

FINANCING SMALL BUSINESS

**FINANCING THE SMALL AND MEDIUM
ENTERPRISES IN ALBANIA**

BLERINA KURTI,
INGRID SHULI

Department of Accounting, Faculty of
Economics, University of Tirana, Albania

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Abstract: The importance of small and medium enterprises in economy is indisputable. They are the main contributor in employment, innovation and economic growth of a country. European Commission is fully supporting the development and growth of Small and Medium Enterprises through changes in legislation, creating a friendly business environment, facilitation in obtaining funds in the last two decades. The share of SME in total enterprises in Albania is 99.6% and their contribution in the GDP is 73%. Their growth is closely linked with their ability to finance their activity, which is one of the most important issues they are faced with due to their size and creditworthiness.

This paper aims to analyze the difficulties and obstacles that SME in Albania encounter in obtaining financing due to lack of source of financing within country, limited opportunities of accessing international capital markets as well as high interest rate.

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Introduction

The European Economy is strongly relying on the small and medium-sized enterprises. They constitute 99% of the enterprises operating in European Union, they are the main provider of job creations and contribute to more than half of the total value-added created by businesses in the EU. Promoting entrepreneurship, improving business environment, facilitation of access to finance have been the main topics of European Commission the last decades. The formalization of these efforts is materialized in the Small Business Act for Europe (SBA) adopted in June 2008.

Albania has undertaken several reforms to create a better business environment, but still obstacles and difficulties exist. Albania, like Europe economy, is dominated by micro enterprises. Financial resource is one of the basic factors that contribute to their growing.

In countries with bank- oriented financial system, the SME's main source of external financing is represented by the bank loan which is vital for the development of these enterprises. Despite the existing of some microfinance institutions, banks in Albania constitute the core source of external funding.

Credit Financing for Small and Medium Enterprises

A well-functioning credit market works best inside a well-developed infrastructure, which includes a stable macroeconomic environment and a supportive legal and institutional framework. Company law, contract and property law, securities law, laws governing consumer and investor protection, and insolvency or bankruptcy laws establish together the basic framework within which financial institutions and markets operate. Good enforcement of laws is also necessary, which entails a well-functioning judicial system. Evidence suggests that when these conditions are met in a satisfactory manner, financial institutions will have the basic incentives to address the information and other problems associated with SME lending (SME Financing Gap, p.20).

Several researches study the obstacles of SME in access to finance.

Leaven (2003) concluded that in developing countries there is a direct link between financial liberalization and the size of the firms regarding the financial constrains, meanwhile Love (2003) in her research in 36 countries verifies that financial development reduces financial constrains therefore increases the firms chances to finance its investment with external fund.

Beck, Demirguc-Kunt, Laeven, & Maksimovic (2004) found out in their research, on the determinants of financial obstacles, conducted in more than 10,000 enterprises from 80 developing and developed countries that size, age and foreign ownership were the most robust predictors of financing obstacles. Furthermore they found out that firms in countries with higher levels of (i) financial intermediary development, (ii) stock market development, (iii) legal system efficiency, (iv) GDP per capita and (v) institutional development report lower financing obstacles.

Beck, Demirguc-Kunt, & Peria (2008; 2011) conclude that foreign banks are more likely to require collateral and attach lower importance to soft information in lending to small and medium-sized firms: They also found that real interest rates for SME loans are lower in banks that are more likely to decentralize their loan approval and risk management processes, the same conclude Ardic, Mylenko, & Saltane (2011).

In developing countries they found that:

- a) foreign banks are more likely to approve loans to small firms than domestic private banks and do so at fees and rates that are not significantly different than those charged by domestic private banks

- b) banks charge 0.8 (0.7) percentage point higher fees for small (medium-sized) enterprises and three percentage points higher interest rates for small enterprises than those in developed countries due to the higher cost of property registration, property right protection and worse credit information environment
- c) higher interest rates due to higher costs of enforcing contracts and worse protection of property rights prevalent.

Beck, Demirguc-Kunt, & Singer (2011) in their study in 50 countries from developing and emerging countries found out that the dominance by banks in most financial systems of developing markets is associated with lower use of financial services by firms of all sizes. To the contrary, a larger share of low-end financial institutions and specialized lenders is associated with higher use of financial services in low-income, but not necessarily in middle-income countries.

Large financial institutions, on the other hand, are not necessarily associated with lower use of financial services. To the contrary, larger specialized lenders and larger banks might actually ease small firms' financing constraints, while large low-end financial institutions seem to impede access to 5 financial institutions only for medium-sized and large enterprises. And larger low-end financial institutions might actually be better in easing access to finance in low-income countries.

Claessens and Tzioumis (2006) conclude that since financial sector development does not necessarily alleviate all firms' financing constraints, there is a need to measure individual firms' ease of access to finance. Such measures would help guide policy to improve the financial sector development role in reducing financing constraints, as well as in enhancing the effects of financing on firm growth.

Durvy (2007) argues that in the seed stage, the companies are funded with equity. The sources of finance evolve as firms grow. At the seed stage, the riskiness of the firm and its profitability contribute to the "valley of death" over which less than half of firms survive. As firms move on from seed to early stage, risks are often slightly lower as the prospects of the firms become clearer and as revenues start coming in. But, debt finance is still unsuitable at this early stage.

First, the lack of collateral and the uncertain prospects of young technology firms, in particular, make bank financing often unobtainable. Second, borrowing is inappropriate because principal and interests payments would limit the cash flow flexibility of an expanding company at crucial times. Third, the usual information asymmetries between entrepreneurs and a bank are more pronounced because of the skills needed to evaluate the activities (mainly high-tech) of start-ups.

Modigliani & Miller (1958) argue that companies would be indifferent between internal or external fund to finance their investment if the perfect capital market exists. Given the market imperfections, the internal fund is the main source due to higher cost or constrains to access the external fund.

The development and performance of SME in Albania

After the fall of communism, the private initiative was wide spread in Balkan region, but Albania didn't embrace it since the beginning with the argument that small and medium enterprises couldn't be as efficient as large enterprises.

After the '90, the public companies slowly stop working and the people found themselves unemployed. People began to start their own "business" in order to get money for the everyday life. At that time there was no law that allowed the legal registration of these businesses. The process of privatization of state owned companies was very slowly until 1994, when it was approved the law for transforming the state companies into commercial companies. On the other hand, after 1994 there was a full privatization of small companies with tradable ownership right. It still remains unsatisfactory the index of governance and enterprises restructuring (see Appendix 1)

In 17.10.2002 was approved the Law nr.8957 "On small and medium enterprises" where it gives for the first time the definition of the enterprises based on the number of employees and their annual turnover.

In 22.12.2008 was approved the Law nr.10042 " On some changes and addition to the Law nr.8957 dated 17.10.2002 "On small and medium enterprises", which changed the criteria for the classification of the enterprises, to be in line with the Small Business Act for Europe approved by European Commission in June 2008. According to the document:

- d) medium-sized enterprises is defined an enterprise which employs fewer than 250 persons and whose annual turnover and/or annual balance sheet total does not exceed ALL 250 million
- e) a small enterprise is defined as an enterprise which employs fewer than 50 persons and whose annual turnover and/or annual balance sheet total does not exceed ALL 50 million
- f) a microenterprise is defined as an enterprise which employs fewer than 10 persons and whose annual turnover and/or annual balance sheet total does not exceed ALL 10 million.

Regarding the reforms in SME, it was approved the Law no. 9497 dated 20.03.2006 "On establishment of the Albanian Agency for Business and Investment", a government agency which substituted the existing three different agencies by that time: Foreign Investment Agency, the Export Promotion Agency and the Agency for SMEs.

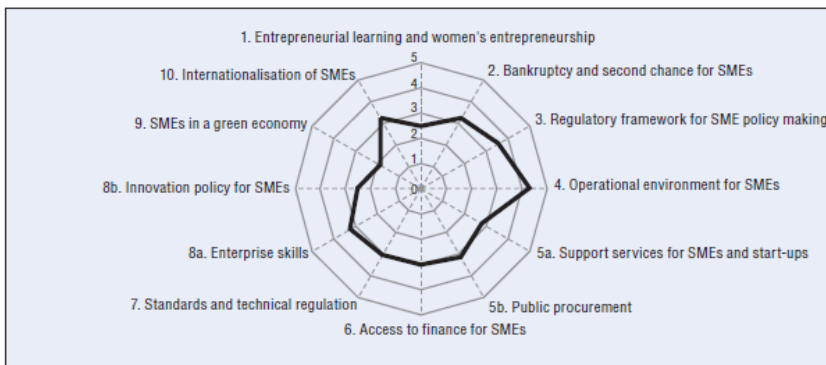
Under the National Strategy for Development and Integration, in 2007 it was approved the "Business and Investment Development Strategy" for the period 2007-2013 (VKM, 2007). The main objectives of this strategy are the development of the enterprise culture, encourage the improvement of the entrepreneurs education and training, ensure the quality of the services towards the business, increase crediting level

and funds for micro credit, financial and technical support for innovative projects.

Micro, small and medium-sized enterprises represent 99.9% of all registered businesses. Indeed, the micro sized enterprises is the really backbone of the economy (see Appendix 2). The share of the SME sector in GDP is 73% of GDP, and employs 81.80 % of all workers.

SMEs are concentrated in the service sector, which is dominated by trade. The enterprises operate mainly in Tirana (40%) and Durrës (11%). Other countries with strong SME presence are the cities of Fier, Korce, Vlora, Elbasan and Shkodra. The north part of Albania has a weak business activity due to the fact that all the investments are concentrated mainly in the capital city. Therefore, this part of the country suffers from the lack of investments, an undeveloped business environment, unqualified work force.

FIGURE 1. SME POLICY INDEX SCORES 2012 FOR ALBANIA



Source: SBA Assessment, 2012

Albania is a leader in the Balkan region regarding the procedures for registering a new company, due to the reforms taken for the business registration process. A new company can be registered within a day. Under the previous system, Tirana Court was the only responsible institution for the registration of the companies. There was no electronic company register; there was no coordination with the other institution, leading this way in longer time and higher cost for this process. In 2007 it was approved the Law on National Registration Center. This agency is a one stop shop for the company's registration process; it is responsible for the electronic company register. The number of the companies registered after the 2007 is significant increased due to the short time and a very low cost of company registration.

Due to the reforms undertaken from the government to create a better environment for the entrepreneurs Albania was ranked better in the SME Policy Index 2012. However, its performance has been uneven across the policy dimensions covered by the SBA (OECD, 2012). Challenges remain in the dimensions such as SME support services, innovation policy, and government measure to improve the environmental performance.

Access to financial sources

The financial market in Albania can be divided in two broad areas:

- Banking & Non banking financial institution - commercial banks, non banking financial institution, saving - credit companies which are supervised and regulated from the Central Bank established in 1992.
- Insurance market, Securities market, Voluntary Private Pension market, regulated and supervised from Albanian Financial Supervisory Authority established in 2006.

Banking system's assets amount to ALL 1,187.90 billion by the end of 2012, recording an annual growth of 6% (Bank of Albania, p.82). Foreign capital provided the major contribution, as banking system in Albania is dominated by banks where the majority of paid in capital is foreign. Foreign capital originating from the European Union continues to have the highest share in the banking system's capital. The share of foreign capital in the Albanian banking system decreased to 89.80 % from 90.30% at end-December 2011. The share of foreign capital in the Albanian banking system is the highest compared in the region.

TABLE 1. SOURCES OF FINANCE FOR SMALL ENTERPRISES

Country	Internal funds or retained earnings	Equity (issue new shares)	Borrowing from banks	Trade credit	Other
Albania	75.11	5.77	13.56	0.09	0.68
Bosnia and Herzegovina	39.16	17.33	23.38	17.15	0.67
Croatia	56.57	0.84	31.7	5.61	5.28
The former Yugoslav Republic of Macedonia	63	4	25	2.4	1.5
Kosovo under UNSCR 1244/99	75.5	5.5	12.7	1.7	1.4
Montenegro	27	24	37	9.9	1.8
Serbia	45.9	12.1	27.9	10.3	3.9

Source: BEEPS, 2010.

Banking system has been continually under reforms in order to comply with Basel Committee's principles and standards for effective

supervision, EU Council directives and best practices in the field of regulation and supervision of financial institutions.

In the last years it is accomplished the objective of full interest rate liberalization, significant increase of lending to private enterprises and a considerable presence of private bank.

Quite the opposite it is presented the situation for securities markets and non-bank financial institutions. No stock is exchanged in Tirana Stock Exchange, it is used only for trading in Albanian treasury bills; the capital market is still very weak.

Although bank is the main channel for funding the economy in Albania, leasing industry and microfinance are two other sources which have increased their role in the last years. This is related to competitive interest rate, lower administrative burdens, lower fees and commissions.

The structure of financing SME in Albania is presented in Table 1.

According to BEEPS 2009, countries in the region have increased their reliance on external finance in comparison to 2005, although internally generated funds still make up the majority of their funding (OECD, 2009).

The main external financing source is from commercial banks. This leads to a higher cost of fund, due to the high interest rate in the banking sector, fees and commissions, administrative burdens. There has been a significant decrease of the lending interest rate from 30% in 1993 to 10.28% in 2012. During 2012 the Central bank has decreased several times the basic interest rate in order to stimulate the economy, but these interventions couldn't have the desired impact to the crediting activity. In addition, the Central Bank of Albania obliges the commercial banks to be transparent with fees and commission they apply in order to avoid the hidden cost.

Zhao (2009) argues that due to weak management of small and medium enterprises, lack of good corporate governance mechanism, lack of transparency of financial information, lack of audit departments, banks are faced with a greater risk.

Access to finance can be evaluated in two broad categories:

Credit environment	Financial Facilities
Collateral and provisioning requirement	Credit guarantee schemes
Creditor rights	Venture capital/equity funds
Cadastre	Leasing
Registration of moveable assets	Business angels network
Credit information services	Microfinance facilities
Financial Literacy	Access to stock market
	Public start up funds

TABLE 2 (A). SCORES FOR SUB-DIMENSION 6.1 : SOURCES OF EXTERNAL FINANCE

		ALB	BIH	HRV	KOS	MKD	MNE	SRB
Credit Guarantee schemes	2012	3.00	3.50	3.50	1.50	2.00	2.00	3.00
	Change since 2009	0.00	+1.50	+0.50	-0.50	-3.00	0.00	0.00
Public start-up funding	2012	2.00	2.00	3.00	2.00	2.00	2.50	3.50
Business angel network	2012	1.00	1.50	2.50	1.00	1.50	1.00	2.00
Microfinance facilities	2012	4.00	3.00	3.00	3.50	3.50	3.00	3.50
Leasing	2012	3.50	3.00	4.50	2.50	3.50	4.50	4.00
	Change since 2009	-0.5	0.00	+0.50	+0.50	-0.5	+0.50	-1.00
Availability of risk capital	2012	2.00	1.00	3.50	1.00	2.00	2.00	3.00
	Change since 2009	0.00	-3.00	-0.50	0.00	-2.00	-1.00	0.00
Access to the stock market	2012	2.00	2.50	3.00	1.00	1.50	3.50	3.50
Overall weighted average for 6.1	2012	2.50	2.50	3.25	1.75	2.25	2.75	3.25

Source: SBA assessment, 2012

TABLE 2(B). SCORES FOR SUB-DIMENSION 6.2 : LEGAL AND REGULATORY FRAMEWORK

		ALB	BIH	HRV	KOS	MKD	MNE	SRB
Cadastre	2012	3.50	4.00	4.50	3.00	3.00	3.00	3.50
	Change since 2009	+0.50	+1.00	+0.50	0.00	0.00	-1.50	+0.50
Credit Information Services	2012	4.00	3.50	3.00	2.00	4.50	3.00	4.50
	Change since 2009	+1.00	-0.25	+0.75	+0.50	+3.00	0.00	+0.75
Registration system for movable assets	2012	3.00	4.50	4.00	2.50	2.50	4.00	5.00
	Change since 2009	0.00	+0.75	+1.00	+0.25	-0.50	+0.25	+1.25
Collateral	2012	3.00	3.00	3.50	2.00	3.00	3.00	3.00
	Change since 2009	-1.00	-2.00	-0.50	0.00	0.00	+1.00	0.00
Creditor rights	2012	3.00	2.50	3.00	2.50	4.00	4.00	5.00
Overall weighted average for 6.2	2012	3.25	3.50	3.50	2.50	3.50	3.50	4.25

Source: SBA assessment, 2012

Unfortunately the picture is not as positive regarding the access to external sources of financing (Table 2 (a)). Business Angel Network, a very good source for start up and growing companies is almost unknown in Albania and the stock market remains still not an option. Leasing activity is focused mainly in auto leasing. The venture capital is almost nonexistent and the private equity activity is very limited. There are projects for financing the SME, such as The Italian -Albanian program (Eur 29.2 million) which involves a line credit, a guarantee fund and grants for technical assistance. The aim of this program is to sustain the growth of SME which capital is owned more than 51% from Albanian citizens. In addition there is a project financed from USAID to sustain the improvement of competition and productivity of SME (10 million USD) implemented in 10 main cities of Albania..

Watson (2010) argues that networking is significantly positively associated with firm survival and, to a lesser extent, growth. Albania do not show any significant improve in the policy dimension of Internalization of SME (Figure 1) . Being part of The Enterprise Europe Network, would provide a wide range of services to SMEs and entrepreneurs such as helping them to access market information, overcome legal obstacles and identify potential business partners across Europe, including innovation support and transnational technology transfer services.

Conclusions

The SME contribution in the economy is crucial as they are the biggest contributors in the GDP, job creation, innovation. The Small and Medium Enterprises access to external sources of financing is constraint from different factors such as the size, the origin of the capital, the performance, asymmetry in the information, etc. SME are the main contributor to the growth and employment in a country, therefore the role of the government is fundamental to improve their position in the credit market. Generally, they rely on internal finance sources such as retaining earning or trade credit. The main external source is the banking system, which implies higher interest rates, substantial collateral and longer formal procedures. There is an improvement in alternatives of external sources such as microfinance and leasing entities which offer a cheap and shorter way of obtaining financing. Despite the progress that Albania has made regarding the legal framework, the government has a key role to sustain and promote the business angels networks, a valuable source for early stage business, to improve the efficiency of the stock exchange, to increase the awareness regarding the significance of financial literacy, to promote new financial instrument such as venture capital and private equity fund, to promote the participation in the Enterprise Europe Network

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Appendix

APPENDIX 1. TRANSITION INDICATORS FOR ALBANIA FOR THE PERIOD 1990-2012

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Large scale privatization	1.0	1.0	1.0	1.0	1.0	1.0	2.0	2.3	2.3	2.3	2.7	2.7
Small scale privatization	1.0	1.0	2.0	2.0	3.0	3.0	4.0	4.0	4.0	4.0	4.0	4.0
Governance and enterprise restructuring	1.0	1.0	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Price liberalization	1.0	1.0	1.0	2.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7	4.3
Trade & Forex system	1.0	1.0	1.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.3
Competition Policy	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.7	1.7	1.7	1.7	1.7

Source: EBRD

APPENDIX 1. TRANSITION INDICATORS FOR ALBANIA FOR THE PERIOD 1990-2012

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Large scale privatization	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.3	3.7	3.7	3.7	3.7
Small scale privatization	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Governance and enterprise restructuring	2.0	2.0	2.0	2.0	2.0	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Price liberalization	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3
Trade & Forex system	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3
Competition Policy	1.7	1.7	1.7	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.3	2.3

Source: EBRD

APPENDIX 2. THE BREAKDOWN OF SME IN ALBANIA
FOR THE PERIOD 1994- 2012

Year	Source of SME Data	SME definition (number of employees)			SME in percentage		
		Micro	Small	Medium	Micro	Small	Medium
2012	INSTAT	1-9	10-49	50-249	95.4	3.7	0.9
2011	INSTAT	1-9	10-49	50-249	95.2	3.9	0.9
2010	INSTAT	1-9	10-49	50-249	95.7	3.5	0.8
2009	INSTAT	1-9	10-49	50-249	95.8	3.4	0.8
2008	INSTAT	1-9	10-49	50-249	96.2	3.0	0.8
2007	INSTAT	1-9	10-49	50-249	95.5	3.6	1.0
2006	INSTAT	1-9	10-49	50-249	96.1	2.9	1.0
2005	INSTAT	1-9	10-49	50-249	96.3	2.8	0.9
2004	INSTAT	1-4	5-19	20-49	91.3	7.2	1.5
2003	INSTAT	1-4	5-19	20-49	91.8	7.0	1.2
2002	INSTAT	1-4	5-19	20-49	92.4	6.6	1.0
2001	INSTAT	1-4	5-19	20-49	92.6	6.6	0.8
2000	INSTAT	1-4	5-19	20-49	92.9	6.1	1.0
1999	INSTAT	1-4	5-19	20-49	93.5	5.7	0.8
1998	INSTAT	1-4	5-19	20-49	93.0	6.1	0.9
1997	UNECE	0-9	10-49	50-249	97.8	1.5	0.7
1996	UNECE	0-9	10-49	50-249	97.6	1.6	0.7
1995	UNECE	0-9	10-49	50-249	98.5	1.4	0.1
1994	UNECE	0-9	10-49	50-249	98.3	1.6	0.2

Source: Albanian Institute of Statistics