The Impact of Access to Finance in Performance of Formal and Informal SMEs: Evidence From Kosovo

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Abstract: It is commonly acknowledged fact that access to finance has a large impact on the firms' performance. On the other hand, the overall macroeconomic, legal, regulatory and financial framework is assumed to be a critical determinant of firms' access to finance. Firms in countries with higher levels of institutional development report lower financing obstacles than firms in countries with less developed institutions. Due to the information asymmetries, SMEs are more likely to be charged relatively high interest rates and asked for higher collateral and loan guarantees. Moreover, informal firms have significant gaps in information, credibility and skills needed to access external finance and they report higher obstacles than formal firms. The empirical evidence shows that use of loans and bank accounts for business by informal firms is very low and a significant majority of firms finance their day-to-day operations and investments through sources other than financial institutions such as: internal funds, moneylenders, family and friends. In this context, Kosovo represents an interesting example, where studying the impact of access to finance on businesses in both formal and informal sector represents a challenging task. Namely, during the past two decades Kosovo has been undergoing through transitional process which is characterized by dynamic and unstable business environment including large share of informal economy. Having in mind the above considerations, the aim of this paper is to assess the access to finance as a determinant of SMEs performance in Kosovo by paying attention to the differences between formal and informal businesses. For this purpose we use results from a survey on 1.250 SMEs. The analysis will include calculating the common summary statistics and drawing statistical inference based on standard hypotheses testing. Finally, we will provide some policy recommendations aiming to reduce barriers encountered by SMEs while accessing external finance.

Keywords: Small and medium enterprises, access to finance, informal sector

1. Introduction

SMEs in many countries have become the major contributor to employment, GDP growth as well as economic development. The number of those firms has grown considerably during the last decade showing that they are of crucial importance for job creation and economic growth in developed and developing countries. Though, in order to increase their entrepreneurial activities they need support of institutional policies and access to external finance in appropriate conditions. The lack of access to finance weakens the potential of SMEs to contribute to the creation of new jobs, productivity and value added.

In the OECD area SMEs employ more than half of the labor force in the private sector. In the European Union they account for over 99% of all enterprises. Furthermore, 91% of these enterprises are micro-firms with less than 10 workers. Given their importance in all economies they are essential for economic development (OECD, 2009). The SMEs represent a factor of balance at the micro and macroeconomic level. Having as the correspondence the middle class in the society, the SMEs counter balance the monopolies and oligopolies, reducing the capacity of the big companies in controlling the market. In the circumstances where the economic environment is in a permanent change, the SMEs are flexible and they have a great capacity of adjustment, encouraged by the low dimensions and the fast decision making process (Savlovschi and Robu, 2011). SMEs are generators of entrepreneurial activity which is very important for transition process, since it is a good source for economic growth through job creation and offering a wide variety of products and services (McMillan and Woodruff, 2002).

The overall macroeconomic, legal, regulatory and financial framework is the critical determinant of firms' access to finance. Poor protection of shareholders, poor contract enforcement, corruption, poor accounting standards, heavily restricted banking systems, and high inflation tend to have underdeveloped financial systems, which in turn imposes constraints to firms that are willing to borrow from the banks (Demirkuc-Kunt and Levine, 2008). Evidence suggests that banks are more conservative when they provide loans to SMEs (Zhou and de Witt, 2009). Due to the information asymmetries, SMEs are more likely to be charged relatively high interest rates and asked for high collateral and loan guarantees (Stiglitz and Weiss, 1981). Similarly, Beck (2007) in his empirical research found that SMEs are more constrained by financing and other institutional obstacles than large enterprises, impacted by the weaknesses in the financial systems of many developing countries.

Firms in countries with higher levels of institutional development report lower financing obstacles than firms in countries with less developed institutions. The positive effect of financial and institutional development can also be observed in the use of external finance. Better protection of property rights increases external financing of small firms significantly more than it does for large firms, particularly due to the differential impact it has on bank and supplier finance (Beck et al., 2004b). Many expected benefits of financial consolidation and liberalization are not achievable before institutional development reaches a certain adequate level (Beck et al. 2004; Maurer 2008). Risteska et al. (2014) on the basis of the performed analysis of SMEs in Macedonia have identified the following issues as problems: lack of initial capital; frequent changes in legal regulation; high interest rates; insufficient and unstable consumption; strong competition from the big companies.

In addition, it is worth mentioning that informal economy represents a large share of economic activities of the country. Formal firms can engage with economic and legal institutions for sustaining their activity such as: engaging with chamber of commerce for entering the market, with banks for credit, with courts for contract enforcement and liquidation procedures, with local and international agencies for grants and consultations, with insurances in case of injury or sickness, etc. In contrast, most informal firms have to cope with the exclusion from these institutions facing certain barriers of external environment and lack of support. Due to institutional barriers and lack of access to finance informal firms are marginalized and could not enhance their survival and growth aspiration. Benefits provided by developed institutional context can motivate informal firms to join formal sector. Theory provide that scale down of institutional barriers and offering more attractive services to formal firms such as: easy access to finance, low cost of finance, grants, infrastructure, consultancy support, public procurement opportunities which attracts informal firms to shift to formal economy (De Soto, 2000; Ayagari, 2005; Levine, 2008; La Porta et al., 2014).

Informal firms have significant gaps in information, credibility and skills needed to access external finance and they report higher obstacles than formal firms. Utilizing data on informal firms collected by World Bank's enterprise survey (Farazi, 2014) shows that use of loans and bank accounts by informal firms is very low and a significant majority of firms finance their day-to-day operations and investments through sources other than financial institutions such as: internal funds, money lenders, family and friends. Most of the firms would like to register but tend not to opt for it due to tax reasons and state that relatively easier access to finance would be the most important benefit they could obtain from registering. The owners of informal firms typically lack financial education, often lack adequate financial records, business and credit history, and also do not have acceptable collateral when asking for a loan (Hommes et al., 2015).

The paper proceeds as follows: The first section present a brief summary of the literature concerned with access to finance of SMEs in formal and informal sector. In section 2 we will explain the importance of SME sector and business climate. In section 3 we provide means of financing gap as barrier for SMEs. In section 4 we explain differences between SMEs in formal and informal sector. In section 5 descriptive statistics are presented for both samples of the formal and informal sector. Then in section 6 we analyze differences regarding access to finance in the formal and informal sector. Finally, we provide conclusions and some policy recommendations aiming to reduce financing barriers encountered by SMEs.

2. The importance of SME sector and business climate

SMEs promote market diversification, enhance innovation, provide employment opportunities and contribute to economic growth. SMEs in 2014 accounted for 99.8 % of all enterprises of the non-financial business sector in EU. Moreover, in 2014, 22.3 million SMEs were active across EU and they employed almost 90 million people which represents 67% of total employment, and generated 58% of the sector's value added. Majority of SMEs are micro companies employing less than 10 people (93%). About three quarters of SMEs are active in the five key sectors: trade, services, construction, manufacturing, and accommodation and food services (EC, 2015).

It is a widely acknowledged fact that SMEs are the backbone of the European economy. Different countries set various definitions to SMEs. For instance, in EU SMEs are defined as businesses which employ less than 250 staff and have an annual turnover of less than EUR 50 million. They comprise three categories of enterprises namely micro, small and medium sized enterprises (EC, 2015). However, based on EU recommendations there are two main factors that determine whether the business is part of SMEs category. These two factors are the number of employees and business turnover or balance sheet (Table 1).

Table 1. SME category in the EU

Firm sized	Employees	Turnover or	Balance sheet
Medium	< 250	< € 50 m	< € 43 m
Small	< 50	< € 10 m	< € 10 m
Micro	< 10	< € 2 m	< € 2 m

Source: European Commission, SME annual report 2015

Unlike the EU definition of SMEs in Kosovo the only criterion that determines whether the firm is micro, small or medium is the number of employees (Table 2).

Table 2. Category and structure of SMEs in Kosovo

Firm sized	Number of employees	Enterprises		Employees	
		Number	Share	Number	Share
Micro size	1 - 9	43,735	95 %	86,360	45.6 %
Small size	10 - 49	1,940	4.2 %	35,546	18.7 %
Medium size	50 - 249	310	0.7 %	31,094	16.4 %
Large size	250 or more	47	0.1 %	36,623	19.3 %
Total		46,032	100.0 %	189,623	100.0 %

Source: KOSME Report on SMEs in Kosovo, 2014

As we can see from Table 2 the Kosovo's economy is based on small and medium sized enterprises (SMEs) as engine of employment and growth. According to Tax Administration of Kosovo about 46000 SMEs have been actively operating in 2013. SMEs represent 99.9% of total number of firms and they employ about 80% of people in the private sector. Besides the positive impact of SMEs on employment opportunities, they have considerable contribution on raising incomes, living standards of people, diversification of products and services, innovation, competitiveness, and GDP growth. Similarly, the Organization for Economic Cooperation and Development (OECD) reports that more than 95% of enterprises in OECD area are SMEs expected to play a crucial role in growth of GDP and that will employ the largest part of workers (OECD, 2009). In Table 3 is presented the contribution of micro, small, medium and large enterprises in Kosovo's GDP according to Kosovo Tax Administration (KTA).

Table 3. The share of SMEs participation in GDP of Kosovo

Firm size	Number of firms	Turnover ('000€)	Share of GDP (%)
Micro	14,968	656,885	16.79
Small	1,210	667,585	17.07
Medium	185	369,455	9.44
Large	58	528,558	13.51
Total	16,421	2,222,485	56.81

Source: MTI, SMEs Development Strategy, 2012-2016

Based on the data above we can see that total annual turnover of SMEs in Kosovo in 2012 was 43.3%. Obviously, the share of SMEs participation in the GDP is quite high, giving them a significant role in the economic development of the country.

Kosovo's economy suffers huge deficit on trading balance which raises the need for analyzing the impact of business environment on performance of enterprises. Due to the weak business environment, SMEs in Kosovo are not competitive in international market. Weak export potential limits the contribution of firms to GDP, job creation and economic development. Exports are dominant in the sector of base metals and minerals produced by large companies. Dollars *et al.* (2006) show that the business environment affects the minimum level of productivity needed for a firm to export and thus only most productive firms find exporting profitable. Therefore, strengthening and developing the SME sector is a policy priority of the Kosovo's government. This is particularly reflected in the government's 'Private Sector Development Strategy 2013-2017' as well as in the 'SME Development Strategy 2012-2016' which aims to create a SME-friendly business environment, promote an entrepreneurial culture, and raise the competitiveness of SMEs. The government has also established a dedicated institution, the Kosovo Investment and Enterprise Support Agency (KIESA) operating under the Ministry of Trade and Industry (MTI), which alongside of promoting foreign investments is responsible for supporting policies and programs for SMEs (KOSME, 2014).

Although facing a numerous obstacles SMEs in Kosovo have become the major contributors to employment as well as economic development. Though, in order to increase their entrepreneurial activities they need support of institutional policies and access to external finance in appropriate forms. Based on the World Bank doing business report, Kosovo is ranked 66th out of 189 countries in 2016. In Table 4 are presented some of the indicators improved in 2016 compared to 2015.

Table4. Rank of indicators of doing business in Kosovo in 2015 and 2016

Indicator	Rank in 2015	Rank in 2016	Progress/Deterioration
Ease of doing business rank (1-189)	75	66	
1. Starting a business	42	47	Deteriorated
2. Dealing with construction permits	136	136	Stagnant
3. Getting electricity	112	124	Deteriorated
4. Registering property	34	32	Improved
5. Getting credit	23	28	Deteriorated
6. Protecting investors	62	57	Improved
7. Paying taxes	63	67	Deteriorated
8. Trading across borders	118	71	Improved
9. Enforcing contracts	138	48	Improved
10. Resolving insolvency	164	163	Improved

Source: World Bank Doing Business Report, 2015 & 2016

Despite the fact that the business environment in Kosovo is improving with regard to indicators measured by ease of doing business report, there are other serious barriers that World Bank does not take into account in its annual report. For example, getting credit is easy, but cost of credit is extremely high. In addition, the 2014 corruption perception index ranks Kosovo 102nd out of 175 countries indicating high level of corruption in public sector of the country. Some other barriers such as political instability and small market hinder domestic and foreign investments in SME sector. Due to high cost of credit funds, SMEs finance their business through internal funds rather than bank credits.

There are several surveys over the past few years that assess the factors which affect the ability of Kosovo SME sector to grow and survive, as well as the motivation, opinions and perceptions of SMEs managers (e.g. EBRD, 2010; BSCK, 2012; World Bank, 2013; KOSME, 2014; Riinvest Institute, 2014). These surveys suggest that the main obstacles to the development of SMEs are related in the first place to financial shortcomings (lack of access to finance, high interest rates) and institutions (regulations, rule of law, lack of SMEs support, bureaucracy). In addition, there have been problems relating to market conditions (poverty of people, small market demands and lack of access to international markets) labor force problems (shortage of managerial and skilled labor), political instability and corruption. Although, infrastructure (lack of energy power supply and lack of water supply, transport) has improved, it is still among barriers for SMEs growth. The ranking of barriers has changed in the last ten years, but the factors mentioned above have remained among the main constraints to SME development, and in fact the government has not done enough to alleviate these problems.

3. Financing gap

The financing gap is prevalent in economies around the world. It is regarded as a huge barrier that interrupts development of SMEs. Financing gap is a term that is typically meant to imply that sizeable share of SMEs cannot obtain financing from banks, capital markets or otherwise suppliers of finance for their business activities because the flow of credit would be affected by changes in either the demand or the supply of credit (Quaye et al., 2014). As we mentioned earlier SMEs are the backbone of all economies and therefore financial means are more crucial for this type of firms. Increased information on all aspects of SME market development could promote SME financing, as financial institutions would be better able to judge the attractiveness of the segment and adapt their business models to serve it. In order to get a more complete picture of the SME finance landscape, systematic efforts should be launched to estimate the number of SMEs in the informal sector as well as to examine their access to financial service (IFC, 2010). Financing gap occurs when there is less supply of funds compared to demand for funds requested by SMEs. According to OSCE (2014) an actual financing gap exists if firms that merit financing cannot obtain it due to the existence of market imperfections.

Even though small companies are not multinational, they all face the same issue in their early stage – providing means to enable them to start up the business and test their product or service. If SMEs cannot find the financing they need, brilliant ideas and entrepreneurial activities may fall by the wayside and this represents a loss in potential growth for the economy. (Barth et al. (2011) argue that SMEs from countries with higher levels of non-performing loans encounter greater financing obstacles. Banking sectors with higher ratios of non-performing loan indicate higher default risks. Thus, banks tend to charge higher interest rates, require larger collateral value and undertake more prudent lending for SMEs (De la Torre et al., 2008). This phenomenon is more present in transition economies. SMEs with larger market potential are easier to access credits. The type of industry is another feature that determines the SMEs demand for finance. In this context, Levine (2004) argues that SMEs in manufacturing industries need higher amount of finance to achieve their growth objectives. On the other hand, Silva and Carreira (2010) argue that due to lack of assets firms in service sector avoid long term lending.

More developed banking sector contributes positively to SME's access to both short- and long-term loans. Banks from more developed banking systems provide loans with average longer duration and lower annual interest rates (Barth et al., 2011). In general, financial access in developing countries is observed to be much lower compared to that in developed countries. Developed financial markets provide payment services, mobilize deposits, and ease investment financing. Efficient financial markets reduce the reliance on internal funds and on money from informal sources such as family and friends by connecting firms to a broad range of lenders and investors (IFC, 2013).

SMEs have significant gaps in information and skills needed to access external finance. Some of barriers that hinder allocation of funds to SME sector are: asymmetric information, lack of trust between SMEs and banks, lack of management skills, poor business plans of the SMEs, lack of track record and collateral in SMEs, and lack of institutional support to protect investment and enforce contracts. Beck (2007) argue that transaction costs and asymmetric information between borrower and lender are the driving factors explaining the limited access to external finance by many SMEs in developing as well as developed economies. Removing regulatory obstacles could also significantly increase SMEs' access to finance. In addition, more efficient courts and legal procedures have the potential to reduce enforcement costs for lenders (IFC, 2010).

A significant number of entrepreneurs and SMEs could use funds productively if available, but are often denied access to financing, thus impeding their creation, survival and growth. Although, SMEs represent a wide spectrum with respect to their relative size, sector of activity, seniority, location and performance, there is a vital need for innovative solution for their financing in a globalized knowledge-based economy (OECD, 2009). Access to finance has been identified as a key element for SMEs to succeed in their drive to build productive capacity, to compete, to create jobs as well as contribute to poverty alleviation in developing countries. Without finance SMEs cannot absorb new technologies nor can they expand to compete in global markets or even strike business linkages with larger firms (Quaye et al., 2014). Berger and Udell (1995) argue that lending records of SMEs are important to obtain bank loans. The experience in business means that SMEs may have accumulated assets to meet the collateral requirements in order to access credits from banks.

4. Formality vs. informality

The informal economy is larger in developing rather than in developed countries. Estimating the size of the informal economy in 110 developing, transition and OECD countries, Schneider (2002) found that the average size of the informal economy as a percent of official GNI in 2000, in developing countries was 41%, in transition countries 38% and in OECD countries 18%. Moreover, the informal economy in developing countries is growing rather than shrinking (USAID, 2005). Though, it is a part of developed modern economies make us understand that informality is a long-term or permanent issue in the economy. Informal economy compounds no simple definition. For example, firms may license or register but they pay few taxes, or avoid paying at all. In the case of Kosovo, due to easy procedures and free of charge registration, firms can be registered but many of them avoid taxes or do not declare employees subsequently avoiding tariffs and social contributions. According to Chen (2007) the new definition of the informal economy focuses in the nature of employment in addition to the characteristics of enterprises. Thus, the informal economy is comprised of all forms of “informal employment” that is employment without labor or social protection inside and outside informal enterprises, including both self-employment in small unregistered enterprises and wage employment in unprotected jobs.

According to De Soto’s romantic view on informality (1989) informal firms are reservoirs of productive entrepreneurial energy. He argues that informal firms would like to become formal but are held back by government taxes and regulation, the lack of secure property rights, as well as access to finance. By this view, De Soto explains that informal firms are fundamentally similar with formal ones but are kept down by policy. If institutional barriers would scale down informal firms would get formalization, borrow and get benefits of being formal, and by doing so would contribute to expand economic growth. In contrast, La Porta and Shleifer (2014) argue that informal firms exhibit low productivity and rarely make transition to formality. Government policies represent obstacle to informal firms, but they are obstacle to formal firms as well. Informal firms generally are run by uneducated entrepreneurs and they add little value.

The evidence in the research of La Porta and Shleifer (2014) appears consistent with Lewis’s (1954) dual view of informality, which sees the formal and informal economies as largely segregated, producing different products with different labor, capital, and entrepreneurial inputs, and serving different customers. Namely, different economic forces on both the demand and the supply side keep the two sectors separate. In such economies, the informal sector delivers low-quality goods cheaply to people who are themselves informal workers and who cannot afford the output of the higher-quality but more-expensive formal sector. In contrast, the formal sector remains small and offers high quality goods to a minority of formal workers (La Porta and Shleifer, 2014).

Another issue that makes distinction between formal and informal firms is the skills of employees they hire. Formal firms hire most often higher skilled employees comparing to informal firms. Skilled employees deliver high quality output and based on their performance get more payment. Similarly, high quality managers prefer to work for formal firms. Accordingly, they are willing to pay taxes and bear the cost of government regulations in exchange for being able to advertise their products, access external capital, and access public goods. In contrast, low quality managers avoid taxes and regulations, since the benefits operating in the formal economy are less valuable for small firms (La Porta and Shleifer, 2008).

Formal firms have to pay taxes and comply with regulations, so they have a cost disadvantage relative to the informal firms. On the other hand, they have institutional support such as: grants, access to finance, public service utilities. Joining the formal sector would raise the costs of informal firms, but the benefits they could receive by formalization may outweigh taxes and other employee social contribution payments. With this respect, government policies and regulations are determinant of the size of informal sector. Schneider (2002), argue that a large burden of taxation and social security contributions combined with government regulations are the main determinants of the size of the informal economy.

Using the dataset of firms across 43 countries Williams (2013) argue that informal sector enterprises employ a sizeable share of the total workforce and that marked cross national variations exist in the proportion employed in informal sector enterprises, which is associated with the level of GNP per capita, public sector corruption, tax rates, level of social contributions and poverty rates. Employment in informal sector enterprises is more prevalent in economies where there is greater poverty and less protection of workers facing marginalized population. With respect to this, Nikoloski et al. (2012) argue that in depressed labor markets which lack job creation in the formal sector, informal employment helps people to enter the workforce by offering an alternative to unemployment or inactivity and, prevents a further decline in living standards.

5. Empirical analysis

In order to determine whether the access to finance have an impact in performance of formal and informal SMEs, we have undertaken assessment in both sectors. The assessment was based on the surveys carried out on representative sample of SMEs in formal and informal sector. The first survey with formal 1,000 SMEs was carried out by Riinvest Institute in all regions of Kosovo and including firm activities in different sectors. The sample of SMEs was stratified by the database of SMEs taken by Tax Administration of Kosovo. The second survey with sample size of 250 informal businesses was carried by using the same questionnaire modified to informal sector specifics. The surveys were carried out in the similar way with regard to geographic and sector distribution in all regions of Kosovo and including main sectors of economic activity of SMEs such as: service, trade, production and construction. As data are scarce and there is no database of any public agency that contains evidences of the informal SMEs, the sample was selected by applying snowballing techniques.

The study will get analysis for the impact of access to finance in performance of formal and informal SMEs. For this purpose we use results from a survey on 1.250 SMEs to find similarities and distinction about the impact of access to finance in formal and informal businesses. The analysis will include calculating the common summary statistics and drawing statistical inference based on comparison of two populations.

There are two main sources to obtain data of businesses operating in the formal sector: Business Registration Agency (ABRK) and Kosovo Tax Administration (KTA). For the purpose of the study KTA data is being preferred over ABRK data for the reason that ARBK business register is not cleared accordingly and contain many inactive firms. However, the inconvenience is that data from official register do cover only formal economy but not the informal economy. The survey on SMEs has been conducted in order to obtain further information on the feature, obstacles and support needs of SMEs to easier access finance. The sample of the survey has been designed in such a way to take account business environment obstacles for SMEs, and to provide results for the main sectors, size categories and regions of Kosovo.

On the other hand, there is no official register over informal businesses. The main criterion for inclusion in the sample is that business is not registered at all. After the survey carried out in informal sector the impression is that the number of businesses not registered at all is large. However, it is not possible to approximate the number of informal businesses or to estimate their proportion compared to formal businesses. Due to the lack of official registers and the tendency of these businesses keep their activities hidden from public authorities it is very challenging to gather the necessary data from them for the purpose of empirical study. Therefore, the most appropriate form of approaching informal businesses was snowball technique. Snowball sampling is a special non-probability method e for developing a research sample where existing study subjects recruit future subjects from among their acquaintances. This sampling technique is often used in hidden populations which are difficult for researchers to access, or in cases where a sampling frame is hard to establish and it is assumed that cases are affiliated through links that can be exploited to locate other respondents based on existing one (Katz, 2006). The sample structure of the informal businesses has been similar with that of the formal sector regarding enterprise size category, sectors of activity and geographic distribution. The summary descriptive statistics for both samples of formal and informal sectors is given in Table 5.

Table 5. Size categories in the samples of formal and informal SMEs

Size categories	Formal sector sample		Informal sector sample	
	Number of businesses	Share	Number of businesses	Share
1 - 9 persons employed	856	85.60%	225	90%
10 - 49 persons employed	123	12.30%	22	8.80%
50 - 249 persons employed	21	2.10%	3	1.20%
Total	1,000	100%	250	100%

From the Table 5 we can see that in the sample of 1,000 formal businesses majority of businesses (85.6%) belong to the micro sized enterprises with 1 to 9 persons employed. Small sized enterprises employing 10 to 49 persons are represented with 12.3%, while the rest in the sample are medium sized businesses represented with 2.1% of the total number. The representative sample has been extracted from the business register of KTA with categorizing of SMEs accordingly.

On the other hand in the sample of 250 informal businesses 90% belong to the micro size enterprises with 1 to 9 persons employed. The share of small businesses represents 8.80%, while the share of medium businesses is only 1.20%. The formal sector consists of 95% of micro sized enterprises. Based on our experience from previous research, the informal sector comprises more than 95% micro size enterprises with 1 to 9 persons employed. Businesses with larger number of employees and capital turnover are more difficult to survive in the informal sector. Therefore, businesses that aim at business consolidation and growth need to be formalized in order to benefit most from external environment, particularly in the possibility of easier access to financing and institutional support. Most frequent cases where informal businesses can be found with larger number of persons employed are those in farming and agriculture or production respectively (Table 6)**.**

Table 6. Distribution of the sample of formal and informal businesses over sectors of business activities

Sectors	Formal sector sample		Informal sector sample	
	Number	Share	Number	Share
Service	428	42.80%	64	25.60%
Trade	434	43.40%	80	32%
Production	110	11%	95	38%
Construction	28	2.80%	11	4.40%
Total	1000	100%	250	100%

From Table 6 we can see that SMEs sample of formal sector consists of 42.8% of businesses in the service sector, 43.4% of businesses in the trade sector, 11% of businesses in the production sector, and 2.8% of businesses in the construction sector. A sector analysis provides more details inside SMEs in Kosovo. Based on KTA register trade constitute dominant sector with share of 43% of the total number of enterprises. Service sector is on the second place with 33%, followed by the production sector with 12 % of enterprises, while construction sector contain 7% of enterprises (KOSME, 2014).

Also, in Table 6 we can note that sample of informal sector is divided in four main sectors of economic activities. Production sector contain more informal businesses compared to other economic sectors, it is represented by 38% of businesses. As small units they are located in different locations and usually they sell their products in open markets across regions in Kosovo, but they cannot export. Moreover, in the informal sector the number of businesses in the production is greater compared to other sectors of business activities. Most of the informal businesses in the production sector are among those for production of household furniture, farms and agriculture businesses.

Trade sector also contain large number of informal units, since it is represented by 32% of the total number of businesses. These types of informal businesses in many cases sell products in different markets across regions in Kosovo. Service sector is represented by 25.6% of businesses. Although this sector is among largest in the formal sector, this is not the case in informal sector because it is most difficult for these companies to operate without registration and licensing permits. Finally, construction sector is represented with 4.4% of the total number of businesses. Despite we have interviewed small number of units, construction sector contain a large number of the informal businesses, and they are in most cases micro size category employing between 1 to 9 employees. Due to specifics of the work, for reasons that those businesses have no certain locations where they offer services, and they conduct their work at different locations make it difficult to be interviewed.

Table 7 Average salary for employees in formal sector vs informal sector

Sectors	Average salary	Salary Increase/SMEs		Salary Decrease/SMEs		No change/SMEs	
		Number	share	Number	share	Number	share
Formal	228.1	340	34%	121	12.10%	539	53.90%
Informal	246.82	23	9.44%	125	50%	102	40.56%

From Table 7 we can see that the average monthly salary that businesses pay for employees in the formal sector in Kosovo is € 228.1. Moreover, 34% of businesses claimed that their salaries increased in the last four years, 12.10% of businesses claimed that their salaries decreased, while more than half (53.9%) of businesses claimed that their salaries have not changed. On the other hand, the average monthly salary that informal businesses pay for their employees is € 246.82. Moreover, only 9.44% of businesses claimed that there has been increase, 50% of businesses claimed that there has been decrease, while 40.56% claimed that there has been no change in the level of salaries in the last four years.

We can note that informal businesses work in critical conditions with only few of them having increase of salaries, while most of them have decline or no change in salaries. Furthermore, informal businesses have had more declines in the salaries compared to formal businesses. Though, the average salary for the time being is higher in informal businesses, this has been changing in favor of formal businesses for the reason that in the last four years has been less decrease, respectively more increase in the salaries in the formal sector compared to informal sector. Due to slightly improvement of the business environment formal businesses could receive more support from institutions, while informal businesses could be further marginalized and threaten by strong competition. Therefore, the trend of salaries could continue to increase in the formal sector more than in the informal sector.

Table 8 average number of employees and growth of businesses by number of employees in formal vs. informal sector

Region	4 years ago	Now		4 years from now (forecast)	
	Av. Number	Number	Increase/decrease	Av. Number	Increase/decrease
Formal	5.81	6.77	16.66%	8.63	27.35%
Informal	4.7	4.59	-2.44%	4.48	-2.39%

From Table 8 we can see that the average number of persons employed within the sample of formal sector is 6.77, while the average number of persons employed within the sample of formal sector is

4.59. This difference indicates that informal businesses are smaller than formal businesses in terms of employed personnel. Our analysis based on business growth in terms of employment in both sectors shows that formal sector had average growth in the last four years by 16.66%, while informal sector had negative growth or decline by -2.44%. Moreover, employment forecast in the next four years in both sectors shows that businesses in the formal sector is expected to have increase in the number of employees by 27.35%, while businesses in the informal sector is expected to have decline in the number of employees by -2.39%. These trends of employment in both sectors indicate that formal sector enjoys better performance over informal sector in terms of growth of the number of employees.

6. Access to finance in the formal sector vs. informal sector

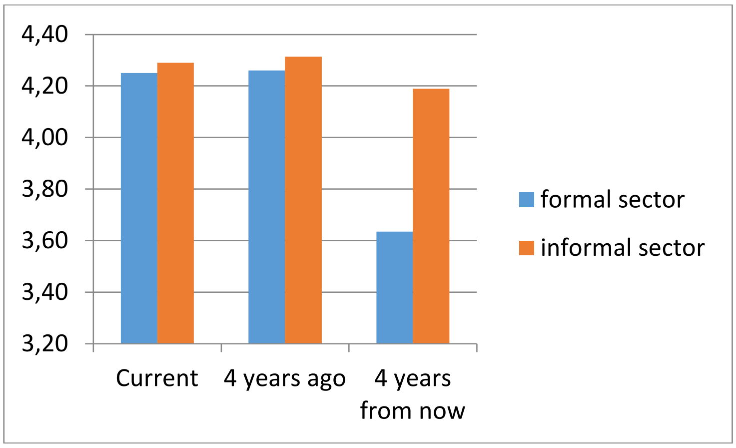
Access to finance is very important determinant for starting and growing businesses. Businesses can count on two main sources of finance: internal and external. For the purposes of the study we are interested to know the obstacles of enterprises to access external finance and the assessment of differences between formal and informal sector in accessing finance. In this context, we have introduced three potential barriers that determine the use of external finance for businesses such as: limited access to finance, high cost of finance and the lack of grants. In order to scale responses we apply the most widely used Likert scale with the following modalities: 1-not an obstacle, 2-small obstacle, 3-neutral; 4-obstacle; 5 big obstacles. In the figures below we represent summary of the answers and comparisons between the two sectors: formal and informal regarding the access to finance.

Figure 1: Limited access to finance: current, 4 year ago and 4 years from now in the formal and informal sector.

From Figure 1 we can see that assessment for limited access to finance based on the perception of businesses in the formal and informal sector is done in three intervals: now, four years ago, and four years in the future. Formal businesses perceive limited access to finance as an obstacle to business operation and growth more than informal businesses. However, formal businesses foresee an improvement in limited access to financing, while informal businesses perceive that limited access to financing will be relatively the same after four years.

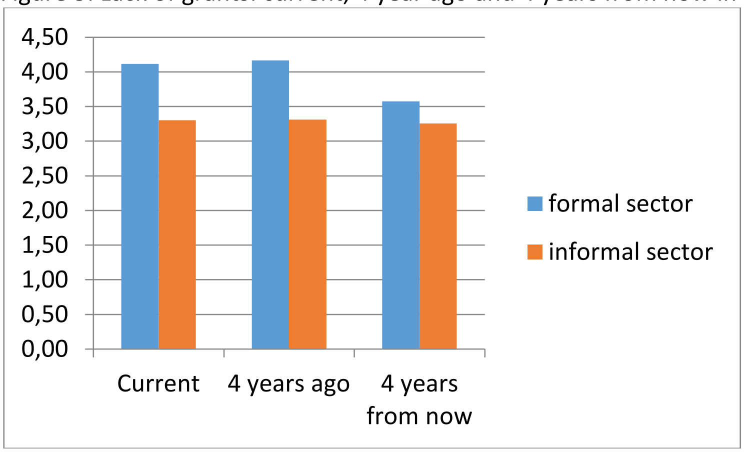
Informal businesses are not well consolidated and mostly have a lack of growth objectives. Due to the fact of operating in the informal sector they do not count so much in accessing external finance. Moreover, informal businesses in most cases keep working with the aim of self-employment and maintain the survival rather than growth. In such circumstances they mainly rely on internal finance and other informal sources of financing. Some of the informal businesses are not interested in external finance for reasons that they have no profitable investment projects and have difficulties to return due to the very high interest rates.

Figure 2: High cost of finance: current, 4 year ago and 4 years from now in the formal and informal sector



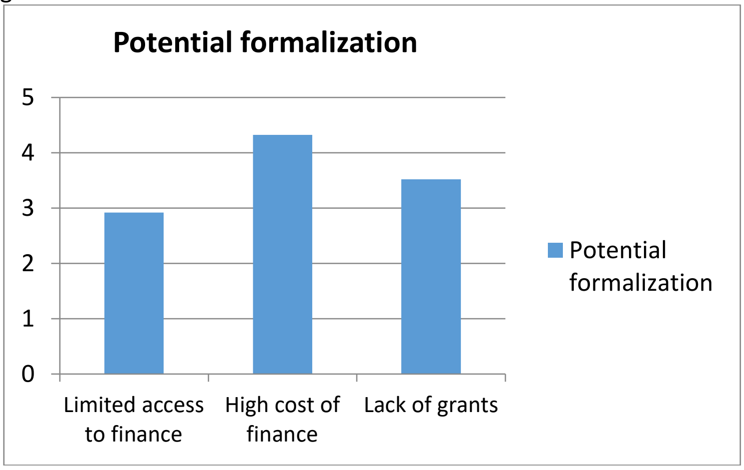
From Figure 2 we can note that for both sectors: formal and informal the cost of finance is major obstacle that impedes business operation and growth. Informal businesses compared to formal businesses assess the high cost of finance as the biggest obstacle. In the next four years, formal businesses perceive that high cost of finance will be less of an obstacle in their operation and growth. Most likely, they are optimistic that cost of finance, consequently interest rates will move downward. On the other hand, informal businesses perceive that cost of finance or interest rates will remain high and therefore will be an obstacle to their operation and growth. Due to high cost of finance many businesses, particularly those of informal sector entirely avoid application for the loans.

Figure 3: Lack of grants: current, 4 year ago and 4 years from now in the formal and informal sector



From Figure 3 we can see that lack of grants is obstacle for both formal and informal sector. Though, this is more obstacles for formal businesses compared to informal businesses. With this respect, formal businesses differ from informal businesses by several features such as: they register and pay taxes as well as other social contributions; in turn they expect more institutional support through grants and access to finance in appropriate conditions. Moreover, formal businesses in comparison with informal businesses have more expectations for reasons that are more capable in their organization, skills and education, preparation of business plans, so as a result they find easier fulfillment of certain criteria for obtaining grants. Therefore, those businesses assess the lack of grants as an obstacle for their operations and growth.

Figure 4: Potential formalization barriers: limited access to finance, high cost of finance, and lack of grants



In order to get assessment of informal businesses about financing obstacles that impede formalization of businesses we have also addressed this problem with Likert scale survey questions as following: 1-not an obstacle, 2-small obstacle, 3-neutral; 4-obstacle; 5 big obstacles.

From Figure 4 we can see that among financing barriers high cost of finance is biggest obstacle that impedes potential formalization of businesses, followed by lack of grants, and finally limited access to finance is the smallest obstacle that could affect the potential formalization of businesses.

7. Conclusions and policy recommendations

This paper has shown the importance of access to finance in performance of businesses in the formal and informal sector. Over the last few years SME sector in Kosovo has grown in terms of businesses and employment. Formal SMEs during last four years have outperformed informal SMEs in terms of employment. According to perception of SMEs in formal and informal sector it is forecasted that formal SMEs will continue perform better than informal SMEs in terms of employment in the next four years. Moreover, SMEs in the informal sector are being contracted in terms of employment. Regarding size category authors of the research have observed that informal SMEs are smaller compared to formal SMEs. Based on the survey experience of the researchers informal sector comprises more than 95% by micro size enterprises with 1 to 9 persons employed. With this respect, businesses with larger number of persons employed and turnover of capital have more difficulties to survive in the informal sector. Therefore, businesses that aim at business consolidation and growth need to be formalized in order to benefit most from external environment, particularly in the possibility of easier access to financing and institutional support. Moreover, In order to ease access to finance emerging economies need to strengthen incentives for SMEs to move into the formal sector (Levine R. 2002).

The study has found that formal businesses perceive limited access to finance as an obstacle to business operation and growth more than informal businesses. On the other hand, high costs of finance hinder businesses of both sectors, though it is greater obstacle for informal sector rather than formal sector. Informal businesses face mistrust by financial institutions and due to the fact of operating in the informal sector they do not count that much on accessing bank finances. Instead, they rather rely on internal finance and other informal sources of financing. Most likely, informal businesses are not interested in external finance for the reason they face difficulties return the money given the very high interests on loans.

The lack of grants is more obstacles for formal businesses compared to informal businesses. With this respect, formal businesses differ from informal businesses by several features such as: they register and pay taxes as well as other social contributions; in turn they expect more institutional support through grants and access to finance in appropriate conditions. On contrary, the operation in the informal sector means not only escape tax burdens and social contributions, but at the same time losing the possibility of receiving various benefits and opportunities particularly institutional support in the form of grants and access to finance in appropriate conditions.

Due to importance of SMEs in employment, especially in the case of Kosovo where unemployment rate is very high and the major concern in the economy, the policy should focus on further reforms of business environment. In this context, in order to encourage potential formalization of SMEs policy should facilitate access to financing rather than take punishing measures against informal SMEs.

Facilitating access to finance for SMEs requires the authorities a further liberalization and development of financial market. Alternatives should be explored to facilitate access to finance and offer affordable finance with appropriate terms and condition which is strongly demanded by SMEs.

Further, public authorities should provide effective functioning of the rule of law for the resolution of contractual disputes of businesses and reduction of the risks for financial institutions in order SMEs to secure loans with appropriate terms and conditions. Further progress is needed to define and implement a property right on real properties in order to facilitate collateral requirements as a basis for securing loans and circulation of financial capital.

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