



## Institutions – Entrepreneurship Nexus – Kosovo’s Perspective

ENVER KRASNIQI

College of International Management “Globus”  
Prishtina, Kosovo

ANISA KUME

Faculty of Economy, University of Tirana  
Tirana, Albania

### **Abstract:**

*The purpose of this study is to examine the impact of institutions in entrepreneurship activities for the small and medium enterprises (SME) sector in Kosovo. The survey refers to the long-term research experience in the role of institutions for small business development.*

*A new dimension to the theory of entrepreneurship was offered recently by Baumol, who highlights the role of institutions in the allocation of the entrepreneur’s potential in productive and non-productive activities. In a transitional economy, entrepreneurs are faced with numerous difficulties such as the legal system, strengthening property rights, government regulation, the tax regime and corruption, and administrative burdens.*

*The topic is developed based on a broad literature and practices in the SME development sector, and the great importance of analysing the role and importance of institutions for economic growth and firms’ wealth. During the preparation of this study, a range of methods were used to research and study institutional and non-institutional barriers for SME development in the era of globalization.*

*Using a sample of Business Support Centre Kosovo (BSCK) research from 2011, the findings of this study indicate that the majority of CEOs agree that many barriers can be summarised as formal and non-formal that have a huge impact in SME development.*

*These findings suggest that successful entrepreneurship and SME strategic development are conditioned by factors such as: formal institutions (the central and local government leadership, taxes, business legislation and regulation, access to finance, frequency of policy changes) and non-formal institutions (culture and society, corruption and informal ties with public officials, administrative burden and informal implementation of laws, mafia and racketeering).*

**Key words:** entrepreneurship, formal and non-formal institutions, business legislation and regulation, administrative burden, policy changes, corruption, mafia and racketeering.

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## **Problem Statement**

Over the past few years Kosovo's economy has shown significant progress in transitioning to a market-based system and maintaining macroeconomic stability, but it is still highly dependent on the international community and the diaspora for financial and technical assistance.

Businesses in Kosovo face many managerial issues which, if they are neglected, will negatively affect their efficiency. Small businesses are more vulnerable to the risk compared to large businesses, due to their inability to diversify, insufficient capital to contend with the reduction or loss of market revenues, and higher operating costs per unit of revenue. But they can benefit from the advantages of being small businesses, as they are more flexible and they easily adjust to the nature of changes. For this purpose, they have greater need of managerial advice.

The purpose of this research was to analyze the profile of SMEs in Kosovo. Through this research, some aspects of the management of SMEs and their interconnection with the legal environment were analysed. This study is intended to support the needs of SME managers in all aspects of business performance, as well as central and local level decision-makers

in the drafting of regulations, and to assist them in the development of SME policies.

## **Literature Review**

In a transition economy, entrepreneurs are faced with numerous formal and non-formal difficulties. As pointed out by North (1990), "Institutions are the humanly devised constraints that structure political, economic, and social interaction. Formal institutions include constitutional, legal and organizational framework for individual actions, while informal institutions consist of unmodified attitudes which are embodied in society regulating individual behaviour." As pointed out by Williamson (2000), neoclassical economics takes institutions as granted by assuming that the laws and courts are in place to enforce contracts and protect the property rights of parties to a transaction. The recent literature has begun to pay attention to the role and impact of institutions on entrepreneurial behaviour (Boettke and Coyne 2006). The old institutional economics emphasizes the socio-economic aspects and shape of the market as a social institution. Therefore, the behaviour of individuals should be taken into account when institutions change (Hodgson 1997).

North (1990, 2005) made a clear distinction between formal and informal institutions influencing the incentive system in a society, and hence shaping individual behaviour. In particular, it is important to distinguish between formal institutions such as the creation of new laws, procedures and property rights framework and social institutions which are embodied in the social lives of entrepreneurs and the society as a whole. Informal institutions are operationalized in people's values and norms. The role of social institutions should be seen as complementary in understanding the role of other institutions. The main difference between formal and informal institutions is that the former includes the rules that are enforced by the state, so firms solve problems through recourse to third party sanctions while the latter includes networks which are reinforced by means of social relationships depending

on the nature of the relationship between parties in the network (Nee 1998).

While neoclassical theory has neglected the role of institutions in the operation of the market system, the process of transition in formerly socialist countries demonstrated the crucial role for entrepreneurship of institutions such as the legal environment, property rights, free trade laws and other necessary for the functioning of the new market system - something which is almost taken for granted in the mature market economies (Karlsson 2002). Therefore, institutional theory provides a good guiding framework due to specific features of the external environment that influence entrepreneurship compared to more mature market economies (Smallbone and Welter 2006; 2008).

In the initial phase of the transition to a market economy, the introduction of new laws creates new opportunities for entrepreneurship by allowing private owners to exist legally, but a deficient legal infrastructure, such as implementation gaps, restricts entrepreneurship development (Smallbone and Welter 2009). In this transition phase, it is understandable that business start-ups will contribute to economic development (mainly through employment generation and self-employment), but in the later stages the institutional setting needs to be modified in order to create conditions for entrepreneurship development.

## **Research Methodology**

The study is based on statistical analysis of data collected from a sample developed by BSCK in 2011, including 500 companies in Kosovo<sup>1</sup>. The process of drafting the questionnaire and sample selection was conducted by experts in the field. Interviews were conducted with key persons from companies, mainly managers/owners or financial managers.

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<sup>1</sup> BSCK Study Research 2011

The respondents were asked to provide quantitative and qualitative answers (their motives for growth, data on firm performance, perceptions regarding the business environment and information about entrepreneurship and strategic management activities). The business sample was selected at random from the business register Kosova Business Registration Agency (KBRA) from the Ministry of Trade and Industry (MTI). Procedures for the selection of sample size and the companies that will be interviewed were made with Excel and SPSS.

## Data analysis and interpretation

After several phases of testing the sample size of selected companies, the team decided to organize the distribution of the sample according to two categories: the size of the company and the sector in which the business operates (See table 1)

**Table 1. Share of enterprises in the population and the sample by size and sector**

| Sector Size                               | Micro | Small | Medium | Total | Share of sector in population | Share of sector in the sample |
|---|-------|-------|--------|-------|-------------------------------|-------------------------------|
| Manufacturing                             | 95.2  | 2.4   | 2.4    | 100.0 | 10.1                          | 23                            |
| Services                                  | 97.0  | 1.7   | 1.3    | 100.0 | 40.0                          | 35                            |
| Trade                                     | 98.7  | 0.8   | 0.6    | 100.0 | 50.0                          | 42                            |
| % share of company size in the population | 97.7  | 1.3   | 1.0    | 100.0 | 100.0                         | 100                           |
| % share of company size in the sample     | 70    | 25    | 5      | 100   | -                             | -                             |

*Note: total number of enterprises is 100,000; Source: BSCK Study Research 2011*

## Business Environment

The literature explains that the dynamic growth of the new private sector, particularly of SMEs, has been one of the key driving forces behind the economic recovery in transition economies. Furthermore, the extant research on the experience

of other transition economies asserts that the promotion of entrepreneurship and small firms remains the single [best?] solution to promoting economic development.

Unlike the majority of the transition economies, Kosovo has not been very conducive for SMEs, and SMEs continue to face an unfriendly environment. Kosovo faces issues in creating new institutions and a favourable business environment coming primarily as the consequence of war, difficulties of the transition process along with privatization, quality of institutions etc. Yet, as presented on table 2, the market in Kosovo poses several other obstacles to the development of SMEs. The table below shows the obstacles to the development of SMEs as perceived by entrepreneurs, and compares the results of the 2010 and 2011 BSCK surveys. The results are presented in average where 1- is not an obstacle and 5- is the major obstacle.

**Table 2. Business barriers presented in Average**

| No | Business Barriers 2011       | Ave. | No | Business Barriers in 2010    | Ave. |
|----|------------------------------|------|----|------------------------------|------|
| 1  | Strong competition           | 3.95 | 1  | Informal economy             | 3.92 |
| 2  | Informal economy             | 3.81 | 2  | Strong competition           | 3.84 |
| 3  | Taxes too high               | 3.58 | 3  | Corruption                   | 3.79 |
| 4  | Supply with electricity      | 3.57 | 4  | Taxes too high               | 3.64 |
| 5  | Corruption                   | 3.55 | 5  | Fiscal evasion               | 3.41 |
| 6  | Fiscal evasion               | 3.34 | 6  | Supply with electricity      | 3.33 |
| 7  | Law enforcement              | 3.22 | 7  | Law enforcement              | 3.30 |
| 8  | Crime, robbery and anarchy   | 3.21 | 8  | Sufficient and adequate Laws | 3.15 |
| 9  | Administrative burdens       | 3.18 | 9  | Political instability        | 3.13 |
| 10 | Sufficient and adequate Laws | 2.93 | 10 | Administrative burdens       | 3.07 |
| 11 | Political instability        | 2.88 | 11 | Crime, robbery and anarchy   | 3.05 |
| 12 | Delayed collection of debts  | 2.68 | 12 | Lack of market demand        | 2.94 |
| 13 | Lack of market demand        | 2.63 | 13 | Delayed collection of debts  | 2.79 |
| 14 | Access to finance            | 2.58 | 14 | Access to finance            | 2.43 |

|    |  |      |    |  |      |
|----|--|------|----|--|------|
| 15 | Insufficient capacities                      | 2.22 | 15 | Insufficient capacities                      | 2.17 |
| 16 | Supply of materials, machinery and equipment | 1.98 | 16 | Supply of materials, machinery and equipment | 1.98 |
| 17 | Luck of information concerning business      | 1.87 | 17 | Luck of information concerning business      | 1.85 |
| 18 | Business licensing                           | 1.65 | 18 | Transport                                    | 1.80 |
| 19 | Transport                                    | 1.64 | 19 | Business licensing                           | 1.65 |
| 20 | Employee skills                              | 1.59 | 20 | Employee skills                              | 1.53 |
| 21 | Managerial skills                            | 1.35 | 21 | Managerial skills                            | 1.35 |

Source: BSCK SME Survey 2010 and 2011.

The results show that the order and the size of the obstacles among 2010 and 2011 have barely changed. Furthermore, if we compare these two years’ results with the results of the UNDP 2007 publication “Development and transition in Kosovo” about SME barriers we will see that the obstacles are similar and have not changed. The same problems and barriers are consistent through the years. Comparing the results between 2007 and 2011, it can be understood that the only major positive change is transport (roads and telecommunication); which is no longer seen by entrepreneurs as a major obstacle.

**Business Barriers in 2011 - Factor analyses  
Reliability Statistics**

|                  |             |
|------------------|-------------|
| Cronbach's Alpha | No of Items |
| .886             | 21          |

| No.  | Business barriers grouping | 1     | 2 | 3 | 4 |
|--|----------------------------|-------|---|---|---|
| <b>Crime, Corruption and Fiscal evasion</b>                |                            |       |   |   |   |
| 1  | Crime, robbery and anarchy | 0.829 |   |   |   |
| 2  | Corruption                 | 0.783 |   |   |   |
| 3  | Fiscal evasion             | 0.780 |   |   |   |
| 4  | Informal economy           | 0.671 |   |   |   |
| <b>Lack of management skills and employees performance</b> |                            |       |   |   |   |

|  |  |  |  |              |              |
|--|--|--|--|--------------|--------------|
| 1  | Employee skills                              |  |  | <b>0.775</b> |              |
| 2  | Insufficient capacities                      |  |  | <b>0.743</b> |              |
| 3  | Business licensing                           |  |  | <b>0.604</b> |              |
| 4  | Supply of materials, machinery and equipment |  |  | <b>0.587</b> |              |
| 5  | Managerial skills                            |  |  | <b>0.570</b> |              |
| 6  | Political instability                        |  |  | <b>0.545</b> |              |
| 7  | Transport                                    |  |  | <b>0.544</b> |              |
| 8  | Supply with electricity                      |  |  | <b>0.379</b> |              |
| <b>High taxes, law enforcement and administrative burdens</b>                  |  |  |  |              |              |
| 1  | Taxes too high                               |  |  | <b>0.852</b> |              |
| 2  | Administrative burdens                       |  |  | <b>0.843</b> |              |
| 3  | Sufficient and adequate Laws                 |  |  | <b>0.614</b> |              |
| 4  | Law enforcement                              |  |  | <b>0.518</b> |              |
| 5  | Access to finance                            |  |  | <b>0.348</b> |              |
| <b>Lack of market demand, strong competition, and delayed collection debts</b> |  |  |  |              |              |
| 1  | Lack of market demand                        |  |  |              | <b>0.681</b> |
| 2  | Strong competition                           |  |  |              | <b>0.675</b> |
| 3  | Delayed collection of debts                  |  |  |              | <b>0.552</b> |
| 4  | Luck of information concerning business      |  |  |              | <b>0.515</b> |

According to the factor analyses for business barriers, the results are as follows:

- a) In the first group of barriers are “Taxes too high” (0.852) and “Administrative burdens” (0.843),
- b) In the second group are “Crime, robbery and anarchy” (0.829), “Corruption” (0.783) and “Fiscal evasion” (0.780),
- c) In the third group are “Lack of employee skills” (0.775) and “Insufficient management capacities” (0.743),
- d) In the fourth group are “Lack of market demand” (0.681) and “strong competition” (0.675).

## Conclusions

The analysis presented in this paper leads to the following conclusions:

- The majority of the businesses in Kosovo are organized as individual businesses (89.4 %), a 1 per cent increase from the prior year situation. Only 8.3 per cent of companies in the sample are organized as business partnerships and 1.8 per cent as shareholding companies reconfirming the conclusion that business partnerships are not a common practice among SMEs in Kosovo.
- Regarding the partnership businesses, 66 per cent of entrepreneurs declared that they have family relationships, 15 per cent professional relationships, and 15 per cent were joint ventures/joint financing. These statistics identify the limited quality of these relationships; this is a big concern for the development of the SME sector.
- Businesses in Kosovo have difficulties in funding due to the low level of credit in the economy. Business owners/managers consider financial consolidation as the most important problem in the process of restructuring their businesses. Analysing the last two-year period shows that the number of firms that have a clear vision for the future, a better-defined strategy and clear tasks for personnel is increasing; this is a result of the increase in competition.
- The survey results show that entrepreneurs are more concerned with constraints related to external environment rather than with internal factors such as managerial or employee skills, which were ranked at the very bottom of the list of constraints.
- The issues mentioned as obstacles to exporting enterprises are also delays at the border, inadequate legislation, lack of infrastructure and political risk. Importing enterprises face obstacles during importation too, such as customs and inadequate legislation, while

methods of payment are seen as a lower barrier for these enterprises.

- It is important to stress the fact that, compared to previous years, the awareness of companies for cooperation with academic institutions is increasing,
- Analysis indicates that most businesses think that networking contacts with business associations, business partners, family and friends are very important for the development of their businesses.

### **Proposed changes in current procedures**

When Kosovo joins the EU, a new market will be created, where the impact of the environment and competition will be more aggressive. Domestic companies will be less protected than they are now. The high competition in the business environment may result in increased levels of strategic management in favour of survival and prosperity.

Upon creation of this new market, strategic management will constitute for Kosovo companies a very important means to adapt to ongoing changes in international markets and create long-term advantages for the company. The main and somewhat generalizing recommendation that might be given to Kosovo companies to face this moment of crises and global markets they aspire is the efficiency and effectiveness in their Strategic Management, by giving at the same time some other specific recommendations as following:

- Companies should identify all their stakeholders and the impact they have in their activity;
- Use of market research as a method to better understand the external environment where those companies operate from the moment they enter those markets;
- Due to the fact that the informal economy poses unfair competition to legitimate businesses, the Government should make a vigorous and sustained effort to reduce the size of the informal economy (through selective tax incentives);

- The role of business advisory services should be expanded, covering not simply business-plan formulation, but also marketing mix, accounting and cost management etc.;
- An alternative path to growth for SMEs to consider is international diversification, which in this case can be unproductive if Kosovo companies lack the necessary infrastructure and strategic view to successfully handle the complexity of international markets;
- In terms of organizational learning in the SMEs of Kosovo, firms attempt to be committed, but it is not enough to be adapted with the rapid changes of the environment.

The value of this study depends on the reliability and honesty of the responses of managers surveyed. There are also a number of other factors that affect the performance of a company, which are not included in this study, that require caution in interpreting the results. However, we believe that the results from this study once again show that strategic planning is helping small firms to be effective in fighting the competition and to find more effective ways to grow. This research launched in 2010 and is planned to continue into the future.

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