

REGULATIONS AND FINANCING OF SMEs IN ALBANIA

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ABSTRACT

An important factor that has contributed in the realization of a positive economic growth in Albania in the last 20 years is undoubtedly the Small and Medium Enterprise (SME) sector. SME financing is a topic of significant research interest to academics, and an issue of great importance to the policy makers around the world. Economic, as well as technical and social arguments warrant the promotion of SMEs.

They create large scale, low-cost employment opportunities, use locally available inputs and technologies, mobilize small and scattered private savings, develop entrepreneurship, and correct the regional imbalance in development that exists in industrialized countries. Several studies identify financing, infrastructure facilities, taxes, regulations and stability in policies as major obstacles for the growth of small and medium businesses. Improving the business environment for SME development is a key objective of the policy framework in Albania.

Keywords: *financing sources, economic growth, SMEs, legal framework*

JEL Classification: *L11, L25, O17*

INTRODUCTION

Small and medium business is the backbone of national economies; it is the basis of a free enterprise economic system. In the last two decades Albania has experienced the revitalization of small and medium business. After the collapse of the centrally planned economy, a fast paced private sector and small and medium-sized businesses grow from day to day. Increased entrepreneurial activity in these economies is more oriented towards trade rather than industry. Small business development is an essential element of economic development. Some of the reasons for the economic strategic importance of small businesses are:

1. It contributes to employment growth with more job openings than big business
2. It serves as the backbone to free market and transition economies; in the long run it provides the majority of employment
3. Its products and services are geared towards the domestic market, making good use of national resources
4. Increased technological innovation
5. It uses new technology to develop domestic skills
6. SMEs are an important factor for regional development and export promotion

Development of small and medium enterprises is the primary element for the creation of a sustainable economic development, poverty reduction and alleviation of social problems by bringing a more equitable distribution of income and employment growth. By considering the importance of small and medium enterprises in the country's economic and social development, this paper attempts to explain the difficult conditions faced by small and medium enterprises in trying to finance their businesses and the supporting policies for the Albanian government to subsidize this sector.

DEFINITION OF SMEs

The definition of SMEs in Albania is closer to EU standards, made possible through the law amended on SMEs in December 2008. The previous criteria embodied only the number of staff working for the SME. The new definition sets as criteria the staff headcount and the yearly turnover. However, the turnover criterion is far lower from the EU turnover level. Accordingly, the new definition of SMEs includes entities that employ no more than 250 people and have a yearly turnover of no more than ALL 250 million. Furthermore, SMEs are divided in smaller categories, namely:

- Micro enterprises, 10 employees or less and a yearly turnover of up to ALL 10 million.
- Small enterprises, 50 employees or less and a yearly turnover of up to ALL 50 million.
- Medium enterprises, 250 employees or less and a yearly turnover of up to ALL 250 million.

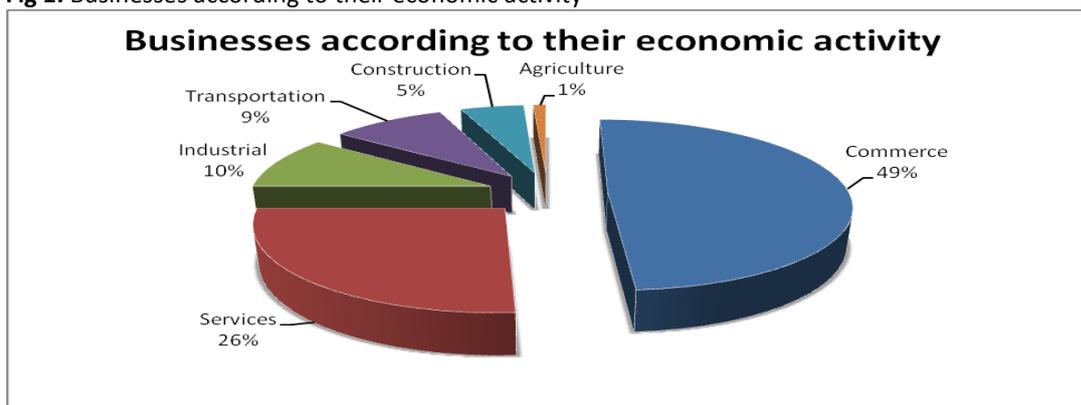
A CURRENT OVERVIEW OF SMEs SECTOR IN ALBANIA

In Albania, the SME sector was created and quickly consolidated during the 1990s, when for the first time Albania witnessed the rising of the private sector after almost 50 years of Communism. The number of active small and medium enterprises increased from 87.500 business entities in 2007 to 106.400 in 2009, and reduced to 100.687 entities in 2011 (data based on INSTAT). Similar to other European countries, the SME sector makes up for almost 99.6 percent of the Albanian economy and represents the most important pillar in the sustainability of domestic production and private sector employment with 82% of the overall working force.

Micro enterprises constitute the largest part of the total enterprises with 91,95%, then come small businesses with 4,26%, medium enterprises are third with 3,04%, and last are large enterprises that make up 0,75% of the entire private businesses registered in the Republic of Albania. The majority of Albanian SMEs are limited liability companies. The rest are physical persons and joint venture companies, and most of the latter fall in the category of very important large businesses (VIP businesses).

Since the late 90s, the Albanian government has taken a series of structural reforms, including land reform, private financial market reforms, and privatization of government owned entities. During this time, almost all Small and Medium Enterprises (SME), have been privatized and made significant progress in the privatization of strategic economic sectors such as telecommunications and banking. In terms of geographical distribution of businesses in Albania around 51% of active businesses are located within Tirana and Durres, which employs 57% of total private sector employees; 25% of active businesses are located in Elbasan, Korce, Vlore, and 12% are located in the Fier prefecture. Furthermore commerce and services make up 75% of the total distribution of SMEs in 2010 by economic sector, employing 45.2% of all private sector employees (See Fig. 1).

Fig 1. Businesses according to their economic activity



MAIN PROBLEMS FACING SMES

There are three major issues for a better functioning and development of the SME sector that need to be addressed:

1. **Legal Barriers (taxes, tax administration, bureaucracies, etc)**
2. **Fair Competition**
3. **Feasibility for different methods of financing**

Legal Barriers - Albania is under a series of reforms and economic changes that are required for entry into the EU. Albania finally received a positive report for "candidate" status in the EU, which in turn will force the Ministry of Finance to have a unified description of SMEs as in the European Union.

Tax Policies - From 2005 to 2010 a number of liberal policies regarding taxes have been approved to ease the fiscal burden for businesses:

1. Reduction of income tax from 23% to 20%
2. Reduction of simplified tax for small businesses from 3% to 1,5%, and a 50% reduction of local taxes for small businesses
3. The removal of VAT for book publishing companies
4. The removal of VAT for commercials in the media sector
5. 9% reduction of the social security tax burden for employers (from 29% to 20%)
6. 25% price reduction for electricity bills for all businesses

Although recent fiscal reforms have been adopted and there is a modern legal framework of taxation, it is necessary to make some revisions and changes, especially in terms of implementation of the

relevant legal framework and guidelines. The gap in implementation and lack of human capacity in the tax services requires strengthening the tax administration. This year, unlike other years, the tax administration applies new procedures with substantial changes in the fiscal treatment of small businesses. Changes consist of two major lines:

1. Move from having a fixed tax rate of the municipal category, yearly income, type of business activity and its current address, to a tax rate based on yearly taxable income
2. The second essential change is based on careful examination accounting books

Legal Procedures of VAT for Small Businesses

In recent years the Albanian businesses has had various feasible tax procedures implemented, the reduction of social security tax, lowering of income tax to 10%, greater possibilities for financing through loans (due to lowering the country's budget deficit), and finally a VAT of 6% for agriculture products. All these have led to a rapid growth of SMEs that is associated with increasing difficulty to legally control them. After passing the taxable income tax for small businesses rather than the previous 1.5% tax on total revenue, many believed that these businesses in attempt to pay less tax would not declare actual revenues and illegally increase their yearly expenses. To avoid this problem an idea was put forward to place VAT even for small businesses.

Starting from January 1st, 2008, small businesses have entered in the VAT scheme. The effects of this change will be difficult to assess in the early stages of its implementation due to the fact that VAT does not directly affect businesses profits, but consumer income, since VAT is a tax which is levied to the individual consumer.

Changes in tax legislation and the factors that cause them

In an overview of the Albanian legislation one thing is certain, the reduction of social security contribution from the employer year after year, in order to give an opportunity especially for small businesses to capitalize on their profits and increase the number of employees. Changes in general economic legislation have positive trends, but they also have a big problem, they seem too often reflect a lack of vision and forward an undesirable tension in the business environment. The impact of poorly designed fiscal policy and bad implementation of these policies brings about constant pressure for businesses, although somewhat more moderate in recent years. This factor affects almost all types of businesses regardless of the activity or the size of the enterprise.

There are many factors that affect the development of economic legislation, among which:

- a) The continuous battle against tax evasion
- b) Reducing the informal economy
- c) Increased transparency
- d) Increased control
- e) The application of national and international accounting standards
- f) Political factors

a) The continuous battle against tax evasion - The fight against tax evasion is the primary objective of governing bodies and the tax administration. Albanian businesses experiencing rapid growth are often tempted to reach bigger profits through deliberate tax evasion. Poor administrative infrastructure and the lack of human resources in this field have made this activity relatively easy.

b) Reducing the informal economy - Informality appears in many dimensions and is one of the most difficult reforms. There are many businesses that conduct their activities without registering at the proper government offices, but year after year, government action is taken to identify and register entities operating illegally. The factors that create an easy terrain for the informal economy are: 1) power above the law 2) secret negotiations 3) subjective interpretation;

1. **Power above the law** should be resolved as soon as possible by the Albanian administration. A well known and clearly defined code of ethics must be written indicating all the obligations of employees.
2. **Secret negotiations** are another factor that makes informality a reality. Employees in the tax administration have the ability to make "secret negotiations" with businesses that they go out to control. Through "secret negotiations" starts the distortion of information and unfair preferential treatment of certain entities.
3. **Subjective interpretations** are one of the most controversial issues, which are expected to fade by applying the national accounting standards. Through these standards accountants can easily and clearly indicate a financial transaction, value it and reflect it in the financial statements.

c) Increased Transparency - transparent information is a prerequisite for businesses. Information and financial statements are essential for business entities, if this is lacking then there would not be any financially healthy enterprises. This is an observation made by foreign investors in Albania, which due to non-transparent information existing foreign investments are relatively scarce or absent in many areas.

d) Increased Control - Control of business units is very difficult especially in Albania where conditions lack the tax administration personnel for legal searches on the businesses premises. It is impossible to examine the thousands of businesses, especially now that the VAT scheme was added to small businesses as well.

e) The application of national and international accounting standards - **Businesses** need to adopt accounting practices that reflect business financial statements that comply with national and international accounting standards.

f) Political Factors - Businesses feel greater freedom when the hand of the state is not over them all the time, but numerous changes in economic legislation, often to meet the interests of certain groups, has made this freedom to not be felt and businesses are under the continuous pressure of politics.

COMPETITION

Competitiveness of the Albanian Economy and its Businesses

In 2010, competition in Albania displayed improved progress after three years of continuous hard line policies approved by the government for fair and better competition. Business competitiveness index for 2010 rated Albania with a score of 3.94 points, and Albania ranked 88th out of 139 countries that were rated in this index. The progress indicator indicates increased improvement for institutions giving a strong impetus to strengthening the competitiveness of the country. Within the concept of institutions improvements occurring, particularly in those areas related to regulatory reforms which have significantly reduced the burden and uncertainty of administrative procedures on economic activities. Improvements can be seen in terms of law and order, transparent security, and reduced corruption while the legal guarantee of property rights are still a problem as result of confusion and lack of legal reforms.

Unfair Competition

Registered SMEs complain about unfair competition that is present in the informal sector of the economy. However, the current informal sector competition comes not only from unregistered enterprises, but also from registered enterprises through illegal actions and behaviors.

Informality within the Albanian Economy

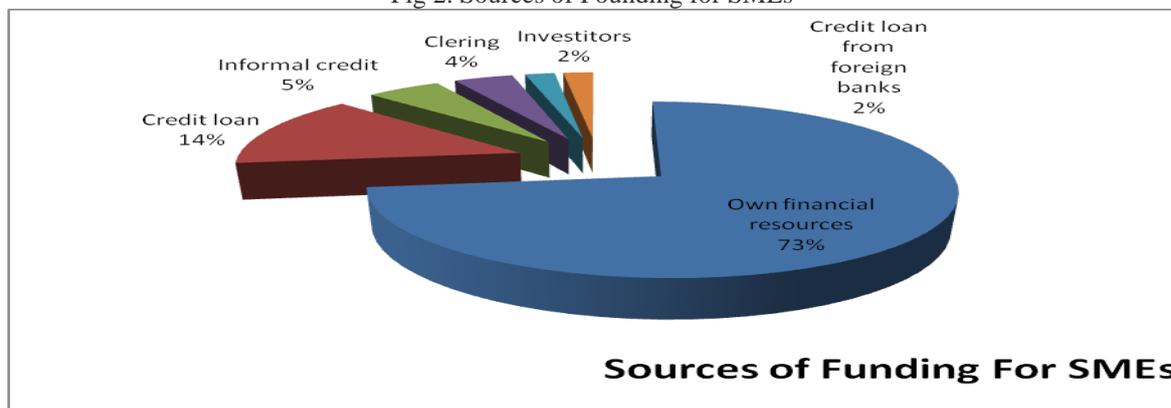
Informality in the Albanian economy is considered high; INSTAT estimates it to be roughly above 20% of GDP. Reducing the informal economy is part of the program and reforms undertaken by the current government. The International Monetary Fund in its 2010 report of Albania indicates that the money collected from taxes by the government fell to 22.9 % of GDP. Since 2003, there has been an increase of tax collection, while a reduction was noticed in 2009 and 2010. Experts indicate that the causes for this decline in tax collection are a few, but the most important are the economic crisis that has hit the region and the never ending informal economy. Now that the public debt is growing, shrinking income raises not so easy questions on the sustainability of state finances. This concern is being strongly articulated to the Albanian government and the public by international institutions that monitor the country's economy.

FINANCING FOR SMES

The Financial Structure of Private Enterprises, and Possible Sources of Funding a

Possible funding options for private enterprises are as follows:

Fig 2. Sources of Founding for SMEs



Their own financial resources

Financing through its own resources constitutes the basis of most business financing in Albania:

- **Reinvestment of earnings** is perfectly natural that the primary source of financing comes from the previous business operational period profits. Reinvestment of profits is an important source of funding for Albanian enterprises, considering the fact that the level of funding from other sources is quiet low. Today over 78% of the funds to finance growth opportunities comes through their own earnings.
- **A separate part of the capital consists in immigrant remittances** outside of Albania. The latest official data from the Bank of Albania show a reduction in remittances in 2010. During 2010 remittances recorded their lowest point in the last seven years. According to data released by the Bank of Albania in 2010 remittances were 695 million Euros, a lot lower than in 2007 where the value reached its highest ever of 952 million Euros. For years, remittances have been an indispensable resource for both family income and the need for foreign currency.
- Another part of the capital gets financed from **illegal income** received by the owners who invest it in their legal business. There is no official data from any government entity or private organization to back this statement.

Donors of Funds

SMEs can accept funding from private donors, even more so in a situation where commercial banks are being quite stringent on lending money. There are a few private donors that operate in Albania, but one of the private donor programs is the Italian credit lending for SMEs, which secures funds for these enterprises that constitute 99% of businesses in Albania. In the donors forum for SMEs some of the issues discussed were the performance of existing activities of these companies.

The European Bank for Reconstruction and Development (EBRD) is one of the most active private-sector financiers in Albania with a recent focus on small production enterprises, development of natural resources, as well as improving infrastructure. The European Investment Bank (EIB) is a lead player in implementing EU priority objectives in the Balkan area. Active in Albania since 1994, the EIB has contributed over €240 million towards projects of key importance for the economy, such as various infrastructure investments including energy and transport.

Informal Credit Loans

Small businesses are more than often the victims of informal credit loans, accepting to receive loans from private individuals, almost always from someone that they know, and refuse to work with financial institutions. This type of financing is easier to acquire and constitutes an important source to finance investments, especially for rural enterprises or new ventures. Although the economy has an ever-increasing trend towards formalization, it is still possible to receive money from individuals that do not operate as legal financial lenders. Given that not all businesses can not secure funds from financial intermediaries, sometimes it is necessary to use this method of financing. Today through this form of lending, businesses meet 5% of their funding.

Investors

Real Estate development and construction of new living spaces are financed through private investors due to the huge profit margins. More than 2% of funding for all types of businesses is secured through private investors. Investors provide funds in considerable amounts and do not require a fixed annual return, but a percentage from the overall profit of the entire project regardless of when it ends. This facilitates the construction firms' economic burden.

Commercial Loans and Financing from Clients

A commercial loan rises from deferred payments to suppliers for the goods and services that a business's client receives through purchases. This form of financing is widespread in Albanian businesses. This has created a large volume of credit which creates premises for the concealment of enterprises that have financial difficulties or are on the verge of bankruptcy. Worth noting that for companies that have a lack of liquidity, a commercial loan is an efficient way of financing.

Funding from clients is also an important funding resource for Albanian businesses. Typically construction firms which through their fund raising subscriptions finance their growth. Thus a fraction of the value of the apartment or commercial space is paid, and at a later time after total liquidation of the purchase the client becomes the owner. Many construction firms finance a substantial part of development projects with funds provided by customer from advance payments.

“Clearing”

“Clearing” or barter is a legal business transaction method and does not create any problems as long as all actions are signed and written in a contract (this type of transaction deals largely with exchanges of commodity, no actual money transaction takes place). The businesses sector that uses clearing the most is construction, but it is known and used in other sectors such as agriculture, services, etc. Through this a land owner agrees to allow the construction of an apartment building and in return he/she receives 25% - 33% of

the total space being constructed. This is a way of financing for construction firms that do not need to commit funds for the purchase of land. Even media companies use this type of financing when they purchase cars, paper, and payment of printing houses, in return they do not pay for these services but offer to re-pay through broadcasting advertisements for these companies.

The role of intermediaries in financing business growth

According to the annual report of World Bank "Doing Business 2012", Albania is ranked 24th in the world for ease of securing a loan. Financial intermediaries, especially banks, play a primary role in the financing of business growth in Albania. The loan provided by banks or credit institutions meets over 13% of the needs for businesses to finance their growth. In Albania, the role of banks and micro-credit institutions as funding ventures made their presence felt in 1999, when the liberalization of the banking system commences. Currently in Albania exists three ways of business financing:

- 1. Micro Credit**
- 2. International Financial Organizations**
- 3. Banking Loans**

CONCLUSION

SMEs play a catalytic role in the development of any country being the engines of growth in developing and transition economies. They are considered as job generators and vital for the economic growth. However, SMEs are still facing many financial difficulties due to various reasons, such as lagging in the banking system, an inadequate financial structure, lack of a guarantee system, etc.

There are different ways to support the private sector through funds, grant aid, low-interest financing from various institutions, etc. Banks as well as businesses and the economy as whole benefit from this. Banks find young clients, long-term business credits get normal market interest rates, and new investments flourish in the country. Creating new financial systems, like a stock market, that have a good function is a must. A stock market should strengthen its role as a secondary market for treasury bills and government bonds, and for the registration and trading of shares and bonds for domestic companies, if the Tirana Stock Exchange begins its operations, businesses will have greater financial resources and many advantages.

Some measures that would improve SMEs financing are:

- Increasing credit levels and the creation of the Albanian fund that guarantees loans
- Credit offered by commercial banks as well as some donors contributes to financing of SMEs
- Creating an agency that guarantees exports
- Use of the loan schemes against the guarantees
- Application of other financial instruments (schemes to guarantee public-private partnerships, promoting joint schemes, etc.)
- Increased funding for micro businesses (by the Albanian government and foreign donors)
- Strengthening the capacities of micro credit institutions

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