property rights protection and use significantly more external finance, particularly from banks and equity markets.

These results underline the importance of improving the institutional environment for increasing the access of small firms to external finance. We would expect that small firms, facing informational asymmetries in financial markets, would substitute subsidized financing from government and financing from sources that rely on personal or commercial relationships, such as trade credit or informal finance. We would also expect that such sources would be more significant in countries with poorly functioning financial systems or weak property rights protection.

What is the experience of financing the SME development in Albania and how the banks and non-bank financial institutions are supporting their growth?

Development of banking system could play an important role in strengthening the private sector development and of SME's in particular. Several surveys of resource financing firms' economic activities confirm that the banking system has played a very limited role in financing company's operations. The data obtained from interviews of firms (EBRD, 1999 and 2000) show that more than 20% of the large enterprises interviewed in Albania refer to state funds as their

principal resource of financing. 5% of large enterprises and 2% of the SMEs interviewed confirm that they have got hold of financing resources only through the banking system.

The country coverage with the banking services is rather limited, albeit the very positive dynamics observed during the last two years. Especially after the restructuring of the Savings Bank which had a country wide network, this is a real issue, particularly for the rural areas.

The positive trend is that private banks are expanding their regional network. This is a clear trend observed during the last two years. The system today operates as indicated on the following table:

Table 6: Structure of the banking system

	1999	2000	2001	2002	2003
Banks	13	13	13	14	15
Non bank financial institutions	1	2	4	5	7
Forex bureaus	10	19	38	58	58
Savings-credit associations				113	131
Savings-credit associations unions				2	2

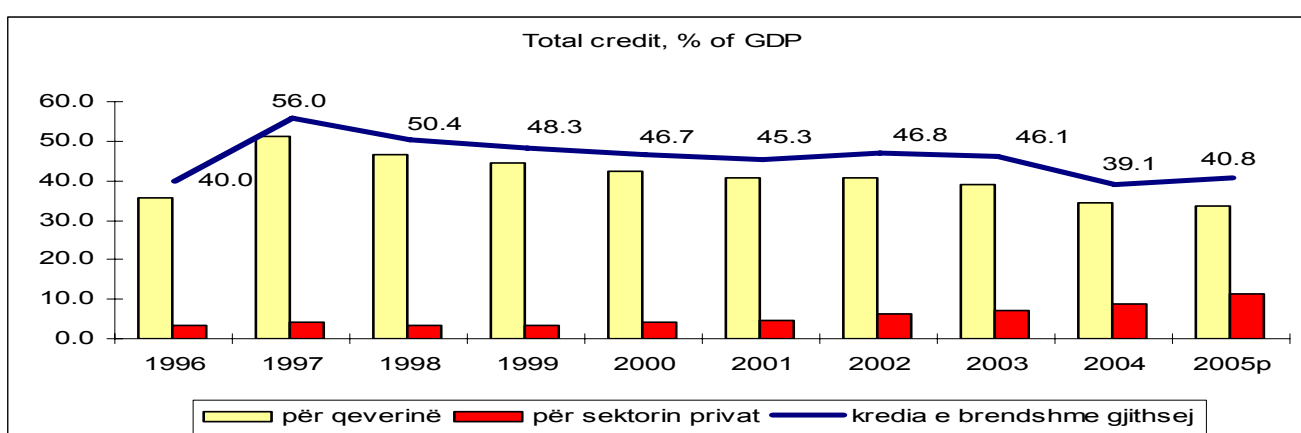
Source: Banking Supervision, Annual Report⁴, 2003

The stock of loans to private sector remains at very low levels of 11.4% of GDP by end of 2005. As the chart shows, although the stock of credit to economy is as high as 40.8% of GDP, the main transactions are between the government and the banking system in the T-bills market.

⁴ Number of banks for 2005 is 16, with a new privately owned by local investors licensed and in operation. Supervision Report for 2004 of the Bank of Albania is not yet published therefore there is no updated data on other part of financial sector.

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Chart 7: Credit from banking system in the economy



Albeit the high growth of the credit stock and its increasing importance in financing the business activities, own and family finance is mostly used by SMEs. In particular, repatriated funds from the emigrant have helped individuals start and finance small business activities. Surveys reveal the primary importance of this source of finance. However, the main source of financing for the SME's has been the own funds. This is clearly demonstrated by the following table (7) data.

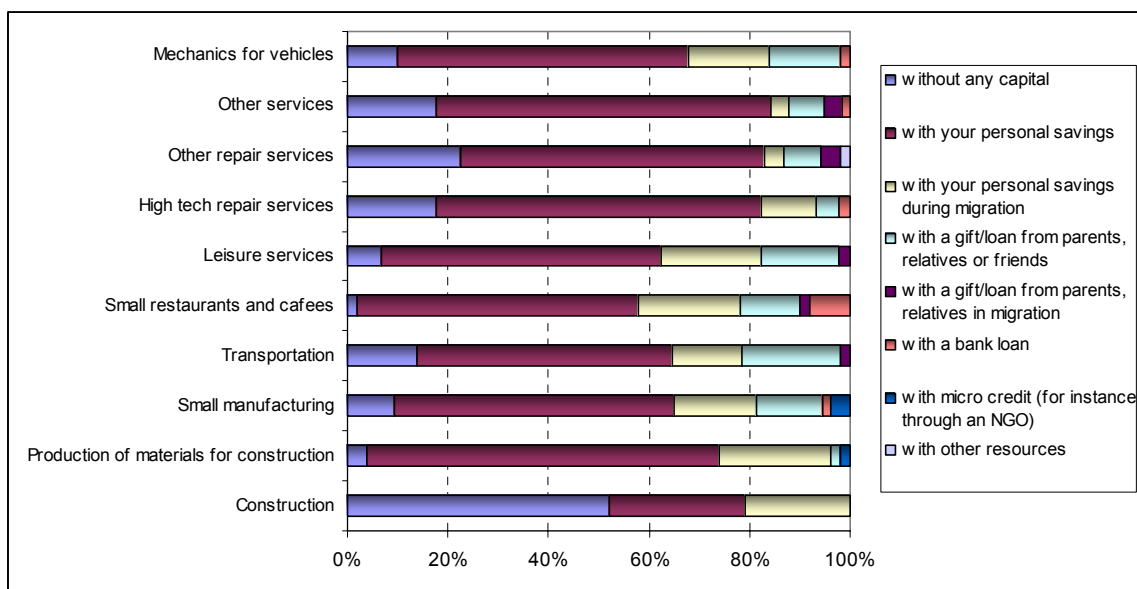
Table 7: Sources of finance used by the SME's:

Working Capital		New Investment	
Internal funds	83.7%	Internal funds	80.6%
Family/Friends	5.4%	Family/Friends	6.9%
Supplier credit	2.8%	Supplier credit	3.0%
Foreign banks	2.3%	Foreign banks	2.6%
Government	2.0%	Other	2.4%
Money lenders	1.3%	Private local banks	1.4%
Private local banks	1.1%	Government	1.4%
Customer credit	0.6%	Money lenders	1.1%
Other	0.5%	Equity	0.3%
Credit cards	0.2%	Customer credit	0.2%
Equity	0.1%	Leasing	0.1%
State-owned banks	0.0%	State-owned banks	0.0%
Leasing	0.0%	Credit cards	0.0%

Source: BEEPS, 2002;

Another study of informal economy (ISB, 2005) reveals the importance of financing sources for the conduct of the business activity as seen by the following chart. This study confirms that for the informal activities personal savings have also been the main source of finance.

Chart 8: financing sources for the informal small businesses



Source: Study on informal economy, ISB, 2005

Bank loans have played no role in starting these activities. Given the small size of these activities, starting the business does not require large investment needs. However, if some of these companies are considering expansion and to gradually become formalized, bank loans can play an important role in strengthening their business activity. According to data revealed by the survey, 33% of the businesses on the turnover over 900 thousand leks/quarter, consider getting of a loan as the most important factor for their future success.

Considering the very family type of business which is mostly present in Albania, other forms of financing other then banks remain the most important source of

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finance. In particular, the non-bank financial institutions, such as credit and loan schemes, have grown rapidly during the last years.

The expansion of activities of non-bank credit institutions has been noteworthy. These organizations have succeeded to establish their presence in rural areas, especially in the mountain regions. Figures in the following table highlight the increasing role of these institutions.

Table 8: financing by non bank financial institutions; (figures are in US dollars)

		2000	2001	2002	2003	2003/ 2002, %	2003/200 0, %
MAFF*							
Credit	Out-	1.400.000	1.800.000	4.100.000	7.536.060	184%	538.29%
standing							
Average Credit		447	576	1.100	1.772	161%	396.42%
Active Clients		3200	3100	3700	4253	115%	132.91%
RFF**							
Credit	Out-	2673.760	3.685.186	5.427.917	7.715.590	142%	288.57%
standing							
Average Credit		767	939	1176	1.310	111%	170.80%
Active Clients		4423	5277	6380	7.621	119%	172.30%
BF***							
Outstanding		4.973.482	6.936.598	10.417.637	12.118.869	116%	243.67%
Credit							
Average Credit		1.886	2.030	2.321	2.255	97%	119.57%
Active Clients		2637	3417	4488	5375	120%	203.83%

* MAFF: Mountain Area Financing Fund

**RFF: Rural Finance Fund

*** BF: Besa Foundation

Source: Progress report on implementation of the national strategy for socio-economic development during 2003 - Objectives and long term vision - Priority action plan 2004-2007; April 2004

A number of donor's financing sources have also been supportive to SME creation. Some of the projects with a component of loan guarantee are reported as follows:

- **Land O'Lakes (LOL)** is a USAID small loan guarantee fund for covering lending risk to small dairy farmers or processors;
- **IFC Loan guarantee risk sharing agreement with American Bank of Albania** - for a total of US\$ 2,5 million. To date no projects have been approved for coverage by this facility.
- **DEG SME Loan guarantee risk sharing agreement with Banca Italo - Albanese** – Both parties have now terminated it, since it never became fully operational as intended. The principal reason being a lack of bankable projects;
- **Albanian Small Business Credit and Assistance Program (ASBC)** is a new USAID funded program providing credit and TA to existing SMEs in production sectors. It also has a small SME loan guarantee facility, but this is not operational as yet.

Concluding this part of the paper, literature offers clear evidences that financial development fosters economic growth by relieving constraints on small firm growth. The literature findings also support the view that financial development disproportionately boosts the growth of small firms relative to large firms. Therefore, policy reforms that improve the operation of the financial system will boost the growth of SMEs.

Conclusions

Competitiveness of economy is affected by factors at enterprise level as well as overall environment on which the companies operate. In particular, this paper stresses the importance of factors at micro level which is enforced by the restructuring processes of the economy. Strengthening of the competitiveness is affected by private investment and deepening of the structural reforms which were partially covered and analyzed by this paper.

Summing up, the improvement of business environment and the minimization of informality in the business enterprise, coupled with strengthening of the financial sector, could be important elements in enhancing the competitiveness of the economy and provide a strong incentive for strengthening the SME's development.

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Appendix 1: Advantages of SME relative to larger counterparts

	Small firms	Large firms
Marketing	Ability to react quickly to keep abreast of fast-changing market requirements. (Market start-up abroad can be prohibitively costly.)	Comprehensive distribution and servicing facilities. High degree of market power with existing products.
Management	Lack of bureaucracy. Dynamic, entrepreneurial managers react quickly to take advantage of new opportunities and are willing to accept risk.	Professional managers able to control complex organisations and to establish corporate strategies. (Can suffer an excess of bureaucracy. Often controlled by accountants who can be averse to risk. Managers can become mere "administrators" who lack dynamism with respect to new long-term opportunities.)
Internal communications	Efficient and informal internal communication networks. Affords a fast response to internal problem-solving: provides ability to reorganise rapidly to adapt to change in the external environment.	(Internal communications often cumbersome: this can lead to slow reaction to external threats and opportunities.)
Qualified technical manpower	(Frequent lack of suitably qualified technical specialists. Often unable to support a formal R&D effort on an appreciable scale.)	Ability to attract highly-skilled technical specialists. Can support the establishment of a large R&D laboratory.
External communications	(Frequent lack of time or resources to identify and use important external sources of scientific and technological expertise.)	Ability to "plug in" to external sources of scientific and technological expertise. Can afford library and information services. Can sub-contract R&D to specialist centres of expertise. Can buy crucial technical information and technology.
Finance	(Can experience great difficulty in attracting capital, especially risk capital. Innovation can represent a disproportionately large financial risk. Inability to spread risk over a portfolio of projects.)	Ability to borrow on capital market. Ability to spread risk over a portfolio of projects. Better able to fund diversification into new technologies and new markets.
Economies of scale and the systems approach	(In some areas, scale economies form substantial entry barriers to small firms. Inability to offer integrated product lines or systems.)	Ability to gain scale economies in R&D, production and marketing. Ability to offer a range of complementary products. Ability to bid for large turnkey projects.
Growth	(Can experience difficulty in acquiring external capital necessary for rapid growth. Entrepreneurial managers sometimes unable to cope with increasingly complex organisation.)	Ability to finance expansion of production base. Ability to fund growth via diversification and acquisition.
Patents	(Can experience problems in coping with the patent system. Cannot afford time or costs involved in patent litigation.)	Ability to employ patent specialists. Can afford to litigate to defend patents against infringement.
Government regulations	(Often cannot cope with complex regulations. Unit costs of compliance for small firms often high.)	Ability to fund legal services to cope with complex regulatory requirements. Can spread regulatory costs. Able to fund R&D necessary for compliance.

1. Statements in brackets represent areas of potential disadvantage. Abstracted from Rothwell and Zegveld (1982).
 Source: Rothwell, R. (1983), "Innovation and Firm Size: A Case for Dynamic Complementarity", *General Management*, Vol. 8, No. 3, Spring.

Appendix 2: General data by size of enterprises - year 2004; in million leks

Firms size	Number of enterprises	Annual average of employed	Turnover	Investments
1 - 4 employed	35,006	53,798	128,438	4,975
5 - 9 employed	1,860	11,630	60,328	3,297
10-19 employed	906	11,902	65,203	5,164
20-49 employed	559	16,679	78,415	6,517
50+ employed	336	63,283	196,701	34,236
Total	38,667	157,292	529,085	54,189
Industry				
1 - 4 employed	3,708	7,703	11,600	576
5 - 9 employed	458	2,933	5,230	567
10-19 employed	243	3,378	8,308	1,218
20-49 employed	211	6,757	15,986	3,061
50+ employed	198	42,333	81,760	20,466
Total	4,818	63,104	122,884	25,888
Construction				
1 - 4 employed	502	1,304	3,442	80
5 - 9 employed	286	1,917	6,739	318
10-19 employed	283	3,776	14,540	1,096
20-49 employed	198	5,650	19,623	994
50+ employed	56	4,136	24,644	1,639
Total	1,325	16,783	68,988	4,127
Transport & communication				
1 - 4 employed	4,148	4,680	5,897	206
5 - 9 employed	70	461	1,732	84
10-19 employed	45	614	2,125	540
20-49 employed	24	717	2,602	281
50+ employed	26	9,996	54,656	9,893
Total	4,313	16,468	67,012	11,004
Trade				
1 - 4 employed	19,456	27,292	93,171	3,733
5 - 9 employed	559	3,488	43,101	1,817
10-19 employed	161	2,048	38,142	1,949
20-49 employed	66	1,878	38,470	1,540
50+ employed	16	1,373	31,155	842
Total	20,258	36,079	244,039	9,881
Service				
1 - 4 employed	7,192	12,819	14,328	380
5 - 9 employed	487	2,831	3,526	511
10-19 employed	174	2,086	2,090	361
20-49 employed	60	1,677	1,734	641
50+ employed	40	5,445	4,486	1,396
Total	7,953	24,858	26,164	3,289

Source: INSTAT, General Results of Annual Structural Survey of Economic Enterprises, 2004

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Appendix 3: Overall business conditions in 2005

Bureaucracy	Albania	Region	All Countries
Senior management time spent dealing with requirements of regulations (%)	11.22	5.57	8.16
Consistency of officials' interpretations of regulations	60.59	46.94	46.87
Business licensing and permits (%)	9.90	10.07	12.21
Economic and regulatory policy uncertainty (%)	18.81	23.74	30.54
Macroeconomic instability a "major or severe" obstacle (% of firms)	28.57	22.71	31.48

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Capacity & Innovation	Albania	Region	All Countries
Firms using technology licensed from foreign companies (%)	13.49
ISO certification ownership (%)	16.67	12.20	12.08
Firms undertaking innovation (%)	65.20	65.10	68.96
Average capacity utilization (%)	76.56	82.28	73.34
Skills/education of workers a "major or severe" obstacle (% of firms)	10.40	10.05	17.02

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Corruption	Albania	Region	All Countries
Unofficial payments for firms to get things done (% of sales)	1.83	1.03	2.38
Firms expected to give gifts in meetings with tax inspectors (%)	35.12	21.99	21.74
Value of gift expected to secure government contract (% of contract)	6.15	1.81	3.02
Corruption a "major or severe" obstacle (% of firms)	31.34	17.31	29.86

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Courts	Albania	Region	All Countries
Confidence in the judiciary system (%)	56.44	56.03	56.66
Dispute resolution time (weeks)	15.12	8.94	8.87
Legal system a "major or severe" obstacle (% of firms)	23.62	14.13	12.70

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Crime	Albania	Region	All Countries
Security and protection costs (% of sales)	2.07	1.21	2.26
Losses due to crime (% of sales)	0.02	0.59	1.46
Crime, theft and disorder a "major or severe" obstacle (% of firms)	8.46	9.30	19.72

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Finance	Albania	Region	All Countries
New investment from internal funds (%)	78.51	70.71	63.64
New investment from banks (%)	18.27	12.07	15.71
Working capital financed with credit from suppliers or clients (%)	2.60	5.45	7.14
Firms with an overdraft facility (%)	..	..	45.07
Collateral needed for a loan (% of loan)	153.99	153.73	138.12
Days to clear a check	..	..	3.74
Days to clear a domestic wire	..	..	2.63
Access to land a "major or severe" obstacle (% of firms)	8.37	8.20	13.46
Access to financing a "major or severe" obstacle (% of firms)	15.08	16.18	24.51
Cost of financing a "major or severe" obstacle (% of firms)	23.62	21.76	31.93

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Informality	Albania	Region	All Countries
Sales amount reported by a typical firm for tax purposes (%)	77.04	90.16	81.72
Anti-competitive practices a "major or severe" obstacle (% of firms)	47.50	19.60	26.08

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Infrastructure	Albania	Region	All Countries
Delay in obtaining an electrical connection (days)	19.02	12.30	27.01
Electrical outages (days)	194.23	12.28	25.00
Value lost to electrical outages (% of sales)	11.15	3.37	4.24
Firms that share/own a generator (%)	..	..	38.05
Electricity supply a "major or severe" obstacle (% of firms)	34.48	7.49	22.29
Delay in obtaining a water connection (days)	..	..	24.72
Water supply failures (days)	90.47	4.41	12.81
Value lost to water supply failures (% of sales)	5.65	3.59	3.54
Water supply coming from public sources (%)	..	..	69.31
Transportation a "major or severe" obstacle (% of firms)	11.82	4.92	11.05
Delay in obtaining a telephone connection (days)	33.60	13.84	36.89
Telephone outages (days)	4.98	0.92	4.24
Value lost to telephone outages (% of sales)	2.67	2.22	2.52
Firms using the Web to interact with clients/suppliers (%)	32.84	62.46	45.14
Telecom a "major or severe" obstacle (% of firms)	9.85	4.18	9.82

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Labor	Albania	Region	All Countries
Females in senior management (%)	32.21
Workforce that is unionized (%)	22.93
Optimal employment level compared to current level (%)	106.35	108.55	109.12
Labor regulations a "major or severe" obstacle (% of firms)	2.46	7.08	12.20
Firms offering formal training (%)	70.15	75.00	55.97
Permanent skilled workers receiving training (%)	25.58	25.68	28.15
Production days lost to strikes, etc	0.89	0.06	0.72

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Tax	Albania	Region	All Countries
Time spent in meetings with tax officials (days)	6.29	2.82	3.75
Tax rates a "major or severe" obstacle (% of firms)	40.89	28.79	33.93
Tax administration a "major or severe" obstacle (% of firms)	29.21	21.16	25.92

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Trade	Albania	Region	All Countries
Time to claim imports from customs (days)	1.70	3.85	6.54
Customs and trade regulations a "major or severe" obstacle (% of firms)	25.74	10.14	16.76

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