

## SMALL FIRMS FACING INSTITUTIONAL BARRIERS IN KOSOVA NDIKIMI I PENGESAVE INSTITUCIONALE NE ZHVILLIMIN E NDERMARRJEVE TE VOGLA NE KOSOVE

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### SUMMARY

The purpose of this paper is to study the impact of institutional factors on the growth of small and medium enterprises (SMEs). Kosovo, as one of the last countries in transition characterized by difficult social and economic conditions, is used as a case study in this paper. The main institutional obstacles faced by SMEs in Kosovo that are involved in international trade will be analyzed from the perspective of the institutional theory developed by North (1990). The study is based on interviews of firms in Kosovo, using a structured questionnaire, conducted in 2010. The paper's key findings show that informal activities caused by low levels of professional and ethics of officials in respective institutions, as well as poor enforcement of regulations, have significant impact on increasing transaction costs, which in turn represents a major obstacle to the further growth of SMEs.

**Key words:** Growth, institutional barriers, SMEs, Kosovo.

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### INTRODUCTION

The growth of SMEs does not occur similarly in all countries. In countries in transition, different contextual obstacles impede the growth of firms; these factors include business environment factors, amongst which the most important are institutional ones.

To analyze the impact of both formal institutions (e.g. laws and regulations) and informal activities (e.g. red tape, bribery, corruption, etc.) on the development of entrepreneurship in the transitional environment, numerous researchers have used the institutional perspective based on the institutional theory (North, 1990; Aidis, 2005). Given the other factors that influence the development of entrepreneurship, there were efforts made by different authors to account for its positive contribution to economic growth, as well as for its negative, unproductive, and, furthermore, destructive effect (Baumol, 1990).

As the last country in Europe to enter the transition, Kosovo is confronted with various obstacles, most of which are consequence of the previous socialist system and the inheritance of the war it went through in the late 1990s. These obstacles were only aggravated by the United Nations Administration Mission in Kosovo (UNMIK) after the war. Consequently, after gaining its independence in 2008, Kosovo remains characterized by high levels of insecurity, and in this respect it is a unique case because of the overall politically marginalized context (Hoxha, 2009).

Kosovo, as a country that declared its independence quite recently (on February 17 2008), inherited a myriad of problems from its recent past, which also relate to numerous institutional obstacles. The SME sector constitutes 98 percent of all of the enterprises in Kosovo. There are 55,000 registered businesses

divided in micro enterprises, small and medium enterprises, while the rest are considered large enterprises (MTI, 2007). According to the business register in MTI, the total number of existing businesses active in international trade is 27,000 companies, but only 4,000 of them are actively engaged in international trade (MTI, 2007). SME development in Kosovo is more concentrated in the sectors of trade and services, and less in production and export.

Findings obtained in this paper will widen our understanding of the institutional formal and informal barriers to the growth of SMEs. This can then serve the government policy makers and the business community, in their efforts to create a stable institutional environment that is suitable for the growth of SMEs. In particular, the case of Kosovo adds to the broader analysis the dimension of obstacles caused by war and by international administration

## **THEORETICAL FRAMEWORK AND LITERATURE REVIEW**

Institutional framework remains the most important factor for the growth of enterprises in every country. Here are included formal rules such as constitutional laws, individual rights (i.e. property rights) and other legal acts that derived from the formal rules such as obligations of economic entities *vi.savi* the state obligation deriving from the contractual relationship, obligation from different membership and others (North, 1990). At the same time informal rules with their elements (i.e. social mentality, custom and other relevant elements) have equal impact on the growth of enterprises (North, 1990). The impact of informal rules is more evident in transition and less developed countries. Very often the informal rules are being formalized due to the lack of institutional formal rules (North, 1990). Again this is characteristic for countries in transition and less developed countries.

The low level of institutional performance affect negatively the developed SMEs, this is more evident on the area of entrepreneurship, business laws and taxation system (Aidis and Sauka, 2005). The inability to respect and fulfil

this rules on one side and inability of formal institutions to enforcement them has resulted with uncontrolled activities, mainly corruption and nepotism (Bartlett and Bukvić 2001).

Baumol (1990) provides an analysis of the role of institutions in determining economic development from the perspective of entrepreneurship. He has researched in detail the effect of institutions on the entrepreneurial behaviour through presenting indicators that cause the allocation of entrepreneurial activities in the forms known as productive, non productive and destructive (Baumol, 1990).

The private sector in Kosovo is indeed facing these obstacles from the very beginning. A particularly negative effects for the growth of SMEs in Kosovo were caused by the so-called "*compliance costs*" that are known as "*costs incurred by companies and individuals in meeting legal requirements*" (Verwaal and Donkers, 2001). These compliance costs are particularly high for small enterprises (Hudson and Godwin, 2000; Sandford and Hasseldine, 1992; Sandford at al., 1989).

Regarding the enterprises that are involved in international trade, the frequency of the exchange of information with customs authorities, as well as the way in which this information is gathered and exchanged, can be considered as issues that can increase the efficiency of the firm, due to the possibilities for the reduction of the transaction costs (Verwaal and Donkers, 2001). Besides the formal barriers, the informal ones can also hinder the growth of SMEs. The most important among them – particularly in the Kosovo's case – are those related to corruption and unofficial economy, and we will refer to them as barriers confronted by the firms as a consequence of low ethics of officials.

In order to examine how institutional and other relevant barriers affect the growth of SME active in international trade, the following hypotheses will be tested:

H<sub>1</sub>: The small firms have a better performance than the larger firms

H<sub>2</sub>: The newly SMEs in international trade have shown better performance.

H<sub>3</sub>: Managers of SMEs that have been trained have shown better performance.

H<sub>4</sub>: SMEs that uses special trade agency services have resulted with better performance.

H<sub>5</sub>: The obligation of SMEs to complain with cross border agencies rules causes' low performance.

H<sub>6</sub>: Poor implementation of customs valuation methods by the institutional officers causes low performance on SMEs.

H<sub>7</sub>: SMEs that need to be equipped with different institutional authorizations results with low performance.

H<sub>8</sub>: SMEs that often complying on issued of institutional decision have shown to have better performance.

H<sub>9</sub>: Enforcement of regulations and procedures in unfair ways by triggering illegal activities by institutional officials causes low performance of SMEs active in international trade.

	1	2	3	4	5	6	7	8	9
Employees (1)	1.000								
Age (2)	0.328	1.000							
trade servile (3)	-0.283	0.122	1.000						
Trainings (4)	0.035	0.230	0.246	1.000					
Unfairactivity (5)	0.321	0.167	0.013	-0.173	1.000				
Cvaluation (6)	-0.184	-0.091	-0.006	0.019	-0.212	1.000			
Idecision (7)	0.121	0.292	0.351	0.538	0.125	0.103	1.000		
Ccborder (8)	-0.435	-0.308	0.057	0.126	0.246	0.342	0.052	1.00	
Authlicens (9)	0.026	0.069	0.20	0.342	-0.128	0.105	0.374	-0.012	1.00

**Table 1.** Correlation coefficients

## METHODOLOGY

### Sample

The data used in this paper is based on SMEs survey developed in accordance with various border agencies, busines and trade alliances. The time to fill in the questionnaire was between July and August 2010, and data from the answers in surveys have been processed in September 2010. The sample was designed to study the profile of SMEs active in international trade and their growth performance. The sample represents more than 3 percent of the total population of SMEs sector active in international trade. The sample was randomly selected from the business register in the database of the Ministry of Trade and Industry (MTI) in Kosovo, where more than 4000 active firms are involved in international trade.

The sample consists of 129 enterprises and includes SMEs across all regions of Kosovo engaged in international trade. In addition all sectors of business activities are covered and the sample was stratified twice. First three main

sectors were taken into consideration in order to reflect differences between production, trade and services. Second the sample was stratified according to the EU definition namely micro, small and medium enterprise. The interviews were conducted through the face-to-face method with the key people in SME, namely owners, managers and other alternative people in each enterprise. In addition a test survey has proven that our questionnaire was reliable instrument for data collection.

### Model

$$\ln performance_i = \alpha_0 + \alpha_1 \text{employees} + \alpha_2 \text{age} + \alpha_3 \text{tradeservice} + \alpha_4 \text{training} + \alpha_5 \text{unfair} + \alpha_6 \text{cvaluation} + \alpha_7 \text{iddecision} + \alpha_8 \text{ccborder} + \alpha_9 \text{authlicens} + \epsilon$$

### Dependent variable

The dependent variable is the natural log of performance used as a proxy for growth. Growth is determinate as rate of turnover growth in the beginning and the end of 2010 of firms that are active in the international trade.

### Independent Variables

The all institutional and environment variables are of qualitative nature: *trade agent service, trainings of managers, unfair activities, customs valuation, institutional decision, cross border, authorized licenses*, while the variables such as the number of *employees, trade services* and *firm*

*age* are of non qualitative nature. Most of the variables are converted into dummy variables taking the value of 1 if the respective barrier to firm turnover growth is recorded and taking the value of 0 where recorded otherwise.

	Institutional barriers to SME performance		
	Coefficients	t-statistics	P - value
Constant	3.978565	11.44	0.000
Employees2010	-.0225031**	-2.27	0.025
Age of firm	.0888694**	-2.75	0.007
Trade services	.0000504**	2.68	0.008
Trainings of managers	.1976403	1.31	0.192
Unfair activities	.3714675***	2.97	0.004
Customs valuation methods	-.256356*	-1.82	0.072
Institutional decisions	.425441***	3.02	0.003
Cross border compliance	-.4393681***	-3.41	0.001
Authorization and licenses	-.5926471***	-4.58	0.000
N = 129			
R <sup>2</sup> = 54.8%			
Estimator : Stepwise OLS			
Notes:*** Level of significance at 0.01%, ** 0.05%, * 0.1%			

**Table 2.** OLS regressions

### DISCUSSION OF EMPIRICAL RESULTS

To estimate our model as determinate below, we used the robust least squares regression techniques available in Stata. The stepwise ordinary least square (OLS) estimator is chosen because the previous results have shown some problems of heteroskedasticity and normality. The next step forward clarifying the situation is that we can start immediately to perform our model again and removing stepwise the least significant variables. Hence, the Breusch- Pagan/ Cook-Weisberg test for heteroskedasticity in our data reject the zero hypothesis of constant variable due to the robust standard techniques. In addition to further check of possible data problems regarding the multicollinearity we use the Variance Inflated Factor (VIF). The VIF in our case is 1.20, or less than 10, meaning that we can rule out any multicollinearity by generally low correlation coefficient (see correlation matrix in Appendix nr. 1).

As we can observe further the OLS regression results with the coefficients and standard errors for each of the variables are presented in Appendix 2. In the beginning results provides us with the following findings: hypothesis regarding the firm related characteristics such as size and age are being confirmed and have a negative sign meaning that smaller and younger firms have better growth performance than older and larger firms. The coefficients are statistically significant indicating that variables size and age have a negative and nonlinear relationship of the firm. Further we find the positive sign and statistically significant coefficients of SMEs that are using trade special services to resolves complicated trade regulations, customs procedures and other institutional issues; these increase the chances to have better performance. The trainings dummy variable proved to be positive sign and statistically significant but only 0,1 percent level, indicating that specific human capital knowledge in business environment of Kosovo has not reach

the expected merit (Hoxha, 2009). The variable unfair activities of institutional officers are confirmed and the coefficients are significant with a negative sign even at 10 percent level. The variable related to customs valuation methods has a negative sign but significant only at 1 percent level, which might be also as a result that trader's do not present transaction value of imported goods. The variable institutional decision is also significant and has a positive sign even at 10 percent level.

## CONCLUSION

This study is a wealthy point to the scientific literature over the growth barriers of the SMEs involved in international trade, while exploring institutional factors in particular. The study fulfills a gap on the present research focused in the transition and marginalized places. Our result shows that it is a similarity of the growth barriers of SMEs in Kosovo, according to informal and formal factors on every sector of SMEs in international trade. These factors are burdening the growth of SMEs. The role of informal factors is particularly noteworthy, as they are present on the day-to-day activity. In the future, it would be preferable that the importance should be directed toward rightly implementing the law on the side of the officials and respecting the ethic code of their work.

As in any research work, this paper also had its own limitations; it does however follow the growth of SMEs involved only in international trade. The sample contains firms that are active long enough to be interviewed and not those firms that operate informally. One of main limitations in methodology is the lack of time dynamics, growth is a phenomenon that necessarily happens over time.

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