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Informality in Credit Relations Between Banks and Business Entities – a Risk on Standardization and Modernization of Kosovo Economy

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Abstract

In terms of modern societies, the definition of the notion of certain forms of informal activities in the economy has evolved dynamically. In general, the definition used for the informal economy by lawyers and economists, involves economic transactions or operations in which state institutions not only have no control over them, but they also fail to take action to stop them. Precisely in this form, informality has become one of the most discussed problems in Kosovo politics. Reducing it is vital for the national economy to improve. However, it seems that the passive path which the relevant government institutions are taking in combating this negative phenomenon, not only is not right and adequate, but, above all, presents factors that are of high risk and multidimensional. Unfortunately, the relatively new local banking system, especially in commercial banks, has gradually become a serious stimulus segment of this informal activity. Among other things, the commercial banks, upon establishing credit relations with certain business entities, mainly during the provision of loans and being fully aware, base their credit risk analysis on financial and accounting records that are not official, i.e. are not identical to those provided to the Tax Administration. Now is the last moment that the government must focus its efforts on limiting and reducing the informal economy in the country. Enhancing the role of the Tax Administration and the Financial Intelligence Unit for the purpose of increasing their operational efficiency bears no alternative.

Keywords: economy, informality, law, tax, bank

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1. Introduction

The negotiation process with the European Union on the Stabilization and Association Agreement is a clear reflection of a certain progress that Kosovo has achieved so far during its transition. The next step has to do with the commitment to further advance these talks, followed by strict fulfillment of the specific standards of a European country before entering the EU. With respect to these actions, not only the competent institutions, but

business organizations as well must find a way to focus their energies on the most complex challenges for the economic development.

In this paper, informality in the economic sphere is defined as a phenomenon that affects all economic activities which, entirely or partly, take place outside the view of the state and also disregard the rules of the country. As such, this concept of informality involves tax evasion, informal employment, lower declaration of employee wages, etc. It is interesting to mention that the phenomenon of the informal economy is currently considered among the fundamental problems of our country to which the competent institutions fail to respond adequately. Perhaps in practice, this phenomenon has become a factor as a result of a completely natural and spontaneous reaction to the inability of the system to formalize the economy. It is a known and proven fact that, in developing countries and those in transition, the informal economy provides a significant contribution to economic growth, although accompanied by a number of negative effects. Such countries include Kosovo as well, where the presence of the informal economy goes beyond quotas considered normal, specifically from 40% to 50% here in Kosovo. At this stage, this phenomenon is not a novelty anymore; if anything, it is considered a fact. Unfortunately, the informal economy has taken the role of the main employer in the country and the essential source of consumption. There are several types of informality in the economy, such as companies that are partially or entirely informal, informal employment, informal contracts, informal ownership, informal lending, etc. In all these cases, business transactions, possession of assets, finances and works are performed outside of the formal and legal system. The informal economy, because of its specific nature, will flourish in whatever places it can. This is true not only for Kosovo, but also for developed countries as well. Based on the reasoning above and the analysis of some basic fiscal income data, we can say with conviction that the fight against the informal economy and fiscal evasion, in times of crisis in which we currently live, can be transformed not only into a social buffer, but it can also render possible the increase of salaries and decrease of taxes.

The current stage of the country, which is characterized by enormous levels of certain forms of informal economy, hinders policy-making institutions to escape from the so-called "trap of informality". The turning on the other side of this tendency, which should include reducing the relatively great size of the informal market is essential, as participation in the informal economy represents, above all, a violation of the country's entire legal system.

The banking system in Kosovo, despite its impressive development, is among the last to be established in the region. This certainly is also due to the influence and the effects of the communist system in this segment of the economy. However, now, at a large extent, is accompanied with the lack of a "banking" culture. Specifically, citizens prefer to keep their savings elsewhere, more than in banks. There is no doubt that the country's Central Bank has demonstrated itself to be a successful regulator of this segment. But this regulatory institution, especially now, has to take measures to ensure that credit relations between commercial banks and clients, in the case business entities, include the preparation of a dossier that was previously recognized and certified by the Tax Administration of Kosovo.

1.1. The economic and legal meaning of the informal economy

Based on the review and analysis of the contributions of various authors, it appears that offering a definition of the informal economy is not only a difficult but also a complex process. Difficulties for a correct approach to the

meaning of this negative phenomenon arise from the outset. This is due to the mismatch of legal concepts with economic ones. Not only that, the situation is further complicated with the problems of ensuring the volume of knowledge required to measure and evaluate its size and scope. In this context, competent economic theorists, regardless of the context which they view it from, give very much related definitions. Initially, they not only designate but also perceive certain informal economic activities as a shady economy, parallel economy, underground economy, informal economy, etc., which is present in small units and engaged in the production of goods and services, but are not registered as formal organizations. In some instance they are organizations, registered as formal units, that operate in the production of goods and services, but which only partially declare the volume of their activity. Some are also manufacturing or service providing units, often natural persons, created on a family basis and operates unregistered, exercising their activity without the relevant license [1]. Some authors include economic activities prohibited by law, as well as criminal activities, only in an annex. Many owners and operators of informal enterprises also operate either semi-legally or entirely illegally because the legal system in certain cases is more repressive, burdensome, unmanageable, or simply is absent or inexistent. Furthermore, many activities in the informal economy do not generate sufficient output, employment or income to be able to handle certain levels of taxation.

It is perfectly natural that economists and lawyers, on the basis of their professional competence and expertise, give varying definitions for certain activities or operations of the informal economy. While the economists mentioned above come up with the unique position that informality in the economy is the sum of all economic operations that affect the official GDP, but which are not recorded and therefore not subject to the regular taxation regime. But as such, they are not part of criminal activity. Practically, according to this definition, we can say that there are three GDPs: the official one, the informal and the criminal one [2]. If we can know the first one exactly how much it is, we must understand what the real value of the other two is as well. Nevertheless, given the circumstances and difficulties economies in transition face, perhaps, for a certain period of time, this may be regarded as reasonable.

However, determining the legal definition of the informal economy in principle appears to be different and more complex than the economic one. This is because, whether it concerns the shadow economy, parallel economy, the underground economy, informal economy, etc., any activity that violates the legal system is automatically illegal and conditionally often criminal. Precisely due to this situation, recent literature started to strongly promote debate and comments to clarify the question of the extent to which informality, i.e. certain activities of informal economy, is illegal, but at the same time is not considered criminal, i.e. should not be penalized. Then, from this perspective, illegal activities include unregistered business operations, which can be formalized when caught but not shut down, as such businesses can bring additional revenue in the budget. On the other hand, unlawful operations include activities that should not exist in the first place. These range from human trafficking to illegal drug handling. Such activities, when caught, will cease to exist and not bring additional revenue to the budget.

In our opinion, given situations in which economies in transition are undergoing, the determination of the legal notion whether an informal economy constitutes a criminal act or not, must be considered from the perspective of the “moderate” economic definition of this topic. The well-known author, Smith, is esteemed to be one of the most prominent people to study the phenomenon of economic informality. According to him, the definition of informality can be best determined if it includes activities of both types of the shadow economy. According to

him, the definition of the informal economy involves "the production of goods or services in the market, whether legal or illegal, which are not included in the official GDP measures"[3]. This view is further crystallized by the theorist, Mr. Friedrich Schneider, who specifically defined the shadow economy as "the entire legitimate production of goods and services in the market that is deliberately hidden from the public authorities", by eliminating thus the so-called "underground activities" involving the unlawful activities and services, as well production of goods within households. A more precise conceptual and moderate framework is provided by Bernabè. It sees the interior of the informality concept categorized into four levels, as follows: 1). informal activities, made to "satisfy the basic needs"; 2). "underground" activities that are deliberately concealed from public authorities to avoid payment of taxes or compliance with the rules; 3). illegal activities that produce goods and services prohibited by law or that are Illegally produced by unauthorized manufacturers; and 4). activities within households, which are produce for own consumption. Such a categorization is undoubtedly convenient and relevant for addressing the phenomenon of informality in Kosovo. This approach obviously offers the necessary convenience and assurance for a better handling of informality in countries in transition, particularly in Kosovo. On the basis of this definition of categorization, category 1 and 2 prove the claim that we have given above [4].

However these operations concerning informality in the economy are treated, whether as illegal, unofficial, gray, etc., but not as criminal, they should nevertheless not be considered positive, but in the contrary. If we can precisely measure, in the economic plan, the volume of all dimensions of the informal economy, then the official percentage of informality given by representatives of our institutions (from 30% to 35%) will probably double [5]. Based on this description, the damage caused to the national economy is great and is mainly focused on the impact it causes to the tax base and insurance contributions in the formal and informal economy. Without any doubt, an associate and indicator of informality in the economy is also the violation of moral norms and administrative rules, surely with a certain level of corruption. The economy is not likely to be formalized by remaining in a vicious cycle. Sectors with great informality (informal sectors) create difficulties in collecting taxes or even lead to the phenomenon of uncollected tax revenues, which in turn causes restrictions on public spending and is further reflected in the difficulty to govern the country. Competent state institutions must have a clear strategy to address this phenomenon. In our case, the Republic of Kosovo should now focus in implementing the preventive strategies and mechanisms of repression, which it adopted in its strategic documents to prevent, curb and combat these phenomena, as it spreads [6].

All this is done to encourage businesses that are interested in becoming formalized through the implementation of the legal framework, through new incentives that benefit the integration requirements of the country. Realistically speaking, the country does not lack strategies or legal frameworks to deal with this negative phenomenon. What leaves a lot to be desired is a severe lack of political will and adequate action to be taken. The problem is that the informal economy is the source of the money which is then used for corruption and crimes. By reducing the size of the shadow economy, we directly reduce the funds in the area of crime. We are aware that we cannot annihilate this negative phenomenon in an optimal time period, but we should make every effort to limit it. In this regard, measures to reduce the shadow economy should have priority and considered very important for the growth of the national security of the Republic of Kosovo in the economic aspect.

1.2. Commercial banks and informality

The banking sector in Kosovo, despite its difficulties, is considered as a specific segment with the best performance in the economy for the past fifteen years. Bank deposits and loans have shown growth, whilst the rate of financial services experienced expansion. The Central Bank of Kosovo (CBK) is the legal authority to license, supervise and regulate financial institutions in Kosovo. The commercial banking sector consists of 15 banks. The commercial banks in Kosovo provide a full range of banking services, including loans, guarantees, current accounts, savings accounts, time deposits, national and international transfers, as well as services for the storage of valuable items. Undoubtedly, the banking industry in Kosovo has demonstrated an impressive performance by institutionalizing the cooperation between CBK and the Association of Banks in Kosovo. Even under the "Financial Stability Report", published by the CBK, it was noted that "commercial banks operating in Kosovo, continue to reflect the high degree of sustainability, stability, but also profits [6]. Not only did the CBK and commercial bank publications promote the so-called impressive success of this sector, but a series of reports of independent organizations present almost identical conclusions for such successes. 'Forum 2015' published an analysis called "The Banking Sector - Aid or Barrier" prepared by RIINVEST Institute [7]. Based on this report, the banking system in Kosovo is considered an institution with high reliability, stable and powerful in the face of crisis. Despite these advantages, the report also assessed that precisely this sector, on the flip side, presented the main barriers to the business environment in Kosovo. This is due to high interest rates and low access to credit by businesses, thus seriously hampering private sector development [8]. In addition, these reports noted that the activities in the area of the informal economy in Kosovo also threaten the banking activity. Surprisingly, none of these reports, researches, authorial articles, etc., at least until now, has analyzed the possibility of involvement of commercial banks in stimulating the informal economy. Furthermore, again until now, this phenomenon has been kept silent, although it is wildly recognized that financial and accounting documents of a business turnover, which business entities provide for credit application, is not analogous to the documents that are submitted to the Tax Administration of Kosovo. It is not clear whether the Central Bank of Kosovo (CBK), the Tax Administration of Kosovo (TAK) and the Financial Intelligence Unit (FIU) are in knowledge of this situation?

Based on interviews we had with some credit analyst officials from some of the more powerful commercial banks in Kosovo, we have managed to more precisely prove the fact that the loan application file submitted by business entities is not required that it be identical/analogous to those submitted by such entities to TAK for the purpose of setting tax rates. Furthermore, the banking entities in question do not require that the file include any official document which specifies that the business turnover must refer to declarations made to TAK. In this case, the finding that the analysis performed for the loan application, with documentation that are not compatible with what is declared to TAK, is a clear indication that the commercial banking sector is a serious contributor to the growth of the informal economy. It is precisely on the basis of this documentation that business programs are credited. If the submitted documentation to the bank represents the accurate turnover achieved by a certain business, then it is easier to ascertain whether that company has committed tax evasion. On the other hand, if the bank issues the loan to a business entity which has presented documentation that does not correspond with the statements of the real turnover, either by increasing them artificially or by presenting the real turnover only to the bank, in each case it demonstrates false representation. The absence of official

communication between the bank, the tax administration and the entity applying directly stimulates the growth of the informal economy in these relations.

1.3. What should be done?

Because the country currently finds itself in the "trap of economic informality", it is clear that an institutional intervention, with preventive or repressive measures in these sectors, is not going to be an easy task. In this state, as a rule, the use of repressive and penalizing measures should be excluded because of the fragile and turbulent socio-economic situation. From this perspective, repressive institutional reaction would be legal but in no way would be moral. The fault of malfunctioning country institutions and the consequences that are a reflection of this situation in the area business environment, does not fall as a burden on business entities. Despite this complex and problematic situation, bearing in mind the obligations that the country has now taken with the signing of the SAA, one thing is clear: that tolerance towards all forms of informal economy must come to an end. A country with such a high percentage of informal economy cannot ever be an integral part of the EU's single market.

Among the first measures to be undertaken by our state institutions must be to focus on improving government performance to achieve the socio-economic goals. Actions should focus on taking measures to pass this economic situation, which is currently characterized by tax evasiveness, towards a taxpaying formal economy, with effective and secure social nets. Particularly now is the time to push with accountability to begin implementing the National Strategy of Kosovo on prevention and combating the informal economy, money laundering, terrorist financing and financial crimes 2014 - 2018. This document should be operationalized in the area of cutting the criminal informal economy by reducing the shadow economy. Reducing the size of the shadow economy, in order to directly cut the funds in the area of crime and consequently ensuring stability. At this stage, we are aware that we cannot annihilate these activities, but should make every effort to limit them as much as possible.

Among the key factors with a direct effect on the local economy is the establishment and continuous improvement of fiscal administration, with the intent to overcome long-term development obstacles of the country and for achieving integration into Europe. Above all, the revenue administration that stems from this process and the effects that SAA produces in order to secure sources of financing, will require greater professional vigilance. The main objective of fiscal administration reform should be to increase budget revenue by expanding the tax base, particularly from sources that affect the reduction of the informal economy.

Another measure should be the connectivity of devices between the business organization and the Tax Administration. All these measures have the potential of reducing the illegal economy. TAK, in the capacity of the national agency for the collection of revenues, should have access to credit files of natural persons and companies. This should be achieved through the imposition of the so-called "analogous" principle, which is being applied as a measure for tax payments, and now will be applied for insurance payments.

The Financial Intelligence Unit (FIU) is a type of an administrative institution. FIU is a liaison body between financial institutions, the business community and law enforcement authorities. Its authority is to coordinate the fight against money laundering, based on the request of groups of interest and financial institutions, to identify clients, register and store data, and report suspicious transactions. Due to its nature, FIU capacities should be

strengthened and tasks that are associated with the investigation of the informal forms that appear on our economy should be increased. It is known that FIU, for the purpose of fulfilling its work, structures the collection of information in order to identify money laundering / financing of terrorism and criminal activities. Apart from entities specified in the law, FIU collects data also from other sources, such as law enforcement authorities (police, investigators, prosecutors); other regulatory authorities (customs, taxation, banks) and any other body that may be a useful source of financial information. Furthermore, it coordinates the work on recording, analyzing and dissemination of data to relevant authorities. All such data are most beneficial to identify the reciprocity of the gray informal economy with the criminal informal economy. In the end, both these forms are illegal.

Another high-risk situation affecting the economic security of the state, in addition to the usury phenomenon which is prevalent in Kosovo, are the debts between business organizations. They are, in most cases, provoked by the fulfillment of late state payments to private companies. This is happening in the area of public works, where the investor is the state itself. The required services or works are executed, but the payments by the state are not fulfilled within the time specified in advance. In reality these late payments of debt pose a great danger for the economy, as they ultimately reduce opportunities for greater growth. For this reason, it is important for the state to settle all overdue payments on public procurements. This will allow business organizations who have executed the contracts to settle their financial due obligations to suppliers, employees, state, and banks. Otherwise, the state itself will cause for the debt to be generated and maximized between business organizations and commercial banks.

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