

The Impact of Informal Economy in the Development of SMEs - Evidence from Kosovo (2008-2012)

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Abstract

This paper discusses the relationship between the informal economy and the development of SMEs in Kosovo. The purpose of this paper is to analyze the informal economy, its causes, effects and its impact on business, as well as government policies to combat the informal economy which is a barrier to business development in Kosovo. During the period of transition, the number of small and medium businesses increased significantly, but their existence depends on external factors, such as informality. The informal economy is present in countries that are structurally and economically fragile, a structure which enables businesses to leave out the formal way of doing business. To meet the objective of this paper we used the observation method to analyze the data from different authors and reports about the informal economy and the development of SMEs. Among the key factors for the growth of informality are high taxes which are seen as an obstacle to business growth. According to the outcomes of this paper, we conclude that the informal economy is an obstacle to SME development in Kosovo. This study makes a significant contribution to the scientific and academic value, to the informal economy in the development of SMEs in Kosovo, in the region and beyond.

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Introduction

Countries in transition face SME growth but at the same time they cope with the growth of the informal economy. The term informal economy refers to any activity which is not recorded in official statistics and is a very important indicator of a country's economy.

Therefore, the informal economy is a topic of discussion and research in academic and governmental organizations in developed countries as well as in developing countries. It is a challenge for economic development which all countries face and has an important role in social well-being of a country in either a positive or a negative direction. There are numerous discussions regarding its role in the economic development of the country and for that matter the researches are divided into two groups. In one side, some think that the informal economy should be supported since it has an impact on reducing unemployment and increasing the number of enterprises very little. While other authors point out that the informal economy has negative impact on the country economy, distorting the main economic indicators, increasing unfair competition in the market and reducing public goods for the society. The informal economy is directly linked to political, economic and social factors. Transition countries have greater opportunities of informal economic growth because of their fragile system of law and the mal-functioning of the new state institutions. In this respect, the informal economy in Kosovo is considered as an obstacle to its economic development, because as a country in transition, it is in the process of institutional and economic transformation which in certain periods of time allows inefficiency in law enforcement.

According to National Strategy of the Republic Kosovo (2014, pp. 5), in 2012 the informal economy at the global level was equal to 33% of the global GDP, while at the European Union level it was 18.5%. According to the same report, as of 2013, Kosovo was estimated to have an informal economy of about 34% of the GDP. Also, according to the survey conducted by (Riinvest et al, 2012, pp. 8), businesses claim only 65.6% of their sales and thus 34.4% of sales are not declared, which means that about 1/3 of the sales are not declared, thus resulting in fiscal evasion and undermining the budget. So according to informal estimates for the period 2006-2012, the scale of the informal economy in Kosovos' neighboring countries varies between 23-38.8% of their respective GDP, which is about the same percentage level of the informal economy in Kosovo (National Strategy of the Republic Kosovo 2014, pp. 5).

This paper will analyze the relationship of the informal economy with the development of SMEs in Kosovo, pointing to its causes and effects on the economy. Under the restrictions that we have had with the collection of the data, (starting from the informal word, showed that businesses are not ready to co-work because they fear exposure), data are taken mainly from official reports, these reports are analysed and we have tried to

analyze the role of the informal economy in SMEs development and a consequence even on the whole economy. So, our motivation is to show the impact of this ‘illegal’ form of doing business, in the firms that follow the legal way of doing business.

In the long term, the negative impact of the informal businesses in society is greater than the positive one, therefore we emphasize the need for government intervention through state policies that should be oriented in strategy that fight against the informal economy and thus gradually transforming it into the formal economy.

Literature Review

Since the introduction of the concept of the informal economy by Keith Hart in 1971, which described the concept of activities that do not respect the rule of state, there are different definitions for this issue (Hart, K., 1973, pp. 61). Often, the informal economy was described by such expressions as: the gray economy, the black economy, the shadow economy, the underground economy. We will present a definition of the informal economy so that the readers would have a clearer concept of it “informality is defined as a phenomenon that describes all economic activities which take place in secret, apart from the states knowledge, and not neglecting the rules of the state. As such, it includes concepts such as tax evasion, non-formal employment and under-declaration of salaries of employees” (Riinvest et al, 2012, pp. 8).

The informal economy consists of the informal gray economy and the informal black economy. The informal gray economy consists of activities that are productive and legal, but are concealed from public authorities in order to avoid payment of taxes and/or social security contributions or to comply with regulations. Revenues from the informal gray economy are legal and regular income that should be taxed. On the other side, black economy consists of revenues from crime. This includes manufacturing activities that generate goods and services forbidden by law or that are illegal when carried out by unauthorized producers (National Strategy of the Republic Kosovo, 2014, pp. 16). In this paper, we analyze the informal gray economy i.e. activities permitted by law, but which avoid taxes. Schneider, F., et al (2010, pp. 5), highlights the reason behind the existence of the informal economy.

According to him, the shadow economy includes the legal production of goods and services but which are intentionally hidden from public authorities for any of these reasons: to avoid tax income, VAT or other taxes; to avoid payment of social security contributions; to avoid the fulfillment of certain legal standards of the labor market, such as minimum wages, maximum working hours, safety standards, etc. and to avoid certain administrative procedures, such as the completion of statistical questionnaires or other administrative forms). But businesses motives for going informal differ. Gerxhani, K. (2004, pp. 27) conducted a survey to find the difference between developed countries and developing ones, and the results were that the main motive of the informal economy businesses to exercise their activity in developed countries was increasing the business, and for businesses that operate in non-developed countries was to ensure the survival of the business. Besides the reasons arising from business growth of the informal economy is the cause of that imposed external business. Nur-tegi, K. D. (2008, pp. 15), made a

research on 4,538 businesses in 23 countries in transition about tax collection and he reached two important conclusions. Firstly, tax rate reduction has no positive connection with tax evasion (in transition countries, tax reduction is not the key to reducing tax evasion). Secondly, fight against corruption is positively correlated with the reduction of tax evasion. Therefore, he suggests that politicians in transition countries should orient more energy to fighting corruption than by changing tax rates.

The same results were also found by (Friedman, E., et al 2000, pp.17) who conducted their research on 69 countries which resulted that there is no evidence that lowering the tax rate will reduce tax evasion. By contrast with these results, the study of (Schneider, F., 2002, pp. 44) claims that raising taxes and health insurance premiums are the main forces that increase the informal economy. It is worth mentioning the survey of (Riinvest et al, 2012, pp. 8) conducted with 600 Kosovar businesses which reported some important data from the field. According to the report, unfair competition (arising from tax evasion and under-declaration of workers) is cited as the top barrier to doing business by the respondents. They noted that as a measure to reduce informality is to increase fines, where 42.4% of them believe that the level of fines is high or very high. That makes us realize that 57.6% of respondents do not percept the fines for tax evasion that high, an impression which turns out that if the fine was the higher, it would amount to less informality in Kosovo. From this survey, it results that businesses in Kosovo report 63% of workers on average, that is 37% of workers are not reported. We also found that tax evasion is negatively correlated with the size of firms (measured by number of employees), that is, smaller firms tend to conceal taxes more compared to larger firms.

Objectives of The Paper

In this paper, we intend to show the role of the informal economy in SME development in Kosovo. The period of analysis involves (2008-2012), since there are no available reports about the degree of informality in Kosovo on the latest period of time. We show the impact of informal factors in the country's economy and the well-being of citizens in Kosovo.

We accomplish this analysis by answering the research questions:

- ✓ How much the informal economy is widespread in Kosovo?
- ✓ How does the informal economy affect the development of formal SMEs in Kosovo?
- ✓ Does the informal economy reduce the supply of public goods?

Methodology

For writing this paper is used a methodology which consists in combining the data obtained through the use of existing literature, online papers, academic articles, reports, and international findings about the informal economy. Also this paper uses data published by Kosovo Agency of Statistics, The National Strategy of the Republic of

Kosovo About the Informal Economy, national reports about the informal economy, as well as other relevant sources. For writing this paper was used the analytical approach.

Empirical findings for informality in Kosovo (2008-2012)

In this part of the paper we give an answer to the first research question: How much is the informal economy widespread in Kosovo?

Often it is considered that the impact of the informal economy to the economy is negligible, but in Kosovo the informal economy according to official reports presented in table 1, accounts for about 25-33% of GDP therefore it is considered as very important for the economic development of the country.

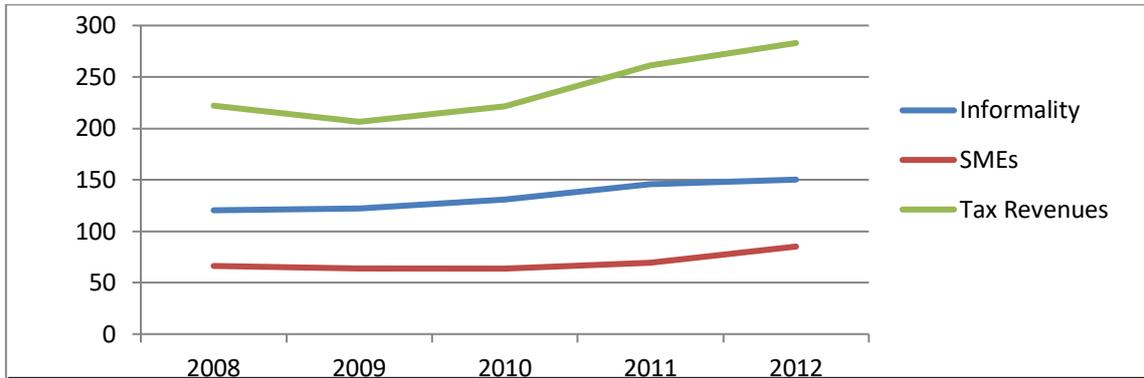
The informal economy in different countries during the transition period consists predominantly of tax evasion, the labor market and the position of workers therein. The informal economy causes budget deficit and reduces public good and therefore emerges a need to develop strategies for intervention and for combating informality. In situations where the informal economy is high, state policies are oriented in auditing businesses or in increasing the tax rate in order to replenish the budget. Table 1 shows, in absolute values (minimal and maximal), the informal economy in Kosovo for 5 years (see Table 1).

Table 1. Estimated value of the informal economy in Kosovo during 2008-2012

Values from GDP	2008	2009	2010	2011	2012
Minimum	1 052 066 500€	1 070 079 400€	1 145 735 400€	1 275 224 600€	1 312 678 800€
Maximum	1 355 471 500€	1 378 679 100€	1 476 153 500€	1 642 986 000€	1 691 241 600€

Source: GDP for activities 2006-2012, The Agency of Statistics, 2013. Cited by the National Strategy of the Republic Kosovo 2014.

It is seen from Table 1, that the informal economy has grown over the years. But it should be noted that there is also an increasing number of SMEs. In Graphic 1, we present the graphical connection between the informal economy, the number of SMEs and the state budget along five years. So, it can be noted that in 2011-2012, the trajectory of informality has a positive trend with a growth lower than positive trend of the two other variables SMEs and enterprises from taxes. So informal economy in 2011 reduces the flow of increment in comparison with two other variables (see. Graphic 1.)



Graphic 1. The link between Informality, SMEs and tax revenues (2008-2012)

The evasion of taxes role in increasing informality in Kosovo

As the main variable that affects the growth of the informal economy is tax evasion. Tax evasion is negatively correlated with the rate of tax. According to (Riinvest et al, 2012, pp. 8) in a hypothetical question submitted to the respondents that there is a tax increase of 10 percentage points, 78% of respondents indicated a willingness to evade taxes. Kosovo applies three main tax regimes: VAT is charged at the standard rate of eighteen percent (18%), with the exception of inferior goods that are charged with eight percent (8%); the income tax on corporations is 10%; and the personal income tax is progressive (with a maximum of 10%) (Law no. 05 / L -037, 2015, pp. 23).

Table 2. shows tax revenues by years and it can be noticed that 2013 was the best year as of tax revenues.

Table 2. Revenues from taxes (2008-2014) (million)

Year	2008	2009	2010	2011	2012	2013	2014
Value	222.2	206.7	221.1	261.1	283,8	305,4	303,6

Source: Annual Report on the implementation of the work plan of the TAK, 2011, 2013 & 2015

Regarding the intensity of auditing businesses for taxes, 37.3% of respondents believe that there is a high or very high possibility of them being caught evading taxes. However, 62.7% of respondents believe that if they decide to evade taxes, they can do so easily, without getting caught by the authorities (Riinvest et al, 2012, pp. 8). This means that an increased rate of inspecting businesses leads to lower fiscal evasion. From this data can be shown that with the raise of the tax norm, business will raise the scale of informality as a way to survive in the very competing trade. Also, the data show that if in enterprise there are not continuous audition they will try to raise the informality scale. So, it is showed that there is low level of moral for taxes in Kosovar business.

How to increase the moral in business for taxes?

Tax evasion can decrease as the morale about the taxes increases. Usually the average citizen is inclined to pay taxes if he has adequate information and is aware that through

the taxes it improves the well-being of his society and helps himself in the long run. The citizen wants, through the payment of taxes, to improve the public services that the company uses. In a country where there is high a level of corruption, the incentive to pay taxes will be low, and thus citizens will try to avoid their tax payment because they consider that their money does not go to the right place and that there is no improvement for the social life. Friedman, E., et al (2000, pp. 17) found that only governments with low corruption rate can maintain a high tax rate. Wintrobe, R. (2001, pp.13), states that the solution to the problem of tax evasion is in developing the logic of democracy. According to him, it should be noted that the rule of law will be implemented, that it will include the penalties appropriate for tax evasion, but that will be within the parameters of the rule of law. In a democracy, theoretically at least, the citizen should feel his relationship with the state is a relationship of return and not that of a liability. So, the moral for taxes increase only when the citizen pays for the state when he exploits the benefits offered by the state and not when he feels forced. If he obliged to pay by forced, he tends to evade taxes.

Discussion for the Impact of the Informal Economy in the Development of Formal SMEs

In this elaboration about the connection of the informal economy with the development of SMEs we will answer the second and the third research questions respectively: How does the informal economy affect the development of legal SMEs in Kosovo; Does the informal economy reduce the supply of public goods?

The informal economy is part of the economy of a country which connects with SMEs of the formal economy either directly or indirectly. Its role in economic development is negative. In the following steps, we will present the steps which show the impact of the informal economy in the development of SMEs and the economy as a whole.

The informal economy has the following consequences for the formal economy:

Increases the unfair competition. The informal economy enables the development of gray economic activities whereby businesses operating in these economies develop to the detriment of businesses who exercise formal activities. So, a formal business and an informal business do not work in the same conditions. As the informal business risk in taking actions against law and hiding their taxes. And the case of not being punished creates competing advantages in trade.

Reduction of wages. As a result of permitting the operation of the gray economy as a consequence there happens results in a reduced payment for work as laborers who work in informality can work with a payment which is less than the minimum wage prescribed by law, and can even work extensively just to reach the minimum wage. The employee in this form cannot complain since it is not listed as a regular employee that contributes with his taxes. Since there are no workers' unions as guarantors of its rights, in this type of employment workers are paid less than in the formal market. This form of payment reduces the production costs for business to do informal activities which further translates to cheaper products by these businesses. Starting from logic that produces product with

the same quality but with lower price than competing firm, then the request for products of this firm will be increased. According to the study made by (Hudson, J., et al, 2012, pp. 107) who interviewed 4,720 businesses which conduct their activities in Eastern Europe, the informal sector has a negative impact on the wages of workers, i.e. by increasing informality the wages of workers are reduced.

Reduced purchasing power. As a result of low payment of employees in the informal sector there is a decreased purchasing power from the same worker, who may have been a customer of the formal firms. The decrease in purchasing power means moving the aggregate request low-left and as a result we will have a decrease of price of industrial products. This situation for the formal firms means decrease in selling, decrease in production as a result also decreasing the business taxes to the state. In this situation people tend to buy more of the common goods and to reduce their demand for luxury goods, which is a characteristic of countries with low economic development.

Price reduction. The firms that work their activity in the gray economy, as a result of tax evasion, are able to sell their products with a price much lower than the regular tax-paying firms. This situation enables the gray economy firms to develop while those in the formal economy are being contracted.

Damaged formal firms. The biggest losers on the informal economy are legal businesses, who are damaged in two aspects. On one side, they are damaged because informal firms sell their products with the cheapest price which enables them to attract consumers from regular firms. While, on the other side, as the state suffers a loss from tax evasion, in order to fill the budget, it attempts to raise taxes which further damages regular taxpaying firms. According to Worthington & Britton (2009, pp. 102) in this cases the government policies is better to control (decrease) the rate of growth of public spending rather than by increasing revenue through changes in taxation, since the latter could depress demand. In such a situation, regular firms cannot increase their investments in improving technology in order to increase their productivity. So, the gray economy becomes attractive for regular firms also, thus forcing them to go informal.

A decrease in the number of taxpayers. Tax reduction from paying taxes businesses in the state coffers that comes as a result of informality comes in two ways: a) by reducing sales of the legal firms and b) from the movement of the legal firms to the illegal market. It is worth highlighting, reductions in government spending and/or increases in taxation will have the opposite effect, depressing business prospects and probably discouraging investment and causing a rise in unemployment (Worthington & Britton, 2009, pp. 106).

State budget. From the informal economy development, the state budget is damaged the most because it depends mostly from businesses taxes. Not collecting the taxes for the budget results in a poor budget which translates into a poor country and reduces the quality of public expenditures. Also, the development of the country is correlated negatively with the development of the informal economy, i.e. developing countries tend to hide taxes more, therefore this situation leads towards two other consequences: a) the increase of the informal economy which starts a new cycle out these steps and b) thus reduces social well-being.

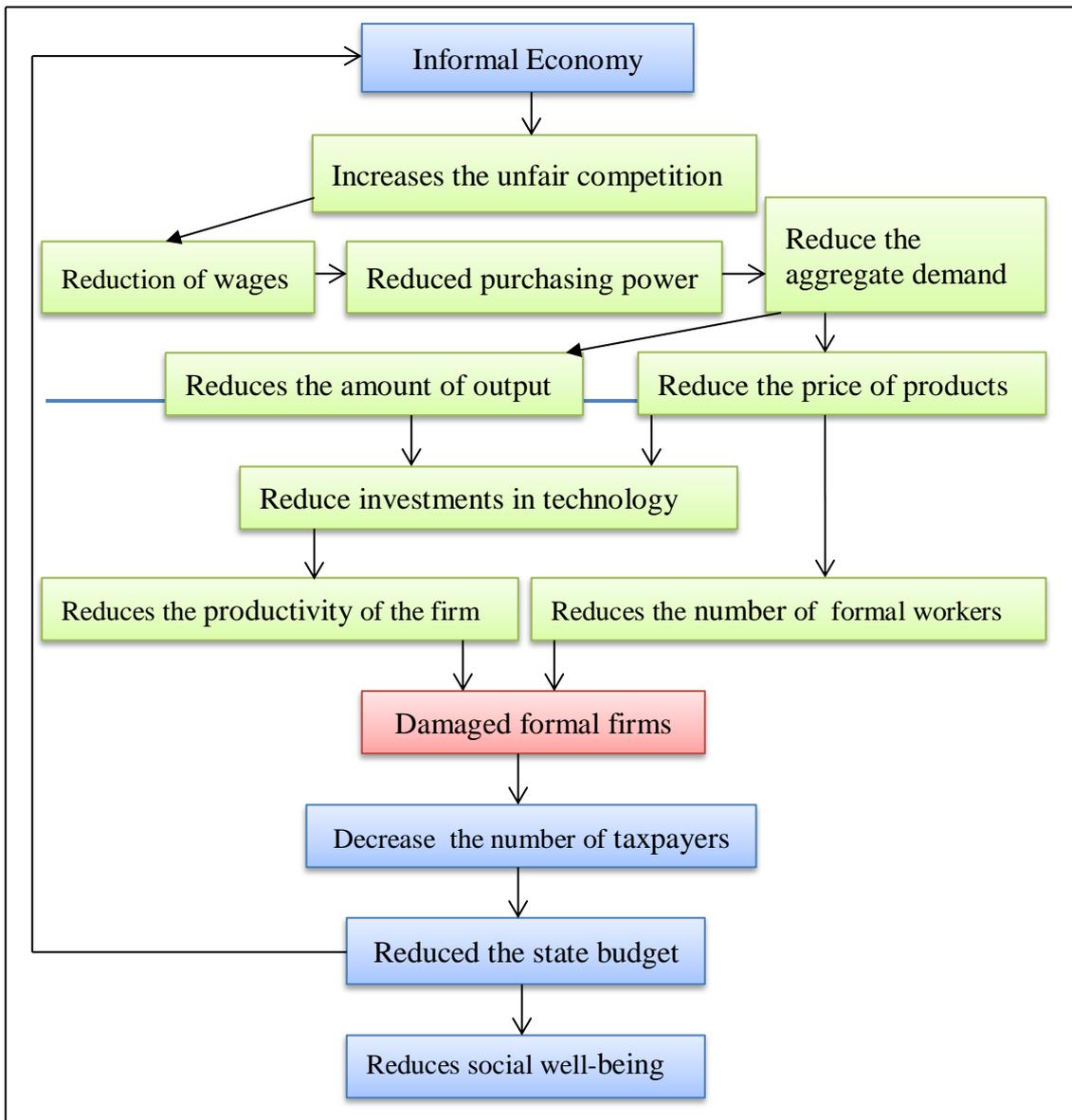


Figure 1. The Impact of Informal Economy in the formal SMEs, by the authors

Conclusions

In this paper, we discussed the role of the informal economy in the development of formal SMEs and in the economic development in general. Non-payment of taxes from informal firms benefits them in the short term but in the long term these firms apply the "double-loser" strategy. This happens in two ways. Firstly, informal economy weakens the whole economy through the loss of formal SMEs. Informal businesses who try to avoid taxes can hire more workers, which initially seems like a right action but it brings lower cost of the labor, affecting formal SMEs directly and indirectly the informal ones.

Formal SMEs have higher manufacturing costs in comparison with informal businesses that do not pay taxes to the state. This enables informal businesses to operate in two modes which gives them a competitive advantage compared to the formal businesses. First, informal businesses can sell their products at the lowest price, which allows them better positioning in the industry. At second, informal firms can sell products with the same market price but to attain a higher profit margin than the formal businesses. Formal businesses have important roles in filling the state budget, so the weakening of formal businesses translates into budget deficit. The weakening of the state budget means a reduced supply of public goods towards citizens. Kosovo has an informal economy of an average of 25-33% of its GDP. Results of the analysis show that the informal economy has negative impact on the development of SMEs in the country and the economic development of Kosovo.

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