

Editors

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# **Albania: The Role of Intangible Capital in Future Growth**

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Albania: The Role of Intangible Capital in Future Growth

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# Table of contents

<i>Janez Prašnikar, Tjaša Redek, Fatmir Memaj:</i> INTRODUCTION .....	1
<i>Tjaša Redek, Fatmir Memaj, Janez Prašnikar, Domen Trobec:</i> ALBANIA: TWO DECADES OF ECONOMIC DEVELOPMENT AT A GLANCE ....	4
<i>Janez Prašnikar, Tjaša Redek:</i> INTANGIBLE CAPITAL IN ALBANIA: RESEARCH METHODOLOGY .....	55
<i>Matjaž Koman, Gordana Lalović:</i> RELATIONAL, INFORMATIONAL, AND ITC CAPITAL .....	68
<i>Vesna Žabkar, Fatmir Memaj:</i> BRANDING AND BRAND CAPITAL .....	83
<i>Tjaša Redek:</i> THE CASE OF R&D .....	99
<i>Janez Prašnikar, Fatmir Memaj, Damjan Voje:</i> SOCIAL CAPITAL AND CORPORATE GOVERNANCE .....	124
<i>Nada Zupan, Daša Farčnik:</i> INVESTMENT IN HUMAN CAPITAL .....	141
<i>Janez Prašnikar, Aljoša Valentinčič, Andraž Ušlakar:</i> FIRMS' FINANCIAL POLICIES .....	168

# INTRODUCTION

Albania has made significant progress since the beginning of its transition. Its GDP per capita has risen several times and the country has restructured a large share of its productive means. If economic growth has been, until now, achieved primarily through restructuring and export orientation of cost competitive low value added industries, its future growth strategy, still export oriented, will have to shift towards higher value added production in order to further excel GDP growth and the transition of the country towards middle income countries.

Successful economic growth in transition economies and many other emerging economies largely depends not only on increasing export orientation of the economy, but also on moving production towards more demanding segments. For example in Korea, industrialization was based on producing low value added products like simple products in electronics and machinery. But the strategic orientation of both companies and, more importantly, the state, helped Korea become a leading producer in many segments of the global market, thus taking the primary position from developed countries for some products (such as LCD television screens produced by LG, formerly led by the Japanese and also Samsung; steel-making by the company POSCO) and strengthening its position with other products (such as car industry companies Hyundai and Kia) with the desire to further excel based on its global growth. The trickle-down impact of a few strong, more technologically advanced export-oriented companies is also far from negligible. Domestic value chains can benefit from higher demand for their

products, but the impact of these companies primarily opens opportunities in terms of future sales in global markets, access to new knowledge, and technology, thus increasing growth potential.

Export orientation is often first based on cost competition, but successful experiences of Asian and European economies show that own product development and global market penetration with own brands pushes the economy's developmental frontier up. Both innovation and branding represent key components of intangible capital. Intangible capital is a major source of productivity growth and increased value added. According to the most recent research in the field, intangible capital contributes up to one-third of productivity growth (e.g. Corrado et al., 2009<sup>1</sup>). Also, it is one of the major explanatory factors of 'new economy' success. Although the majority of research is being done for developed economies, developing economies also benefit from intangible capital, although the awareness of its importance and actual investment in companies are generally lower (Prašnikar (ed.), 2010<sup>2</sup>).

The research of intangible capital in Albania is the first of its kind in the country, but it is a part of the research on intangible capital in the Western Balkan region. The methodology applied across the region was developed with a focus on the characteristics and role of intangible capital in developing countries. Consequently, the study in many aspects contributes to the theoretical, methodological and empirical literature.

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<sup>1</sup> Corrado, C., Hulten, C., & Sichel, D. (2009). Intangible Capital and U.S. Economic Growth. *Review of Income and Wealth*, 55, 661-685

<sup>2</sup> Prašnikar, J. (ed.) (2010). *The role of intangible assets in exiting the crisis*. Ljubljana: Časnik Finance.

The book is divided into two major parts: an overview of economic development in Albania after the Second World War with a focus on transition and a study of intangible capital in Albanian companies, and an empirical analysis of the situation in 2011.

The book comprises nine chapters. Following this introduction, the second chapter deals with the macroeconomic development in Albania, in the last 20 years. Although the progress has been significant, both Albanian companies and, consequently, the entire economy are still quite inward oriented despite the obvious reorientation towards global markets. Investment in intangible capital would significantly contribute to future restructuring and growth of the Albanian economy.

Investment in intangible capital is the focus of the second part of the book. In the third chapter, first the methodology of the analysis is briefly discussed, defining the components of intangible capital and describing the questionnaire, the sample and data collection. The chapters that follow, chapters four to nine, provide a detailed analysis of the intangible capital components. Chapter four analyzes information and relationship capital and IT, and chapter five discusses branding. Chapter six provides analysis of research and development activity in Albanian firms, chapter seven deals with social capital, focusing on owners-workers-managers relationships. The analysis of human resource management in chapter eight provides additional insight on the topic with also a focus on organization itself. Last, the characteristics of financial activities are analyzed in chapter nine.

*Tjaša Redek, Fatmir Memaj, Janez Prašnikar, Domen Trobec*

# **ALBANIA: TWO DECADES OF ECONOMIC DEVELOPMENT AT A GLANCE**

## **1 Introduction**

Albania is a small Balkan country with a very rich and diverse history. The 'land of the eagle' has, according to Jeffries (1990, p. 77), felt a profound impact of foreign domination, from Roman and Byzantine rule, through almost five centuries of Ottoman domination ending in 1912, to Italian invasion in 1939. In 1944 the country attained independence, and in 1946 'The People's Republic, led by Enver Hoxha, was founded and communism, following the Soviet model, was implemented.

The pre-war Albania was one of the least developed countries in Europe. According to Schnytzer (1982, p.1, in Jeffries, 1990, p. 78), in 1938 industry accounted only for 4.4 percent of national income, agriculture was the major source of value and exports; about two-thirds of it was primarily livestock. There were only 150 industrial enterprises and 50 percent of them employed less than 10 employees. The majority of the population, 85 percent, was rural with a life



expectancy of 38 years. The country is richly endowed with natural resources, among which Jeffries (1990, p. 78) lists primarily fertile land and energy resources (hydroelectric and also coal, oil and gas). The country is also rich with other mineral resources, such as chrome, nickel, copper, iron and manganese (National Agency of Mineral Resources, 2010).

Natural resources partially were an important base for the fast, primarily industrial growth, during communism. But the period of communism in Albania is remembered largely for other reasons. According to Zickel and Iwaskiw (1992, p.xxxv), Albania was 'for more than forty years one of the most obscure and reclusive countries in the world. A totalitarian communist regime, led by party founder and first secretary Enver Hoxha from 1944 until his death in 1985, maintained strict control over every facet of the country's internal affairs, while implementing a staunchly idiosyncratic foreign policy.' Jeffries (1990, p. 84) also adds that Albania banned all religious institutions and practices in 1967 and became the first atheist state in the world. There was no legal private sector in manufacturing (in other socialist<sup>1</sup> economies a limited amount was usually allowed), but there was state monopoly both in domestic and foreign trade. Communism in Albania was one of the most rigid of its kind. Its characteristics severely marked Albanian development in the past and also set the foundations for its post-socialist development (Jeffries, 1990, p. 84).

Albania was the last country to step on the path of transition (Muco, 1997, p. 18). The first step towards changes, in at the time very rigid communism was marked with the death of Enver Hoxha in 1985. The results of the reforms were poor. But

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<sup>1</sup> The term 'socialist' will be used to denote the period after the Second World War. This is the predominant expression used in Albania. The more extreme notation 'communism' is only used by the most vigorous critics. Also, communism never existed in real life, at least not as Marx envisaged it. 'Communism' will consequently be used only when giving direct citation of sources.

in 1990 the political elite, led by Ramiz Alia and ‘swayed by large-scale student demonstrations, strikes, and the exodus of thousands of Albanians to Italy and Greece, and fearing the prospect of a violent overthrow,’ allowed a multiparty system (Zickel and Iwaskiw, 1992, p. xxxv). The first more serious steps towards reforms were made, according to Muco (1997, p. 18) in 1991, after the first democratic election. After initial political difficulties a reform plan, comprised of typical transition reforms (a series of laws about price liberalization, investment deregulation, macroeconomic intervention, as a tight monetary policy and budgetary austerity, land distribution and small-scale privatization), was prepared. The results of the reforms were dramatic, as in many other countries. Output declined by 50 percent in just two years (1990-92) and the country’s budget deficit also reached staggering heights in both 1991 and 1992 with 44 and 50 percent of GDP. The country went through an unstable period during the 1990s, weathering a second decline at the end of the decade. But the new millennium brought about strong growth ranging between five to seven percent per year. Despite the initial shock, the reforms eventually brought results.

Albania, a parliamentary democracy, remains for the moment one of the minor countries in the region. With a surface of roughly 27 thousand square kilometers (World Atlas, 2011), it represents about 0.2 percent of Europe. The majority of its approximately 3.2 million inhabitants is rural population (World Bank, 2012). With a per capita GNI of 4,000 US\$ in 2010, the country was ranked 124th out of 213 places by the World Bank among countries like Bosnia and Herzegovina (110th, 4,790 US\$), Macedonia (116th, 4,520 US\$), Peru and the Maldives, and well behind the richest countries like Monaco (1st, 197,590 US\$), Liechtenstein (2nd, 136,540 US\$) and Norway (3rd, 85,380 US\$). In purchasing power terms, the country ranked 109th among 215 countries in 2010 with a per capita GNI of 8,840 US\$ (World Bank, 2011). Despite a relatively strong performance after transition,

poverty is still an important problem with 12 percent of the population living below the poverty line (Table 1). The developmental lag with the richer population is evident also from the low urban population share. Agriculture remains an important sector in Albania with over one-third of GDP.

*Table 1: Albania at a glance*

	Albania	Europe and Central Asia	Upper-middle income countries
<b>2009</b>			
Population (2010, mid-year, millions)	3.2	405	2452
GNI per capita (2010, Atlas method, US\$)	3960	7272	5884
GNI (2010, Atlas method, US\$ bn)	12.7	2947	14429
<b>Most recent available estimate, 2004-2010</b>			
Poverty (% of population below national poverty line)	12	-	-
Urban population (% of total)	48	64	57
Life expectancy at birth (in years)	77	71	73
Literacy (in the age group 15 years or older, %)	96	98	93

Source: World Bank, 2012.

Currently, the country is still undergoing the process of economic restructuring, but the outlook is quite positive with strong growth in the past decade. Even during the general economic decline due to financial turmoil in global markets, Albania continued to record positive growth between 2007 and 2010. Its future depends largely on the success of continuing reforms and investment patterns.

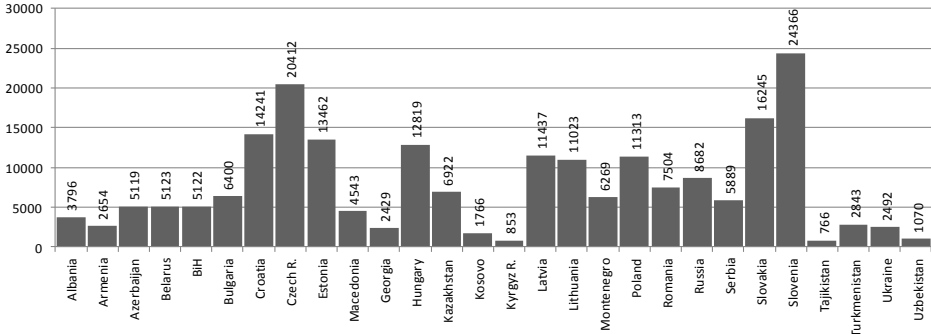
To understand the current economic processes in Albania, the general macroeconomic setting must be available. In continuing, the general macroeconomic developments are first described, followed by a more detailed

analysis of the reforms with a focus on privatization and new entry and industrial developments. The analysis is further illustrated by several company case studies, which explain the situation in terms of intangible capital in Albanian companies.

## 2 Macroeconomic developments

Albania is one of the transition economies. Its developmental characteristics and problems are largely linked to its past, and its comparative performance in reform patterns are comparable to other transition countries.

Figure 1: GDP per capita in US dollars in 2009 in transition countries\*



\* Data for Moldova was not available (0.0 value was provided).

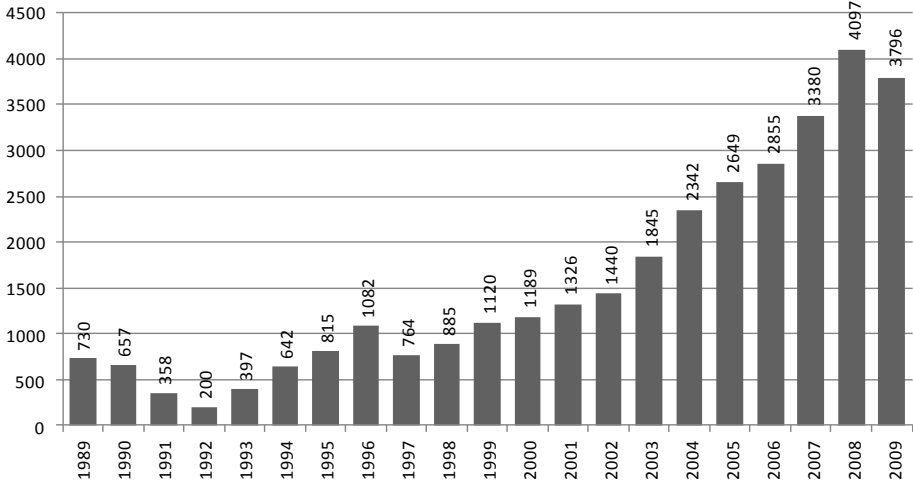
Data: EBRD, 2011a.

The country ranked 9th poorest among 28 transition economies in 2009 with roughly 3,800 US\$<sup>2</sup> of GDP per capita, which is among the poorest third of transition countries (Figure 1). It was also the second poorest economy among Central and Eastern (CEE) and South-Eastern European (SEE) countries; only Kosovo was poorer with slightly less than 1,800 US\$ per capita.

<sup>2</sup> Data from the EBRD and the World Bank differ, because the World Bank uses the Atlas method of currency conversion (for details, see the World Bank’s web page), while the EBRD uses current exchange rates.

Nonetheless, Albania has made significant progress since the beginning of transition; its GDP in 1989 was 730 US\$ (Figure 2) (all data EBRD, 2011a, in current prices). Economic growth followed the Southeast European transition pattern: initial decline was followed by a period of growth, but the end of 1990s was again marked by a decline. This brief downturn, though, was later compensated by strong growth (for reforms see Table 3).

Figure 2: GDP per capita in US dollars, 1989-2010



Data: EBRD, 2011a.

The economic situation in Albania is a result of the country’s specific economic situation before transition and its transition reform packages. In order to understand the current position, let us briefly analyze the past.

**2.1 Pre transition situation**

Muco (1997) claims that despite being a socialist and centralized economy, Albania did not consider itself as a consistent part of the ‘Eastern socialist bloc’. The

country remained an economic mystery to researchers due to the lack of data and research, especially to foreign observers. But it was obvious that the authorities implemented a rigid socialist model based on Marxist ideas and Stalin's implementations (Schnytzer, 1982 and 1992 in Muco, 1997, p. 6) that were governing the socio-economic life of the country. After the Second World War and during the 45 years of communism, the country was organized in a rigorously centralized manner: 'all economic decisions on production, pricing, wage setting, investment and external trade were centralized, while changes between the plans were generally minimal' (Muco, 1997, p. 7). According to Zickel and Iwaskiw (1992, pp. 105-106), the resulting poverty was actually an ironic outcome, a monument to socialist mismanagement. Namely, Albania has significant fossil fuel and mineral deposits and huge hydroelectric potential. Also, the fertile lowlands offer ideal conditions for cultivation of fruits and vegetables. Unfortunately, the mismanaged industrial expansion resulted in poverty and staggering unemployment in the country with the highest birth rate in Europe, and in the beginning of the 1990s numerous people fled abroad seeking opportunities.

The economic situation in Albania was, according to Muco (1997, pp. 8-12), marked by several deeply-rooted problems arising from socialist practices. The most prominent feature of the Albanian economy was its desire for self-sufficiency (see Jeffries, 1990, Muco, 1997), which led to extreme production diversification and a complete ignorance of the comparative advantages principle. Lacking suitable technological support and tradition in industrial branches, manufacturing was marked by inefficiency, low productivity and high costs. If industry represented much less than 10 percent of output prior to World War II (4.4 percent in the 1920s according to Jeffries, 1990), a strategy based on industrialization led to the rise of the industrial sector, which in 1989 represented 41.7 percent of output, and agriculture kept a solid one-third of output with over 35 percent (EBRD, 2011a).

The industry employed one-fifth of the population and absorbed over 40 percent of investment. The strategic goal was to develop heavy industry, electricity and mineral production (which were very important export products), machinery, metallurgical and chemical industry, while light industries and food processing were given less attention (Muco, 1997, p. 10). Agriculture was comparatively neglected despite its size in terms of already mentioned output and employment (over 50 percent), although efforts had been made in increasing arable land. The country was relatively self-sufficient in food production (85 percent of total food consumption, but bread production remained a problem (Muco, 1997, p. 11), but due to backward technology the production was inefficient. Also, given the rugged mountain terrain, the country was too focused on crops and much too little on livestock. Private property in both agriculture and industry was virtually non-existent<sup>3</sup>, although some form of private property in both sectors was normally allowed in socialism, even in the Soviet Union (for country details see Jeffries, 1990).

The economic results of socialism are displayed in Table 2. Initially, high investment rate growth led to high growth of industrial production and high output growth, but growth was clearly extensive, as evidenced by the industrial labor productivity data. Agricultural growth was also significant. But, given the socialist emphasis on industrial growth, agricultural growth, as expected, lagged behind industrial growth. In the 1980s growth slowed down as economic problems culminated.

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<sup>3</sup> In agriculture, a private plot of 200 square meters and a certain number of live-stock was allowed. In the 1980s there was much experimentation with private plots, collectivization, brigade plots and cattle, and a reversal of collectivization in the second half of the 1980s (see Jeffries, 1990, and Muco, 1997). Each household could have 10 animals, provided these animals were sheep or goats. One cow was equivalent to 10 sheep/goats. Chickens were not counted.

Table 2: Key economic indicators, 1961-88, average annual increase in percentage

	1961-70	1971-80	1981-88
Net material product	7.4	4.6	1.7
Net material product per capita	4.4	2.2	-0.3
Gross industrial production	9.8	7.5	2.8
Industrial labor productivity	1.5	1.8	1.3
Gross agricultural production	6.0	3.8	1.5
Agricultural labor productivity	1.0	-0.2	-2.0
Gross investment	8.4	4.9	1.5

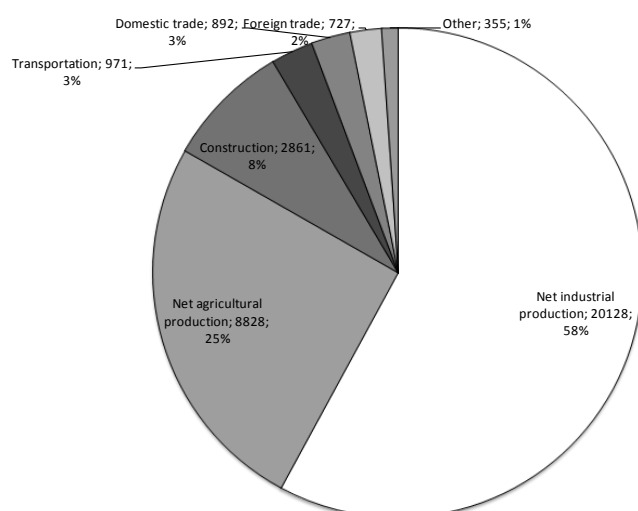
Source: Zickel and Iwaskiw, 1992, p. 244.

According to Figure 3, the structure of the economy at the end of the socialist era in 1986 was clearly biased towards industry. Net industrial production and transportation together accounted for 66 percent of total output in 1986; agriculture still occupies a remarkable 25 percent share. The share of foreign trade in 1986, when the country was already opening up, was two percent and the main trading partner was Yugoslavia, followed by the Eastern European countries of Romania, Poland, Bulgaria and Czechoslovakia, while Italy and Western Germany were its most important partners from the West (Zickel and Iwaskiw, 1992, p. 248).

‘Albania’s communist economic system, with its strict central controls, egalitarian incentive system, and bias toward heavy industry, collapsed in the early 1990s, idling almost all of the country’s production lines’ (Zickel and Iwaskiw, 1992, p. 106). Between 1985 and 1990 the government, pressured by the poor results of the existing model, allowed some decentralization and, therefore, in 1990 ‘a new economic mechanism’ was adopted (Muco, 1997, p. 7).



Figure 3: Net Material Product by branch of origin, 1986, in millions of Lek and percent of total NMP



Source: Zickel and Iwaskiw, 1992, p. 244.

After the demise of the socialist ideology across Europe, Albania was pushed onto a path of transition. Similar to other countries in transition, the country launched a reform package that typically involved (Gomulka, 2000): macroeconomic stabilization, micro liberalization, structural changes, building new market institutions and safety nets. But the country additionally faced specific internal and external shocks (Muco, 1997, p. 6).

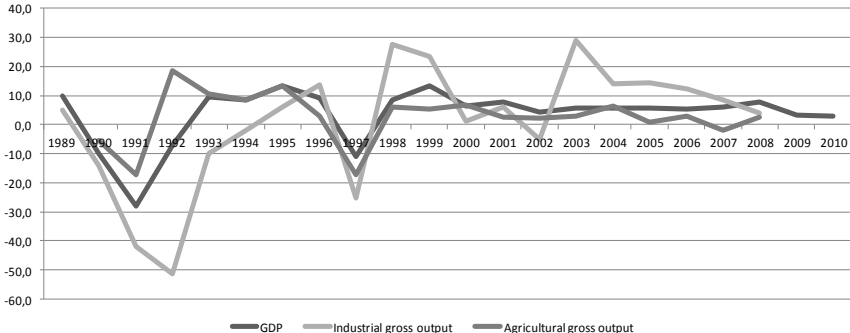
## 2.2 Transition

Due to political tensions first transition reforms in Albania were implemented only in the fall of 1991. Macroeconomic stabilization was necessary as its budget deficit soared (Figure 5) and inflation reached 226 percent in 1992 (EBRD, 2011a). In order to increase budget revenue, a new system of taxes and duties was implemented. In a monetarist manner, the country later in 1992 focused on

inflation, which was, according to EBRD (2011a), reduced by 10 times from 226 to 22.6 percent in just two years. At the end of 1991 prices also started to liberalize. In 1992 the country also started to liberalize external trade and implemented a flexible exchange rate. International trade was dominated by the private sector (80 percent of imports and 50 percent of exports). The current account deficit continued to be a problematic issue: export declined due to poor quality, CMEA (the Council for Mutual Economic Assistance) collapsed, and domestic production generally declined while imports increased, which was the standard set of poor exports results across transition countries (e.g. Gomulka, 2000).

As far as restructuring goes, in 1992 a banking law was approved that started the restructuring of the banking system. Privatization also began in 1992 with small-scale privatization, and in 1995 privatization of large companies followed. Foreign capital was also invited to participate. According to Memaj and Koçi (2001), the results of privatization were mixed.

Figure 4: Real changes in GDP, industrial gross output and agricultural gross output in Albania, 1989-2010



Source: EBRD, 2011a.

Meanwhile, according to Muco (1997, p. 21) political tensions gave rise to a lack of clear vision and inefficiency, similar to many other transition countries, which

contributed to poor economic results (Figure 4). GDP declined by 28 percent in 1991, while industrial production shrank by 42 percent. The unemployment rate peaked in 1992 at 24.4 percent (Figure 7). Business environment also remained one of the important challenges (see Ministry of Economy, Trade and Energy, 2009).

An initial period of transformational recession was followed by a period of growth in the mid-1990s and the country received praise for following the Washington consensus (e.g. Williamson, 2004). But in 1997, Ponzi schemes dragged the country ‘within weeks into anarchy, widespread violence, plundering, and food shortages’ (Bezemer, 2001)<sup>4</sup>. According to the Bezemer (2001, p. 4), the depth of the crisis was a result of Ponzi games, other financial aberrations fostered by restrictive monetary policy, poor regulation, significant capital inflow and a weak government.

The crisis spurred additional reforms to strengthen the weak elements that the 1997 crisis revealed. Consequently, Albania made significant progress in the first decade of transition and growth has since continued (Table 3). The 1999 Transition Report (EBRD, 1999) sums the results of the first decade of transition in Albania by stressing the progress in legislation reforms (especially tax and secured transactions), investment climate, and the invitation of strategic partners and foreign capital in large-scale privatization, all of which enhanced the credibility of the program. Nonetheless, the EBRD (1999, p. 126) points out the problems of ineffective law enforcement, the black market, and weaknesses in the financial system, particularly the lack of credit available to enterprises.

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<sup>4</sup> There was great trust in the economy in money pyramids, even on the side of the state. This further increased the confidence of the people. Some even sold their apartments to join the pyramids with a greater stake. The collapse hugely impacted consumption in the economy, leading to a crisis.

Table 3: Reform process summary

	<b>Liberalization, stabilization, privatization</b>	<b>Enterprises, infrastructure, finance and social reforms</b>
1991	Small-scale privatization begins	
1992	Full current account convertibility introduced Exchange rate unified All quantitative controls on foreign trade removed Most prices liberalized	Two-tiered banking system established
1993	Restitution law for non-agricultural land adopted Privatization of housing begins Privatization agency established	First foreign-owned bank opened Enterprise restructuring agency established
1994	Modernization of tax administration begins Treasury bills market initiated Most small-scale privatization completed	
1995	Voucher privatization begins Land titles introduced	Competition law enacted Bankruptcy law enacted
1996	Central bank independence law adopted VAT introduced	Securities and exchange commission established Stock exchange established First large enterprise liquidated First pyramid scheme collapsed
1997	Crisis VAT increased Emergency IMF assistance approved	Law on transparency adopted Pyramid schemes placed under international administration
1998	Three-year plan agreed with IMF Comprehensive tax reform adopted	State-owned Rural Commercial Bank closed Banking law amended
1999	Major influx of refugees from Kosovo	Capital adequacy ratio raised to 12 percent Credit ceilings for private banks
2000	Accession to WTO	Secured transitions law enacted National Commercial Bank sold to foreign investor Mobile telephone operator sold to foreign investor
2001		Second mobile license awarded to foreign investor
2002	Three-year plan adopted with the IMF	Deposit insurance law enacted Bankruptcy law enacted

Table 3: Reform process summary- continued

2003	Negotiations with the EU on a Stabilization and Association Agreement begin (SAA)	
2004	New competition law and establishment of independent Competition Authority Legal reforms (Serious Crimes Court)	Increased credit to private sector Infrastructural investment
2005	Implementation of law on restoration and compensation of property	Infrastructural investment (roads, railway, port of Durres, electricity)
2006	Negotiations with the EU on a Stabilization and Association Agreement finished New government begins fight with corruption and inefficiency with a series of laws (Millennium Challenge Account) Easing bureaucratic procedures for starting companies Social transfers scheme changed Law on concessions and private procurement	Lower subsidies for electricity New law on banking sector aimed at stronger supervision Strong credit growth (backed with collateral)
2007	Albania part of CEFTA Sale of Albtelecom approved in parliament	Electricity problems led to break up of KESH Airport development Strengthened bank supervision
2008	New national business registration center (cutting time needed to register business) Legislation for protection further amended	Electricity infrastructure investment Privatization - sale of ARMO (oil refinery)
2009	SAA ratified by all member states of the EU One stop shop for licenses and permits opened to improve business environment Formal application for EU membership	Further progress in power sector, participation of private sector Beginning of opening up the power market and introducing competition Banking sector fully privatized Financial crisis did impact the financial sector, but less due to low international integration of the sector
2010		Privatization of some sectors delayed (insurance INSIG, power KESH) Deposit growth of 16 percent, also growth of credit, but only 8.6 percent
2011	Progress towards EU halted Plan to continue privatization (still 1,300 small state-owned firms to privatize), continuing efforts to privatize Insig (insurance company) and Albpetrol	Focus on improving transport infrastructure Improved management of water and wastewater Hydro-electrical plants concessions First 3G license given to Albania Mobile Telecommunications

Source: EBRD Transition Report, 1999, pp. 126-127 for years 1991-1999, for period from 2000 on the source were EBRD Transition Reports 2000-2011, Country report on Albania.

The second decade of transition was marked by the continuance of the reforms, especially in the field of integrating in the European cooperation processes with the Stabilization and Association Agreement with the EU (2009 ratified), CEFTA (2007) and applying for EU membership in 2009. The country has also been tackling several important challenges, especially in improving its business environment and the rule of law, dealing with infrastructural weaknesses, especially transport and electricity supply, and has also privatized some of the major companies (Albtelecom, KESH, partially also INSIG) (Table 3).

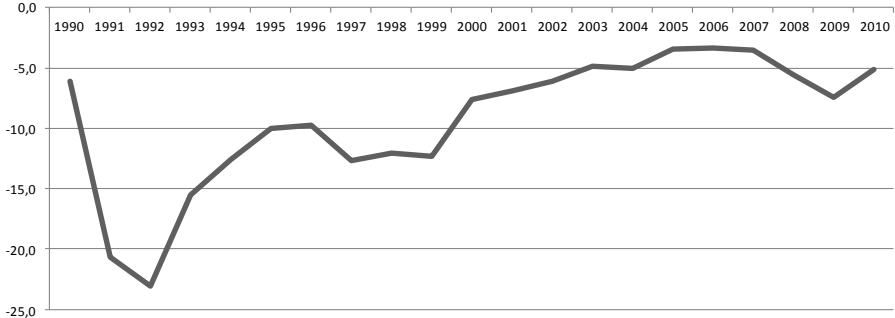
### ***2.3 Albania today***

Two decades of transition brought significant economic progress and systemic reforms during transition and have also provided a relatively solid foundation for growth (Figure 4). The country moved from a low-income to middle-income country with a per capita GDP of around 4,000 euros. Macroeconomic development was marked with strong growth, close to six percent on average in the past decade, while inflation, interest rates and exchange rates maintained stable (World Bank, 2010a). During the past decade economic growth in Albania was driven by the development of construction, business services and transport. The country also benefited from credit expansion, which has been very wide given the previously low base (EBRD, 2005, p. 95). Also, according to the World Bank (2010b), the economic progress in the past decade resulted primarily from structural shifts, labor moved from sectors with lower productivity to sectors with higher productivity: jobs were primarily created in manufacturing (primarily construction) and services, while the role of agriculture decreased.

The economic progress in the past decade was supported strongly by stable macroeconomic policies and structural reforms (Table 3).

Strong economic growth was stimulated also by strong investment performance. The total gross investment increased from 24.6 percent in 2000 to 29.5 percent of GDP in 2009, while private investment rose from 18 to 21.4 percent in the same period. But the World Bank (2010b) adds that the investment structure was skewed towards construction, primarily until 2006. In this period non-construction investment was only 10 percent. Since 2006 the situation has improved, although construction investment is still high, non-construction investment has been increasing (World Bank, 2010b, p. 4).

Figure 5: General government balance, 1990-2010, in percent of GDP



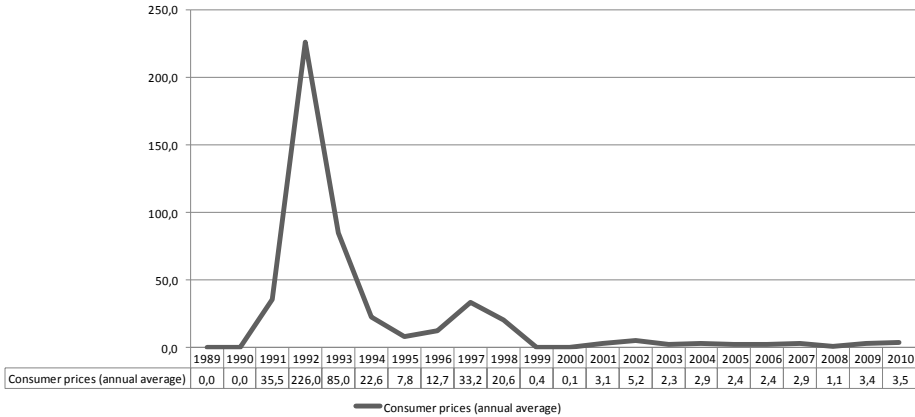
Source: EBRD, 2011a.

A stable macroeconomic environment, primarily resulting from prudent fiscal and monetary policy, also assisted economic growth. Between 2002 and 2007, improvements in revenue administration along with strong economic performance contributed significantly to deficit reductions and the decline of public debt from 62 percent in 2003 to 53 percent of GDP in 2007 (Figure 5). But in 2008 fiscal expansion, caused by an increase in public infrastructure investments and increase in public sector wages and pensions, increased public spending from 29.2 to 33.7 percent of GDP. The government failed to adjust spending, and by 2009 the deficit rose to seven percent. Also, as a result of the government’s contraction of two syndicated loans, public debt increased to almost 60 percent of GDP (World Bank,

2010a, p. 5, World Bank, 2010b, p. 6). At the moment there is great pressure exerted on the government by the opposition and international organizations to not exceed 60 percent of GDP, which means halting infrastructural investment.

Monetary policy was also important in assisting transition by keeping inflation low. Inflation was high in the first half of the 1990s and rose again during the period of financial distress in the second half of the 1990s, but monetary policy later managed to stabilize it and keep it low (Figure 6) and within the central bank’s objective of two to four percent. Albania initially adopted monetary aggregate targeting, but in practice the central bank besides monetary aggregate M3 also took into account exchange rates, price changes in different markets, and demand conditions. Overall, the policy was successful. Additionally, the choice of a flexible exchange rate system also proved to be wise, as it was a good shock absorber (World Bank, 2010b, p. 6).

Figure 6: Consumer price index, percent, annual average, 1989-2010



Source: EBRD, 2011a.

Macroeconomic stability contributed to the development of the financial sector, which supported economic expansion. Also, structural reforms and privatization (especially the privatization of the largest bank, the Savings Bank) led to a quick



expansion of the sector. The ratio of credit to GDP grew from 4.7 percent in 2001 to 37 percent in 2009 (World Bank, 2010b, p. 6).

In 2010 the Albanian economy continued to grow, although the pace of growth slightly deteriorated due to worsened external conditions. The estimated growth for 2010 was 3.8 percent, which is still the highest growth in the region for the second consecutive year. It is important to note that export was the strongest contributor to growth, especially the energy sector exports. Also, Albania managed to attract significant FDI inflow, around 800 million euros. The current account deficit, which was a problem throughout transition, was lower, estimated at about 12 percent of GDP in 2010 (EBRD, 2011b and 2011d). Even the financial crisis left for the moment only a minor mark on the economy. Economic growth remained positive throughout the period with a minimum of 1.9 percent forecasted for 2011, while industrial growth in the first quarter of 2011 was over 25 percent (Bole, 2011). The impact of the crisis will be discussed in detail later on.

*Table 4: Macroeconomic data and projections for Albania, 2008-2011\**

	2008	2009	2010	2011 projected	2012 projected
GDP growth	7.5	3.6	3.8	1.9	3.5
Inflation (end year)	2.2	3.7	3.5	3.7	3.5
Government balance/GDP	-5.5	-7.0	-4.2	-3.7	na
Current account balance/GDP	-15.6	-15.2	-11.8	-10.9	na
Net FDI (in million US\$)	874	924	1098	914	na
External debt/GDP	32.6	41.1	36.6	na	na
Gross reserves/GDP	17.5	19.8	22.7	na	na
Credit to private sector/GDP	35.2	36.7	38.0	na	na

\* For 2011, growth projection by the IMF is 2.5 percent for real growth and 3.9 percent for inflation. EBRD does not publish projections for 2012, consequently for 2012 IMF projections are given.

Source: EBRD, 2011b; EBRD, 2011c; EBRD, 2012; IMF, 2011a.

Of course there are numerous challenges ahead. Primarily, the process of transformation has yet to be finished, especially in the field of liberalization, structural reform, business environment and infrastructure. Also, economic growth, which today largely depends on the primary sector (agriculture, natural resources use), the construction industry, and cost competitive low value-added industries (e.g. textiles and leather industry) will have to be further restructured.

Figure 7: Real changes in the labor force and employment and the unemployment rate in Albania, in percent, 1989-2010



Source: EBRD, 2011a.

One of the important challenges is also the labor market. Despite successful growth, the unemployment rate remained high at around 13 percent (Figure 7) and did not follow the economic cycle. Employment was relatively stable; only in 2008 was there a slight improvement (World Bank, 2010a, p. 5). This indicates that growth was caused primarily by restructuring and consequent productivity growth. Of course employment growth also did not follow the pattern of growth. Job creation was poor and present primarily in industry, transport, telecommunication, trade, hotels and restaurants (IMF, 2008, p. 9).

Surprisingly, despite economic progress and population growth the labor force has been declining gradually since 1999 (with the exception of 2006 with 0.0 percent growth). Also, unemployment did not increase. An important cause of decline in the labor force and stable unemployment is emigration (World Bank, 2010a, p. 5), which is a great loss for future growth. Namely, according to Markova (n.a) in 2005 emigrants represented 26 percent of the working age population (15-64 years) and over one-third of the work force. Overall, according to the National strategy for development and integration (IMF, 2008, p. 9), around 20 percent of the population has been living abroad for more than 10 years (both legal and illegal migration). The government recognizes the size of the migration problem, with both its downsides and positive consequences. It primarily wants to fight brain drain by providing young, skilled personnel (also those educated abroad) good employment opportunities and improve the image and treatment of its emigrant workers abroad by providing suitable institutional support. Remittances are an important positive side effect of migration, and the government aims at directing them into productive investment (IMF, 2008, p. 32).

Closely related to the labor market and migration is also poverty. According to the World Bank (World Bank, 2010b, p. 6), the absolute poverty rate fell from 25.4 percent in 2002 to 12.4 percent in 2008, meaning that instead of over half a million people, now about 275,000 live in absolute poverty. There are significant differences between rural and urban poverty. Rural poverty declined by close to 50 percent, primarily because of remittances inflow in combination with employment shifts from agriculture to other sectors. According to the 'Albania: Poverty reduction strategy paper' (by IMF, 2008, p. 15), poverty is desired to fall below 10 percent by 2013 also due to ambitious developmental and social policy strategies. The most important policy tools are (1) changes in social protection programs (aimed at better coverage of the needs of the poor), (2) reforms in the pension

system, public health system (a set of services would be provided for free), (3) equal opportunities programs (designed to lower the female poverty rate by providing equal opportunities), and (4) reforms in the education system, which is expected to be more responsive to the needs of the economy and thereby increase employment prospects. Importantly, economic progress is expected to additionally reduce poverty, which is primarily due to public stimulation of agricultural and rural development, regional development programs, and spatial planning.

Several other developments are crucial for Albania's economic future, including the outcomes of privatization, foreign direct investment, new entry and business environment quality.

## **3 The business sector**

### ***3.1 Privatization***

Privatization in Albania began in 1992 with land privatization, continued with the privatization of housing and small and medium-sized enterprises. Large companies were the last to follow. The process today is still not completely finished, but the majority of enterprises have been privatized, thus making it possible to judge the efficiency of privatization.

Similarly as other transition economies, the main goals of the privatization process were a reduction of state ownership inefficiency and an increase in output and welfare. At the same time, privatization was expected to be fast, socially just and transparent (Memaj and Dika, 2005, p. 1).

Also, small-scale privatization was in progress, while in agriculture a significant amount of land (70-75 percent of arable land) was freely distributed in 1992 (Muco, 1997, pp. 19-20). Land privatization allowed the private sector in GDP to increase fast because of the relative importance of agriculture in GDP (24.7 percent in 1994, EBRD, 2011a). According to the privatization law of 1991, the virtual free distribution referred not only to agricultural land to members of state farms and co-operatives, but it also enabled rapid privatization of small businesses such as retail shops. As a result of these two processes, the private sector accounted for 50 percent of GDP (Sallaku, 2001) in 1994.

In 1993 housing privatization began and a year later it was basically finished. In November 1993, 97 percent of houses in urban areas were privatized, and 230,000 dwellings transferred to their residents (Hashi and Xhillari, 1999 in Sallaku, 2001).

In 1995 large enterprises (over 300 employees and a value over 500,000 US\$) also started the process of ownership transformation, with mass voucher privatization being the most important method of transformation. Vouchers could be used either in the bidding process, direct sales of assets and companies, or could be placed in investment funds (for details, see Memaj and Koci, 2001 and Malaj and Memaj, 2003). Mass voucher privatization<sup>1</sup> was used in Albania, similar to many other countries, due to its perceived social justice. In 1995 and 1996 in a total of five rounds of mass voucher privatization, 97 companies were privatized in the mechanical, chemical, construction and food industries (Sallaku, 2001).

In 1998 the government launched a new privatization strategy. The new strategy was aimed at increasing company efficiency and developing financial markets. It

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<sup>5</sup> Albania also used privatization leks, a term referred to compensation bonds to ex-politically prosecuted individuals. They were treated as vouchers and could be used in privatization (Memaj and Koci, 2001).

was based on first corporatizing remaining companies and then offering the shares in auctions to both domestic and foreign buyers. Therefore, the aim was also to attract foreign capital, especially in the case of larger companies (Albtelecom, Kesh, Albpetrol, Albanian Mobile Communications). The expected benefit was not only fresh capital, but also a restructuring of ownership (Sallaku, 2001).

#### **The case of Kürüm International: Successful privatization by a foreign owner**

Kürüm International is a steel production hub of Kürüm Holding and a part of the Kürüm Group, a privately owned company from Turkey, which operates in the field of construction steel production (companies in Albania and Turkey), construction (Turkey), production of industrial gases (Albania), shipyard (Albania) and the insurance business (Turkey, Kosovo). It was acquired in 1998 via Albania's privatization program. After privatization the company had to go through painful reorganization, as Chinese technology was obsolete and the whole facility was over-dimensioned. So far, Kürüm Group has invested 170 mil EUR into modernizing the Albanian facility. Today Kürüm International accounts for 40 percent of production of the entire Kürüm Group steel division.

The main products of Kürüm International are hot-rolled steel re-bar, billet and lime (fragmented-hydrated), which mostly serve as supply material to the construction business. The company is purely B2B oriented and very narrowly specialized to serve construction companies with no diversification of their products portfolio. Production in 2009 amounted to 308,141 tons of steel re-bar, 220,541 tons of billet, and 25,950 tons of lime. Although Kürüm International is exporting their products to customers in Serbia, Kosovo, and Montenegro, 60 percent of its sales are in Albania, and they cover 75 percent of all market demand in Albania. The company had 135 mil EUR sales in 2007 and is, despite the crisis, realizing a 6 percent year-to-year growth of sales.

Raw materials used in production are mostly (80 percent of them) imported from the Black Sea area (Turkey, Bulgaria). Albanian iron ore is not clean enough due to obsolete technology. Production know-how is imported from Turkey from where the majority of engineers and expert staff come from (60 middle and top management employees). The rest of the workers (800 employees) are Albanian. Although the company has too many workers given its current production, which is impacting productivity, it is in the mid-term, due to negative publicity caused by lay-offs, more rational to keep the workers.

Production of the company's products is very energy intensive. The company is one of the biggest consumers of electricity in the country (they use 360GWH per year), and is therefore very dependent on the public supply of electricity. To minimize the risk of electricity blackouts, Kürüm International is planning to invest in a 120mega watt hydro plant in 2012 and start buying electricity on the market. The company has ISO 9001:2008, ISO 14001:2004, and OHSAS 18001 certificates.

Competitors of Kürüm International are international producers that are exporting to markets of Kürüm International. There is a tough battle for the market since a large share of sales is directly connected with public tenders for construction in the Balkan region. The

success of Kürüm International is attributed to focused marketing – following the demand from construction companies. The company is focusing their exports to Kosovo where there is the largest expansion of public investments for reconstruction infrastructure and real estate. Otherwise, Kürüm International is facing problems with over-supply of real estate in the Balkan area (decline of demand), political instability, which could possibly influence sales – “wrong party follower,” and is not getting licenses/permits to operate. In order to be successful, Kürüm International has to be able to quickly adapt to changes in the business environment. This is mainly realized through the Kürüm Group’s vision to further diversify their vertically integrated portfolio of operations where they also see two main opportunities for future growth in Albania – the energy sector and mining.

The overall opinion is that the privatization process in Albania in many aspects failed to bring the desired results: efficiency and restructuring. Estrin et al. (1998) estimated that privatization in Albania began in worse initial conditions and with delay. The process is still not completely finished (EBRD, 2010). Nonetheless, studies of privatization efficiency have been prepared. Memaj and Dika (2005) estimate that the voucher privatization process was relatively unsuccessful, and that the mix of methods and the choice of companies were in many cases inappropriate. Memaj and Koci (2001) find that voucher privatization initially caused problems due to the inefficiency of highly dispersed ownership. Thus, a gradual concentration was necessary. An additional problem was also the lack of desire of new shareholders to enter, which caused problems of restructuring and investment. Memaj and Koci (2001) also stress both the lack of and high cost of external finance. Consequently, the majority of companies desire foreign funds to enter. Memaj and Dika (2005) add that the purpose of privatization to increase efficiency was not achieved as expected, and that the causes of inefficiency can be attributed to ‘negative effects of government policies to create a favorable environment for progress, difficult situation for financing the technological restructuring and lack of assistance for managerial restructuring of these companies, unfavorable environment for ownership concentration and for foreign investors’ participation in mass voucher privatization and during the post privatization period, inefficient role of supporting actors in the process and playing “without rules of the game” for

different actors of the demand side etc.' Importantly, the state was not expected to provide direct financial assistance and support, nor to provide required training needed to successfully run the companies (knowledge of business legal rules, marketing, finance, etc.) (Memaj and Koci, 2001). The authors were very critical: 'The state has tried only to "get rid" of them.' (Memaj and Koci, 2001, p. 11).

Memaj and Dika (2005) and Memaj and Koci (2001), having studied the inefficiencies linked with the privatization, prepared a series of recommendations to improve company performance. Many of them are linked to the general business environment. Namely, the authors recommend: (1) the creation of a competitive economic environment, (2) the creation of demand through public procurement, (3) the development of specialized consulting agencies to help the economy (e.g. for foreign investors), (4) the stimulation of growth of the Tirana Stock Exchange in order to help the process of ownership concentration and accessibility of external finance, (5) the development of human resources programs by the government to help companies manage their labor needs, (6) the creation of a suitable regulatory environment.

Economic development in transition economies, however, depends not only on existing companies and their privatization, but also on newly established companies.

### ***3.2 New entry***

Socialist economic environments were dominated mostly by large conglomerate enterprises. In some countries the small private sector was allowed, but in a very limited fashion, while medium-sized firms were virtually non-existent, which is referred to as the 'socialist black hole' (Petrin, 1989). According to Jeffries (1990, p.



80) there was no legal private sector in industry in Albania. While a limited amount of private property was allowed in agriculture (200 square meters), private output had to be sold to co-operatives at state determined prices (Jeffries, 1990, p. 82).

The role of the SME sector is very important in Albania. According to Gruda and Milo (2010, p. 8), 98 percent of all active enterprises are micro in scale (not including the agricultural sector); employing less than five (average employment is 1.5), while about one percent of enterprises are medium-sized companies with an average employment of 42. At the end of 2008 there were 107 thousand companies. The SMEs contribute to 82 percent of turnover, 52 percent of GDP and 57 percent of employment (Gruda and Milo, 2010). The small and medium-sized companies predominantly engage in trade activity (57 percent), followed by agriculture (18 percent) and construction (15 percent) (Gruda and Milo, 2010). Slightly older data (OECD, 2003) also show high concentration of SMEs in Tirana (40 percent or more of all SMEs).

The development of the small and medium sector depends on a number of factors: macroeconomic and microeconomic environment, entrepreneurial and business skills, social and economic conditions for entrepreneurship, financial assistance to small and medium-sized firms, non-financial assistance to small and medium-sized firms and market access (Gruda and Milo, 2010, p. 6). If SMEs in Albania are motivated primarily by obtaining the (minimum) means of survival, their existing nature could hide several potential threats. Prašnikar et al. (2010) analyze the entrepreneurial sector in Kosovo. The authors examine why the SMEs in Kosovo failed to grow. The answer is that there is a significant difference between self-employment and actual risk-taking entrepreneurship. Self-employees, due to their limited resources, often engage in very similar simple activities (trade, kiosk, etc.), earning barely enough to survive. True entrepreneurs will more often recognize the

difficulty of obtaining funds and will more actively recognize problems in the business environment. Both groups are a potential pool of successful SMEs. It is extremely important, though, for the government to open horizons by providing more opportunities for employment in general, especially in the more propulsive sectors. This goal can be achieved also by obtaining more foreign direct investment.

The importance of the environment on the development of SMEs is widely recognized (Ministry of Economy, Trade and Energy, 2011, OECD, 2003, Bahiti and Shahini, 2010), primarily suitable SME policy, legal and regulatory environment, tax policy and supportive environment (suitable financial instruments, advisory services and business incubators), education and training for entrepreneurship, availability of cheap and fast start-ups, improving on-line access, strengthening the technological capacity of small enterprises, and developing stronger, more effective representation of small businesses' interests. The government made several legislative improvements, and established the Agency for SME Development, and is also focusing on SMEs with regards to technological developments (e.g. Ministry of Economy, Trade and Energy, 2011) and the general business climate.

According to the Ministry of Economy, Trade and Energy (2009), the progress made by the country resulted in many positive growth effects, especially increased investment efficiency, the advantages of scale economy, increased investments, the adaptation to new technologies, and the creation of new firms and industries. The document also acknowledges the importance of stable economic growth of the SME sector, primarily an increase in the number of new enterprises, improvement in productivity and competitiveness, and expansion of firms with international potential. It is also stressed that in the view of future EU integration, the competitiveness of the SME sector, which depends on innovativeness, will be important.

### **The case of GPG Company: An innovative company in cost competition**

Golden Pen Generation – GPG was founded in 2007 by an Albanian entrepreneur that took over the knowledge and technology for producing plastic pens of the formerly bankrupt company. GPG is a purely production-oriented company that is exporting 100 percent of its production through a Slovenian partner company that operates as an outsourced sales department. The Slovenian sales partner is also the original designer of GPG's main product. GPG is part of a larger group called Nuova Plastica, which started as a business expansion of GPG producing antitheft security plastic products for clothes and plastic elements for the car industry.

GPG is an exporting company that generates revenues of around 1 mil EUR. GPG buys all of its major plastic supplies (PCPMAA) from Slovenia (Šenki, d.o.o. – [www.senki.si](http://www.senki.si)). Its main competitive advantage is low price due to low labor costs and huge flexibility in production since 52 out of 60 employees are so-called “rented employees,” that is they are employed only when an order is placed and are doing the assembly of pens which is the only part of production which is not automated. All of the GPG engineering staff is trained in Slovenia.

Such a business model, although successful for now, poses a few challenges due to Albania's unique business environment and due to common challenges of production companies around the world. One of them is taxation problems of exporters in Albania due to bureaucratic and corruption issues. Albania has a VAT system, meaning input VAT is paid on all goods purchased, and since exporters do not charge output VAT, this means that exporters claim input tax from the government (are net receivers of VAT). However, net receivers report problems from collecting VAT from the government, which in many cases results in write-offs of input VAT and thus creates substantial influence on financial outcome.

The biggest production cost of GPG is the plastic granule for molding the plastic parts, which represents around 30 percent of the GPG pens price. Another 35 percent of the price is other production costs including labor. Since labor costs are on close to its minimum, the main focus of GPG is to reduce the cost of the granule (main material input) and to further optimize the production process to increase quality of its products, which is already on a very high level with faulty products of less than 0.003 percent. Therefore GPG has established an R&D department, which consists of two of its 8 engineers employed. Their R&D department is cooperating with Italian academic experts on plastic. GPG's main methods are trial and error and learning by doing. In this way they have been able to gradually increase the quality of their pens and introduce new input materials. With successful research they have found out that recycled car headlights are equal substitutes to plastic granule. GPG is thus able to reduce the cost of the main input material and at the same time include an environmentally friendly component into their production by using recycled materials. This will result in lower dependence on their main supplier and lower dependence on input cost fluctuations as plastic granule is a direct derivative from oil. Although the use of recycled materials has big potential, there are bureaucratic limitations due to regulation – mainly ban on “garbage” imports in Albania, and at the same time Albania does not collect enough waste materials separately so it could be efficiently used by GPG. However, they are discussing options on importing recycled headlights from an Italian supplier.

Although GPG is a small company, it is export oriented, focused on technology improvements, and aware of changing business models concerning the environment by using recycled materials.

### 3.3 Business environment

Albania's business environment remains one of its key challenges (EBRD, 2011b). Currently, the country ranks 82nd among 183 economies on the 2011 Doing Business scale, which is low in comparison to the rest of the transition economies if judged by Doing Business. In 2011 according to Doing Business (2011a), Albania was behind the CEE economies and also several former Soviet economies (Table 5), which are often criticized because of their business environments.

Table 5: Ease of doing business 2011: Top 10 and transition countries

Economy	Rank	Economy	Rank	Economy	Rank
Singapore	1	Macedonia	38	Poland	70
Hong Kong	2	Slovak R.	41	Mongolia	73
New Zealand	3	Slovenia	42	<b>Albania</b>	<b>82</b>
United Kingdom	4	Kyrgyz R.	44	Croatia	84
United States	5	Hungary	46	Serbia	89
Denmark	6	Armenia	48	Moldova	90
Canada	7	Bulgaria	51	Bosnia&Herceg.	110
Norway	8	Azerbaijan	54	Kosovo	119
Ireland	9	Romania	56	Russian F.	123
Georgia	12	Kazakhstan	59	Tajikistan	139
Estonia	17	Czech R.	63	Ukraine	145
Lithuania	23	Montenegro	66	Uzbekistan	150
Latvia	24	Belarus	68		

Source: Doing Business, 2011a.

The most problematic procedures of doing business in Albania are: dealing with construction permits, paying taxes and closing a business (Table 6). Property registration, contract enforcement and trade are also quite problematic areas.

Table 6: *Doing businesses in Albania*

<b>Topic Rankings</b>	<b>DB 2011 Rank</b>	<b>DB 2010 Rank</b>	<b>Change in Rank</b>
Starting a Business	45	44	-1
Dealing with Construction Permits	170	172	+2
Registering Property	72	69	-3
Obtaining Credit	15	14	-1
Protecting Investors	15	15	No change
Paying Taxes	149	152	+3
Trading Across Borders	75	70	-5
Enforcing Contracts	89	91	+2
Closing a Business	183	183	No change

Source: Doing Business, 2011b.

Corruption is often mentioned as a problem in Albania. According to the 2010 Corruption Perception Index (CPI), Albania ranked 87th among 178 economies with a score of 3.3 on a scale from 10 (highly clean) to 1 (highly corrupt). Denmark, New Zealand and Singapore are ranked at the top with an index 9.3, followed by Finland and Sweden at 9.2. At the end are Somalia (1.1), Myanmar and Afghanistan (1.4) and Iraq (1.5) (Transparency International, 2011).

Despite low rankings the country has improved its business environment since the beginning of transition. Corruption has also been a focus of the government, especially in the past few years. According to EBRDs Transition Reports (see especially issues 2005-2010), Albania has made significant progress in the business environment, primarily fighting corruption and organized crime, reviewing administrative procedures and improving the rule of law in order to increase efficiency and transparency and strengthen the judiciary system in order to provide a better framework for investors, especially foreign investors.

### 3.4 Trade and FDI

In the past Albania followed the import substitution model of development and tended to reach self-reliance. With transition, Albania started to open up and export promotion became a central element of economic growth and development (World Bank 2010a, World Bank, 2010b). In 2000 Albania became a member of the WTO (WTO, 2012).

Table 7: Total merchandise exports in millions of US\$ and structure of merchandise exports, 2005-2009

	2005	2006	2007	2008	2009
Manufactures exports (million US\$)	525	585	754	948	763
<i>Structure (in percent)</i>					
Iron and steel	7.4	3.9	4.2	12.1	5.6
Chemicals	0.6	0.5	0.5	0.6	0.9
Pharmaceuticals	0.2	0.0	0.1	0.1	0.1
Machinery and transport equipment	5.1	5.3	5.8	5.7	6.8
Office and telecom equipment	0.8	1.2	1.2	0.8	1.3
Electronic data processing and office equipment	0.4	0.5	0.7	0.5	0.5
Telecommunications equipment	0.4	0.7	0.5	0.3	0.7
Integrated circuits and electronic components	0.0	0.0	0.0	0.0	0.0
Automotive products	0.4	0.2	0.3	0.2	0.4
Textiles	0.4	0.5	0.7	0.8	0.9
Clothing	37.7	38.5	38.3	37.0	38.1

Source: WTO Database, 2011.

The country is a very small exporter in global terms, representing only 0.01 percent of total world exports. In 2009 the majority of exports (70.1 percent) was manufactured goods, 21.1 percent was fuels and mining products, and the rest was agricultural exports. The country's reorientation towards exports is quite evident. Namely, from 2000-2009 the average yearly growth of merchandise exports was 17 percent. Main exporting products are clothing, iron and steel industry products and machinery and transport equipment (Table 7). The biggest merchandise export destinations are the EU (84.7 percent), China (4.8 percent), and Macedonia (2.8

percent) (data 2009). In terms of services, the main service to be exported is travel (77.8 percent), followed by transport (10.7 percent) (data for 2009). The average growth of service exports was 21 percent between 2000 and 2009.

FDI is also becoming increasingly significant for future development in Albania. The data shows that the yearly inflow of FDI to Albania reached almost 8 percent of GDP (2009) and 9 percent in 2010 (Table 8). But the inflow is lower than desired (Ministry of Economy, Trade and Energy, 2009), primarily because of the poor institutional environment, rule of law and corruption (EBRD, 2007-2010).

*Table 8: Trends in FDI in Albania: FDI inflow*

	Total FDI *	Per capita FDI *	% of total world FDI	% of GDP	% of Gross Fixed Capital Formation	% of total trade (goods & services)	% of trade of goods
2000	144.3	47.0	0	4	12.5	20.3	55.2
2001	206.4	67.1	0	5.1	13.2	24.6	67.7
2002	135.0	43.7	0	3	8	14.7	40.9
2003	178.0	57.3	0	3.1	7.7	15.2	39.7
2004	345.7	110.6	0	4.7	12.7	21.5	57.1
2005	264.3	84.1	0	3.2	8.8	14.5	40.2
2006	325.3	103.0	0	3.6	9.3	14.1	40.8
2007	656.0	207.0	0	6.1	15.8	21.7	60.9
2008	988.3	310.6	0.1	7.6	20.7	25.8	72.9
2009	979.4	306.8	0.1	8.1	24.5	28	89.8
2010	1096.9	342.3	0.1	9.2	..	26.3	70.8

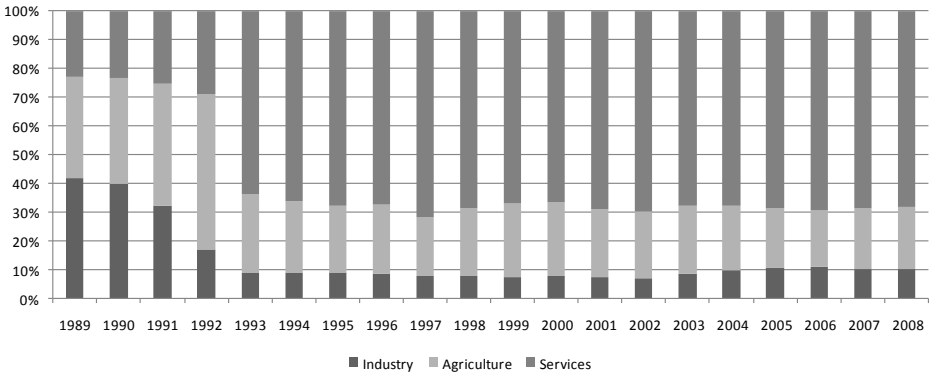
\* US dollars at current prices and current exchange rates in millions

Source: UNCTAD Database, 2012.

### 3.5 Sectoral developments

The Albanian economy has changed extensively since the beginning of transition. While during socialism the focus was on industrial development, transitional restructuring shifted the economic focus away from manufacturing. By 2008 the share of industry fell to only 10.4 percent. Agriculture was traditionally strong in Albania, but its share also declined from around 35 percent in 1989 to 21.5 percent in 2008. The share of services increased dramatically to over two-thirds of GDP (Figure 8).

Figure 8: Structure of Albanian GDP, in percent, 1989-2008



Source: EBRD, 2011a.

Given that the transformation of the Albanian economy is not yet over, the composition of GDP will continue to change. But a detailed look at the sectoral structure reveals that the key sectors in Albania are agriculture, the textile and leather industry, wood and related industries, electricity, gas and water supply, construction, trade, real estate and business services, transport and financial sector (Table 9).



Table 9: The structure of Albanian GDP in percent and growth rate of sectors in 2010

Sectors	% of total	Growth rate
<b>Agriculture, hunting and forestry</b>		
Agriculture, hunting and forestry	17.4	1.1
Fishing	0.2	0.0
<b>Industry</b>		
Mining and quarrying of energy producing materials	0.8	0.3
Mining and quarrying of except energy producing materials	0.4	0.0
Manufacture of products based on cereals	0.6	0.2
Other manufacture of food products	0.8	0.1
Manufacture of textile and leather products	1.5	0.1
Manufacture of wood, paper, furniture; publishing and printing	1.1	0.1
Manufacture of coke, refined petroleum products and nuclear fuel	0.1	-0.1
Manufacture of chemicals, chemical products, rubber and plastic products	0.3	0.0
Manufacture of other non-metallic mineral products	1.0	0.0
Manufacture of basic metals and fabricated metal products	1.0	0.2
Manufacture of machinery and equipment	0.2	0.0
Electricity, gas supply, water	3.0	1.3
<b>Construction</b>		
<b>Services</b>		
Trade	16.3	1.4
Hotel and restaurants	3.0	0.4
Transport	5.2	0.5
Post and communication	3.0	-0.3
Financial activities	4.1	-0.3
Real estate, renting and business activities	8.5	1.0
Public administration and defense, compulsory social security	4.0	0.1
Education	3.3	0.0
Health	1.8	0.0
Other community, social and personal service activities	3.1	0.4
<b>Total VADD</b>		
	<b>89.8</b>	<b>3.9</b>
FISIM	3.6	-0.2
<b>GDP at basic prices</b>		
	<b>86.2</b>	<b>4.2</b>
Taxes	14.0	0.1
Subsidies	0.1	0.0
<b>GDP at market prices</b>		
	<b>100.0</b>	<b>4.3</b>

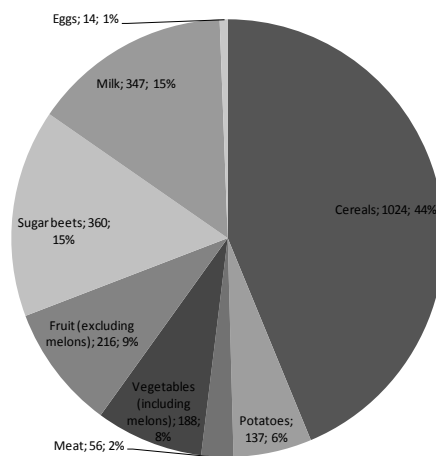
VADD: Gross value added, FISIM: value of financial intermediation services indirectly measured

Source: Instat, 2011.

### 3.5.1 Agriculture

Prior to transition, Albanian traditional mainstay agriculture contributed about a third to the country's net material product and employed more than one-half of the population. Farm products represented a major share of exports; 25 percent in 1990 (Zickel and Iwaskiw, 1992, p. 133). Data (Figure 9) reveals that cereals, primarily wheat, sugar beets and milk represented the most important products in Albania. The data is for 1988, but the structure did not significantly change during 1979-1988 (see Zickel and Iwaskiw, 1992).

Figure 9: Primary agricultural output in Albania in 1988, in thousands of tonnes and percent of total



Source: Zickel and Iwaskiw, 1992.

Today, agriculture and the food industry combined still represent up to 25 percent of GDP. The sectors employ about 60 percent of all labor. Despite the size of these sectors, production does not meet demand in many areas. Agriculture in Albania is on average inefficient and uncompetitive, local terrain is mountainous. As the case study of EWH, Gmbh shows, there is room to develop. The government is also working actively on promoting the wine industry, and olive and fruit production (Ministry of Economy, Trade and Energy, 2009).

### **The case of EWH, GmbH: Building a leading brand in the food industry based on quality and worker relations**

EWH Company is a family operated, meat processing company and retailer of meat products, established in 1992. The company ownership is split equally among an Albanian partner, who is also the executive manager, and a passive Italian owner (equity investor). EWH has a roughly 45 percent market share and realizes around 20 mil EUR revenue. EWH exports a small share of their products to the Egyptian Christian community, otherwise they operate purely in Albanian market.

EWH Company imports all of its meat inputs, primarily from Brazil (Sadia being the biggest supplier). EWH decided for input import due to cost advantages and quality (meat is controlled). Even though around 60 percent of the Albanian population is Muslim, most have no problem eating pork meat, thus around 90 percent of the imported meat is pork. Albanian meat is only bought to be sold as fresh meat locally, but in small quantities and mostly as beef.

Production is centralized in their facility near Tirana. EWH produces 70 types of different products, primarily sausages (40 percent of production). The company is dedicated to using higher quality meat with a lower fat content (10 percent most) in producing products based on its own recipes, which are constantly being improved in line with current trends and available information.

The production lines were imported from Germany and Italy and were in part adjusted to the specific needs of the company. Staff training and maintenance services contribute to higher quality production. Packaging material is imported from Italy. The company also has internal quality control labs for: 1) chemical and physical analysis, 2) microbiological analysis. Internal control and standard for meat quality exceeds those of state regulation.

Distribution is organized through 14 of EWH's retail stores, representing 35 percent of total sales. The rest is wholesale to EWH exclusive stores (some form of franchise), which sell only EWH meat products, have EWH company logos in their stores, but are not regulated on other goods sold in the store. In company-owned stores EWH also sells local fresh meat.

The company employs 200 people from the vicinity, 80 of which are in production. Although there is no collective agreement that offers great flexibility to the employer, the company has a very low fluctuation rate, also due to higher wages than average in the industry. Workers have left the company voluntarily, mostly due to emigration and not better job offers from domestic competition. Workers have to be notified two months in advance if they are to be laid-off, while they do not have to notify the company if they want to leave. EWH also organizes a bus for taking workers to work and home. Labor costs represent roughly 6 percent of total costs.

EWH, with their high quality standards and well-organized production and distribution process, has been able to become a market leader and a price setter. Their price positioning is slightly higher than their competition due to better quality of their products, and high consumer awareness of their brand. There are approximately 50 smaller local meat producers/sellers and 2-3 bigger ones that compete with EWH in the processed meat market. However, they will be faced with changes in the industry if Albania enters the EU. They will have to stop importing from their current source because of EU regulation.

Xherdo Ltd. is also a fine example of a firm that represents the direction for possible development.

**The case of Xherdo Ltd.: Investment and innovation facilitating transition from family business to foreign markets**

Xherdo Ltd. is a medicinal and aromatic plants and essential oil processor and distributor. The company started as a family business in 1991 and incorporated in 1995 as Xherdo Ltd. Although the first distillation units were primitive, with time the technology was upgraded which led to an increase in production volume and export value as well. The company started exporting in 1995. Their most important markets are currently Austria, Germany, Italy, and France.

Although Xherdo started as a family business it incrementally developed into an export-oriented company. It realized the need to invest in order to strengthen its position in the market, as it is currently a relatively small player in its export markets with around 2 million EUR of revenues in 2010. The company made its first significant investment in 2007 serving the company's future goals and marking a new investment cycle. A new facility of 11,500 m<sup>2</sup> was established in Maminas and designated for the processing of dried herbs and spices and the production of essential oils. In 2008 it invested in stainless steel distillation machineries. In 2009 completely new processing lines of dried herbs were designed in Germany and Austria, which were then installed at the processing factory by German specialists. In total, the company invested about 1.3 million EUR. Expected yearly revenues with all equipment fully functional are around 4-5 million EUR.

While 45 percent of revenues come from higher value added essential oils (9 kinds of oil) production, Xherdo still generates 55 percent of revenues from medicinal plants – herbs which are just cleaned, ground, processed, and packed in big bags. Xherdo also produces some products under their own brand (fruits – blueberry and oregano). Xherdo currently employs 12 people permanently and 45 seasonal workers for sorting and harvesting (blueberries and other plants in the region). Xherdo has a supply network operating all over the country. There is still space for improving efficiency through automation in this part of the process.

Xherdo won several award for their operations (International Star Award for Quality in Geneva in 2009 and International Quality Summit Award in the Platinum Category in New York in 2010), and became a member of international organizations like IFEAT (International Federation of Essences and Aroma Chemicals Trade), IFOAM (International Federation of Organic Agriculture Movement), and AMAPSEEC (Association of Medicinal and Aromatic Plants of South Eastern European Countries).

Xherdo's current position in the market offers a lot of challenges and threats. As their current operations are well established and generate decent returns, they are challenged externally by their direct competitors in Albania (eight competitor companies of which three are very similar in nature of business as Xherdo), and internally by their own not optimally efficient processes. Xherdo is currently not producing at optimal capacity and this is the focus of its short-term strategic plan.

On the other hand, Xherdo's long-term goals are ambitious. The company is thinking of using aromatic hydrolytes in the production of organic shampoos, creams, etc., and using waste of extracts and dried herbs as compost/organic matter for park plants. Such thinking may be very good in terms of diversifying portfolio of products, but may also slow down the plan of achieving economies of scale in Xherdo's current operations, which is still not optimal.

### ***3.5.2 Manufacturing***

The manufacturing sector increased significantly in the Albanian economy during socialism. The data for 1988 (Zickel and Iwaskiw, 1992) reveals that the focus was even then on the food industry, which contributed almost 25 percent to total manufacturing output, followed by the light industry (16.2 percent) and engineering industry (14.5 percent). The production of ore was very important with copper itself contributing 8.8 percent of total manufacturing production and other ore-related industries or ore production another 8 percent (iron and metallurgy, glass and ceramics, coal, chromite) combined.

Today, as Table 9 revealed, Albanian manufacturing in the non-food sector is concentrated primarily in textiles, wood, the chemical industry, the leather and shoe industry, metallurgy, and machinery. Production facilities are concentrated primarily in Tirana, Fieri, Durrësi and Elbasani.

The shoe and leather industry is one of the most prosperous branches in Albania at the moment. Approximately 100 companies produce well over one million pairs of shoes every month. The majority of these shoes are exported. Albania is the second largest exporter of shoes to Italy, which in turn is the largest exporter of shoes worldwide. Over the last few years, Albanian exports in the shoe and leather sector have increased by 20-30 percent per year. Albania is very attractive due to its cost competitiveness; the labor costs are only one-tenth of the costs in Italy and one-fifth of the costs in Greece. Also, Albania offers quick transport to Italy and Greece, which both serve as a base for further distribution. The abundance of unskilled and skilled labor (leather and textile engineers) makes the sector more attractive to foreign companies (Ministry of Economy, Trade and Energy, 2009).

The textiles industry is, at the moment, the next highly dynamic sector. Its development is based on the same competitive (cost) advantages. Production in this industry is primarily exported and is based on commission contracts (Ministry of Economy, Trade and Energy, 2009). The case of Stella Company reveals the disadvantages of such an approach.

**The case of Stella Company: Investment in intangible capital needed to increase value added in the textiles industry**

Stella is a textile company producing underwear under their own brand. It was founded in 1993 and is owned from 1996 onward by its CEO, an Albanian businessman. Stella is mainly dependent on its Italian partners as is the case in many Albanian SMEs. All of Stella's 3 million revenues are made in the Italian market, around 20 percent of which is their own sales and around 80 percent is through eight Italian partners. Such partnership arrangements allowed Stella steady, but moderate growth. Its Italian partners also supplied Stella with knowledge about new technologies and adapting cuts and styles to the needs of the international market. Today Stella produces around 120 different styles and cuts for all ages.

Materials are mainly imported from Turkey and Pakistan. The factory has two production plants and employs 300 workers, paid better than the average in the industry (around 200 EUR net and 250 EUR gross wage). The majority of workers are employed in production (sewing). Although they have managed to shift from the mass production of a few products to smaller batches of many diversified products with learning by doing, and they have received knowledge from Italian partners, Stella still lacks the knowledge and equipment to shift production from mainly "refinement operations" to higher value added complete production operations. Stella also does not achieve quality and control standards of high branded European producers and, therefore, cannot pitch the outsourcing refinement business of these companies.

In order to expand operations and sales, Stella will have to make substantial investments in equipment and education to further diversify into the higher value added lingerie market. Currently their brand is positioned in the lower class of their segment. Although Stella has some domestic competition with similar business models, the competition has problems with regulation for exporting to Italy. Stella is mainly threatened by low cost producers from China, Pakistan, and Turkey. In order to further develop and enter new markets with different business models (sales on their own), Stella urgently needs to invest into knowledge and better equipment.

The wood industry is also very important in Albania. According to Policy options for wood energy (2009), forests cover 36 percent of Albania. This sector is one of the fastest growing in Albania and represents a growing share of exports; wood and

paper products represented 3.3 percent of exports in 2009 (Instat, 2010). Given that the exports in this industry are primarily material and intermediate products and that the furniture industry is growing with interest from foreign investors, there is potential for the sector to move into higher value-added production. Crucial investments in tangible and intangible capital are needed in order to make such companies more competitive (the case of Dafinor, Ltd.).

**The case of Dafinor Ltd.: Low technological solutions and export of cheap raw materials**

Dafinor is a wood panel production company. The company started wood production in 1990 as a government-owned company and was privatized by the voucher system in 1993. The company is currently owned by two Albanian brothers and an Italian partner.

Dafinor's production processes of tradable goods in wood industry products and production processes are defined by low technological solutions and the export of semi products or cheap exports of raw materials. Dafinor's technology, quality control, and supervision come from Italy, which is also their main export market (90 percent of their export). Although Dafinor is trying to expand its operations into a higher value added market of finished products, 80 percent of their production is represented by wooden panels and 20 percent by final products, which range from interior design to the manufacturing of a wide range of furniture from massive wood and other wooden products. Therefore only a minority of their products is distributed via B2C market. The biggest advantage of Dafinor is cheap production as raw materials are supplied locally (wood) and the labor force is cheap in respect to the EU average in the industry (although Dafinor pays its workers 20-30 percent higher than the Albanian average). Dafinor, interestingly, employs female workers in the production process, whereas male workers have higher-level positions.

Mining is one of the strategic sectors in Albania. Natural resources such as chromium, copper, nickel and coal are abundant throughout the country. In terms of chrome, the country was, prior to transition, the world's third largest exporter. Today the majority of production is exported only partially processed despite the fact that finalization reaps more economic benefit. Albania also has oil reserves that are estimated to be 30 million tonnes of extractable reserves. The sector is being

actively developed, with the help of the government, and foreign capital is welcomed.

In general, the Albanian government is investing a great deal of effort to help develop the industrial sector. The policies in the industrial sector are closely intertwined with the rest of the development policies, especially those dealing with SME development, export promotion, and FDI (Ministry of Economy, Trade and Energy, 2009).

### ***3.5.3 Services***

Services were traditionally neglected in socialism due to a focus on material production, especially manufacturing. Also, private property was virtually absent and retail trade was a state-owned operation with fixed prices and rationing. Thus, the black market was very lively. With the start of transition, controls on domestic trade were lifted, allowing private initiative. Thus, the service sector boomed, especially retail shops and restaurants (Zickel and Iwaskiw, 1992, p. 56).

Today, services contribute slightly over 50 percent of total GDP (data for 2010, see Table 9). The most important is trade representing 16 percent of GDP, followed by real estate with 8.5 percent, transport with slightly more than five percent, and financial services with 4.1 percent of GDP.



## 4 Albania: financial crisis and future challenges

The global economy has been earmarked by the 2007 burst in the financial sector, leading to a general economic distress with a high toll on many developing economies, including transition economies (e.g. Baltic countries, Slovenia, see Eurostat, 2011). Albania has so far been relatively successful, comparatively, in weathering the crisis.

*Table 10: Economic growth in selected economies, 2001-2012\**

	Albania	EU27	Slovenia	Montenegro	Croatia	Macedonia
2001	7.2	2.0	2.9	1.1	3.7	-4.5
2002	3.4	1.2	3.8	1.9	4.9	0.9
2003	6.0	1.3	2.9	2.4	5.4	2.8
2004	5.9	2.5	4.4	4.4	4.1	4.6
2005	5.7	2.0	4.0	14.7	4.3	4.4
2006	5.5	3.4	5.8	8.6	4.9	5.0
2007	5.9	3.1	6.9	10.6	5.1	6.1
2008	7.7	0.5	3.6	6.9	2.2	5.0
2009	3.3	-4.3	-8.0	-5.7	-6.0	-0.9
2010	3.0	1.9	1.4	2.5	-1.2	1.8
2011	1.9	1.6	1.1	2.7	0.6	3.0
2012	3.5	0.6	1.0	2.2	0.8	2.5

\*Data for 2012 are forecasts.

Source: EBRD, 2011c, Eurostat, 2011.

One of the main reasons behind Albania's success is its comparative closedness and underdeveloped financial system (EBRD, 2011c). In 2007, Albania's growth was strong at 5.9 percent and was, according to EBRD (2011d), also becoming broader based, which is a condition for its sustainability. In 2008 growth was even stronger at over 7 percent, while in 2009 and 2010 it did decelerate, but dropped to a still strong 3 percent. This is the result of a combination of reduced industrial output, a drop in capital inflows, falling remittances, and slower credit growth on the

negative side and increased government spending aimed at reducing this impact. The main contributions to growth come from new mining projects, construction and strong performance in tourism and exports (EBRD, 2011d).

Comparatively, Albania is doing quite well (Table 10). Despite the crisis, economic growth remained positive, unlike in the EU27 and other selected Balkan economies, and was in 2010 the highest in the region for the second consecutive year. Bole (2011) also shows that Albania also experienced relatively stable growth. Only in the fourth quarter of 2009 did growth fall slightly below zero percent. In the countries of South-Eastern Europe growth rates were, on average, negative from the last quarter of 2008 through the second quarter of 2010, which is a significantly longer period. Similarly, the successful trend in Albania can also be observed in industrial production (Bole, 2011).

The fiscal situation should be closely monitored due to the deterioration in 2008 and consequent rise in deficit and debt. The World Bank and the IMF (in World Bank, 2010a) forecast a negative overall deficit of 4.5 percent of GDP for 2011, remaining over 3.5 percent in the red also through 2012-2013. The primary budget is also expected to be negative at around one percent of GDP or less (1.1 in 2011, 0.7 and 0.8 in 2012-2013). A comparative analysis of the fiscal situation confirms that Albania has a high deficit and debt (Table 11), which is a problem recognized also by international organizations. The country's relatively large public debt and lack of exports, competitiveness, and consequent current account deficit pose a threat to future development according to EBRD (2011c). Similarly, the World Bank (2010a) claims the country must focus on retaining macroeconomic stability primarily through fiscal policy rule.

*Table 11: Budget deficit, public debt and foreign financial investment as a percent of GDP, estimates for 2011*

	Budget deficit	Public debt
Albania	-3.73	59.36
Bosnia and Herzegovina	-3.47	39.59
Bulgaria	-2.51	17.78
Croatia	-5.74	47.53
Macedonia	-2.51	26.30
Montenegro	-3.38	43.07
Romania	-4.41	34.36
Serbia	-3.77	44.07
Slovenia	-5.60	43.64

Source: Bole, 2011.

The banking sector for now remains relatively stable. According to the World Bank (2010a), the Albanian banking sector was one of the few in the region that had a large positive net foreign asset position, primarily because of prudent management and limited credit lines of foreign banks, which meant low external private debt. The central bank's efficient supervision spurred by the financial distress caused by pyramid schemes also contributed to the country's relatively stable position. Namely, although non-performing loans increased, the situation is, according to the World Bank (2010a), not critical and claims that the financial system is able to withstand even more severe stress testing. However, a comparative analysis of the region (Table 12) reveals a few caveats, those primarily being the change in capital.

Table 12: Financial system in the region, estimates for 2011

	Coverage of non-performing loans by capital write-off (%)	Change**	Non-performing loans*	Change in non-performing loans	Capital	Change in capital
Albania	56.8	14.0	14.4	7.8	9.1	-4.9
BiH	40.2	2.3	11.7	8.6	18.0	15.7
Bulgaria	71.2	-37.8	13.5	11.0	10.6	48.4
Croatia	39.3	-9.4	11.5	6.6	14.2	23.6
Macedonia	103.3	-14.8	9.1	2.4	11.0	25.8
Montenegro	30.7	-42.9	21.0	17.8	10.5	53.4
Romania	58.6	-1.7	13.4	10.6	7.8	9.5
Serbia	141.5	-46.3	18.6	7.3	21.0	67.3
Slovenia	70.0	-9.3	5.1	3.3	8.8	0.4

\* Non-performing loans as a percent of total loans.

\*\* Change refers to the previous year.

Source: Bole, 2011.

One of the concerns for Albania is also its trade balance (Table 13).

Table 13: External sector in Albania, in percent of GDP

	Actual				Estimate		Projection		
	2005	2006	2007	2008	2009	2010	2011	2012	2013
Current account balance (incl. official transfers)	-6.5	-5.9	-8.6	-14.7	-15.2	-11.4	-10.3	-9.2	-8.5
Trade balance	-24.0	-24.3	-25.9	-28.0	-27.2	-22.2	-21.4	-20.6	-20.0
International reserves (in months of imports)	4.0	4.7	4.3	4.0	4.0	4.0	4.0	4.0	4.0
Remittances	13.7	14.1	13.5	11.2	11.1	11.0	10.9	11.0	11.0
FDI	3.3	3.6	6.0	7.0	8.2	5.3	5.3	5.3	5.2

Source: World Bank, 2010a.

The current account balance continues its negative trend, and since 2010 the current account deficit is around 10 percent. The trade deficit is much higher at around 20 percent. Thus far, financing the trade deficit was not a problem, as about

one-half was covered by remittances and one-quarter by FDI. Interestingly, other capital inflows of primarily unidentified sources (unrecorded remittances) funded about one-third according to the World Bank (2010a, p. 7), while the balance was financed by loans.

Exports have yet to become a major driver of growth. So far, since the end of the 1990s, exports have increased significantly from 10 percent to around one-third of GDP. However, due to the industry's high elasticity to EU growth rates (on average the elasticity is 4, but in construction elasticity is 8), further European problems could harm Albania (World Bank, 2010a). At the moment the country is in danger also because of the risk of spill-over effects from Greece in terms of lower investment, remittances, and financial system crunch.

In the future the main question is how to continue such a growth trajectory. The success, or lack thereof, will depend primarily on the dedication to further improve the business environment, promote exports (also to ease problems with the current account deficit), attract foreign capital, which might become easier conditional on success with European Union negotiations and pacts (SAA, CEFTA), and improve infrastructure to help exports, FDI, and tourism to promote exports (EBRD, 2011b, EBRD, 2008). According to the IMF (2011), the crisis helped reduce the external imbalance and the financial system did not break, although asset quality declined.

Country growth strategy (World Bank, 2010a and 2010b) stresses that becoming an upper middle-income country is challenging. Up until now, the productivity rise resulted from inter-sectoral shifts of labor, but in the future this process will become largely dependent on intra-industry changes. Momentarily, Albania's competitiveness in world markets is primarily due to its lower costs. In the future

the quality of products will become increasingly important. Therefore, investment in innovation, skills, and human capital in general is important. Increasing globalization will also make the country more vulnerable in terms of exposure both to competition as well as external shocks like the current crisis. Thus, it is becoming increasingly important for the government to provide a solid foundation on the basis of which the private sector (domestic and foreign) can develop.

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# **INTANGIBLE CAPITAL IN ALBANIA: RESEARCH METHODOLOGY**

## **1 Intangible capital**

Today, economic value is often created by intangible capital, both in developing and developed countries. Therefore, the role of intangible capital and investment in intangibles is gaining attention in various fields of economic and business science. Research at both macroeconomic and microeconomic levels confirms that intangible capital increases value added, productivity and growth (Corrado et al., 2009, VanArk et al., 2002, Fukao et al., 2009, Miyagawa et al., 2010, VanArk et al., 2009 and other).

The study of intangible capital in Albania was based on the prevailing definition of intangible capital and own extensions of the definition conditional on the current situation in these developing economies and global trends. Many authors have similarly defined the concept of intangible capital (e.g. Buguise et al., 2000, Fernandez et al., 2000, etc.), differing mainly on the focus of respective analyses (accounting, IT, etc.). The line of research focusing on the role of intangible capital in the process of economic growth and its link with productivity relies mainly on the seminal work by Corrado et al. (2009), which divides intangible capital into

three types: computerized information, innovative property and economic competencies (Table 1).

*Table 1: Intangible asset classification*

Type of intangible asset	Further classification
Computerized information	Software
	Databases
Innovative property	R&D, including social sciences and humanities
	Mineral exploration and evaluation
	Copyright and license cost
	Development costs in financial industry
Economic competencies	New architectural and engineering designs
	Brand equity (advertising expenditure, market research)
	Firm specific human capital (continuing vocational training, apprentice training)
	Organizational structure (purchased, own account)

Source: Corrado et al., 2009.

This study of intangible capital focused on Albania extended the definition of intangible capital to include relational, informational capital and social capital. All three types represent both theoretical and methodological innovation in intangible capital literature.

On one hand, informational capital refers to a firm's knowledge about its products, production processes, customers, and resources. It also includes knowledge about competitors' products, production processes, customers, and resources. On the other hand, relational capital includes the stock of relationship with customers, suppliers, competitors, government agencies, and unions (Hunt, 2000). Both types of capital are extremely important in building and sustaining quality and stability in the production and distribution chain. For firms in developing countries, both types of capital are crucial in finding ways for these firms to internationalize (Paley, 2011).

Firm behavior is examined by the bargaining model, focusing on the relationships between workers, management and owners, that is interest groups, and the impact of their relative power on firm behavior and strategy. Social capital is especially important in the former transition economies since it provides information on the direction of privatization and its strategic consequences. It also reflects the characteristics of labor markets and the ways the country is building its human capital.

The study of intangible capital in Albania, therefore, focused on the following aspects of intangible capital: (1) informational and relationship capital, (2) information technology (IT), (3) branding and brand capital, (4) innovation, (5) interest groups in the firm (social capital), and (6) human capital characteristics and organizational characteristics. Underdeveloped financial markets in Albania also play a major role in financing different types of investments, including intangibles. Hence, special focus is given in our work to test the pecking order hypothesis and different methods of capital budgeting procedures.

In continuing, a methodological overview is provided. In the second section, the questionnaire is first described, followed by the description of the sample and survey in Albania.

## **2 Research design**

### ***2.1 Questionnaire structure***

The questionnaire for the study of intangible capital in Albania comprised of 7 sections focusing on different aspects of intangible capital (informational and relationship capital with information technology, branding and brand capital,

innovation and R&D, social capital, HRM and organization, and finance), while the last section focused on general company data, primarily financial data. This section provides only a brief overview of each sub-section of the questionnaire. A detailed presentation will be provided separately in each of the chapters dealing with each specific topic.

*Information and communication technology* (4 questions). ICT was examined in three sub-sections. First, the size of ICT in 2009 was examined, given the expectation that firms with more ICT would be more productive. Then, the importance of ICT in a firm is examined via the hierarchical level of the IT manager within the firm. The higher the position of the IT manager, the more productive a firm should be. Last, the strategic importance of ICT in company documents and the implementation of IT plans are analyzed.

*Relational and informational capital* (10 questions) was measured using a three-part questionnaire focusing on customers, competition and suppliers. First, the export orientation of a firm is examined as a major part of informational capital. Second, we examine how the companies follow and cooperate with the customers and involve them in product development. Third, we examine a firm's business environment, primarily the intensity and consequences of competition, as this can either enhance or reduce innovation activity. Last, we focus on the suppliers and their origin, since it is expected that there is also a link between supplier and company performance in terms of innovation.

*Research and development* (10 questions). The questionnaire on R&D comprised of 10 questions focusing on four major elements of R&D: product and process innovation, sources of information, organization of R&D activity and competences and capabilities. The analysis of R&D was based on the premise that companies

differ significantly both in terms of their origin (developed, developing country) and target market (home based, exporter). Companies from developed countries or those selling to developed markets were expected to be more innovative. Regarding product innovation, we were interested in company comparative performance in terms of product innovation, types of product innovation, the share of revenue dedicated to R&D and the organization of R&D. Companies were asked to share information on process innovation. Next, both internal and external sources of innovation ideas and information relevant for innovation were examined. The last set of questions refers to competences: technological, marketing and complementary.

*Branding and brand capital* (5 questions). Intangible capital is largely dependent on the activities of the marketing sector. The questionnaire consists of five sets of questions to managers that cover decisions in the fields of brand development, brand value, brand investment, marketing innovation and future orientation. Brand development was measured through brand management activities and included questions on whether or not companies develop their own brands, if they develop corporate brands in addition to the separate brands for their products/services, and also, whether or not they have developed brand architecture. Brand management activities related to brand value were estimated by examining if companies have legally protected company brands (with patents, trademarks), finance activities to increase brand value, either corporate brands or product/services brands, and, finally, if they measure brand value, either corporate brands or product/services brands. Separately, brand investments or share of sales for activities to increase the value of brands were measured (including external costs of advertising and marketing activities of advertising agencies and media).

*Interest groups within companies* (7 questions) are especially interesting from the transitional perspective, given that the behavior and strategies of firms can be linked to ownership structure and, consequently, linked to the privatization process in transition countries. In addition, the characteristics of labor markets also determine corporate governance. The sub-section could be roughly divided into three parts. First, the ownership structure is analyzed. Next follows an analysis of employment characteristics in firms, the nature of wages, and presence of worker unionization. Last, decision making and risk sharing are both analyzed

*HRM and organization* sub-section (5 questions) analyzed the three most important aspects: human capital and motivation, organizational climate and organizational structure. In particular, the questions focused on the organization of training within companies and the extent of such activities, the transfer of knowledge, the dynamics of dealing with key employees, and the performance measures of workers. Employee satisfaction and motivation were also examined, as was the flexibility of the organization.

*Finance and investment* (5 questions). The analysis stretched beyond intangible capital to capture the nature of finance and the resources devoted to both tangible and intangible investment. A firm's financial policies can help accelerate or undermine the accumulation of investments in general, including investments in intangibles. To examine the financial behavior of Albanian firms and the level of development of financial markets in Albania, research on intangibles should thus be supplemented with research on financial policies, with both aspects having a strong influence on investments in intangibles. The questionnaire focused on the sources of finance. Capital structure and the criteria used in financing decisions were examined.



In addition to this, the questionnaire also asked for specific data referring to the company, sales, employment, wages and other costs. The data was needed to analyze the impact of intangible capital on productivity.

In total, the questionnaire comprised of 46 questions, the majority of which were structured.

## ***2.2 Questionnaire methodology***

The questionnaire was carefully designed using three main types of questions: cascade type of questions, Likert scale questions and standard questions asking for a specific piece of information (expenditure, etc.).

The majority of questions were based on the cascade type of question following Miyagawa et al. (2010). This is a set of three simple 'yes/no' statements. Each statement within the trio was carefully designed so that each additional yes means that the company is in some aspect at a higher level of development (see Table 1 for an example). Such an approach to building survey questions enables the creation of a measurement scale from 1 to 4, which allows empirical testing. If the first answer is 'no', the company is awarded '1'. If the first answer is 'yes', it is awarded '2'. If the answer to the second sub-statement is 'no', the value remains at '2', if the answer is 'yes', it rises to '3'. If all sub-statements get affirmative answers, the total value amounts to 4, indicating the highest possible attainment in a specific field. In the example question for instance (Table 2), if the company answered 'yes' to all statements, this means that the company also introduced new global products,

indicating the company's high potential in introducing new products.<sup>1</sup> Such an answer was translated into a numeric value of 4.

*Table 2: Example of cascade question from innovation: question 2*

2	<b>Introducing new products</b>	NO	YES
	The company introduced a significant number of new products in our relevant market in the past few years.		
	The majority of those products were not new only for the company, but were also new to the <u>market we work in</u> .		
	We introduced also products that were a novelty in the global markets.		

Source: Intangibles questionnaire for Albania, 2011.

The use of this cascading technique was an important innovation. Questionnaire testing conducted during the year prior to the actual study revealed that companies often have insufficient data, especially when it comes to hard data. Also, the testing clearly showed that the smaller, more diversified or less advanced the company was, the harder it was to obtain a reliable (hard data type) answer. Personal interviews using the questionnaire revealed how important it is not to pose questions that are too specific, long, complicated or detailed, as the answers might be completely different than what was asked (or expected as an answer). Therefore, the simple yes/no cascades allow full capture of the problem while ensuring data quality and reliability.

Second, the questionnaire comprised also some Likert scale questions using a 1 to 5 scale or a 1 to 3 scale, depending on the focus of the question (Table 3).

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<sup>1</sup> But it must be noted that all questions from R&D referred to a company's 'relevant market', that is the market in which that the company sold its major share. Consequently, the question could also refer to domestic or even regional markets. But nonetheless, it indicates the potential of a company to stretch beyond its current borders.

Table 3: Example of a Likert scale question from innovation

7	Technological competences	1	2	3	4	5
1	Research and development in the firm is advanced.					
2	Number of available technological capabilities inside the firm or through strategic partnership is quite large.					
3	We are good at predicting technological trends.					

Source: Intangibles questionnaire for Albania, 2011.

Cascade type questions were supplemented also by standard questions asking for a specific piece of information (market shares, sales, expenditure, etc.) (Table 4). This type of question was used primarily in the last part of the questionnaire where specific company data was requested, which was needed for the study of the link with productivity.

Table 4: Example of a question with specific data from branding/ marketing section

<b>Please, estimate the percentage of sales (in terms of total sales) to a certain area in each of the following years!</b>		
	<b>2009</b>	<b>2008</b>
Albania		
other countries of former Yugoslavia		
EU-15		
countries of former Soviet Union		
rest of the world		

Source: Intangibles questionnaire for Albania, 2011.

The questionnaire we briefly presented is different from existing standardized questionnaires in at least three major aspects. First, it is focused more on developing countries and provides answers to understanding the development gap within and between countries.

Second, the questionnaire primarily uses the cascading technique based on simple ‘yes/no’ questions, which adds to the quality and reliability of data and does not limit the potential for statistical analysis. The questionnaire captures the entire intangible capital structure, but at the same time keeps the questions simple. We supplement the descriptive data also with some hard data.

Third, the questionnaire allows us to obtain data on which types of intangible capital companies have, how processes are conducted, what the results related to these processes are, that is, whether intangible capital is also being used in an appropriate manner. The questionnaire was carefully designed to also capture these aspects, which is again extremely important in analyzing developmental problems at the firm level as well as a comparative perspective.

Last, given many similarities with the standardized questionnaires in selected aspects of intangible capital, the methodology applied nonetheless allows many comparisons, which is extremely important for future comparative analysis with the developed countries.

### ***2.3 Survey description***

The survey was conducted on a sample of 40 Albanian firms in 2011. The sample of firms was not chosen randomly. Due to limited resources, the sample was rather carefully chosen using the snowball method so as to represent the most typical structure of Albanian firms by industry.

The sample consisted of 12 joint stock companies and 28 companies with limited liability. Ten companies (25 percent) were from the construction industry, 37.5 percent of the sample (15 companies) was from the manufacturing sector, while

37.5 percent of companies were from the tertiary sector: 15 percent of companies (6 companies) from trade and 22.5 percent of the sample (9 companies) are from service activities other than trade.

Twenty-seven companies were involved in business-to-business operations, while 13 companies were selling their products to final markets. The companies sold the majority of their products/services in domestic markets (over 80 percent on average), although the majority of the sample (28 companies) were involved in foreign trade to at least some extent.

The sample also well covered the size structure; in the year 2010 companies on average employed 148 people, the smallest company again employed 4 employees, and the largest employed 990. In 2010 the total number of employees in the sample was 5,901.

In order to become familiar with the questionnaire, a company first received it by mail. The questionnaire was then answered during an interview with one of the Albanian research team members (researchers from the Faculty of Economics, University of Tirana). The quality of input data could thereby be directly controlled. The questionnaire was answered by a company's CEO, financial or HR manager, or, in some cases, a combination of the two in cases where specific data (e.g. financial data) was requested.

One of the focal points of the research was the link between a specific type of intangible asset and company performance. To analyze this link, the relationship between productivity and intangible asset type was analyzed. For this purpose, the sample was divided further into two groups, the dividing line being the median

firm. Any other division of the sample, if not noted differently in the chapter, was also conducted using the median.

It should be noted that this type of research required great efforts from both researchers and companies. In some cases it was noted that the questionnaire was long and demanding. Thus, the cooperation of both researchers and companies is greatly appreciated. As a result of these joint efforts, the forthcoming chapters present an in-depth picture of the Albanian economy, which until now has been unavailable.

### **3 Conclusion**

The study of intangible capital in Albania is the first of its kind and provides valuable information about the Albanian economy based on firm-level data. The research team developed the survey methodology applied with the view of the specifics of developing markets. The survey comprised of subsections analyzing each component of intangible capital separately, adding two new components to the standard intangible capital definition: informational and relational capital, and social capital.

The results provide an interesting and consistent explanation of a rather domestically oriented economy, at the moment, striving to become a more export-oriented economy. The analysis begins with the study of informational and relationship capital, ending with HRM.

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# RELATIONAL, INFORMATIONAL, AND ITC CAPITAL

## 1 Introduction

In today's global world the role of intangible capital is becoming more important in achieving competitive advantage and, as such, it becomes critical to understand how a firm's intangible capital is affecting firm performance.

Resource-advantage theory (Hunt, 2000) states that a firm's resources are leveraged to provide for competitive advantage. Griffin et al. (2010) argue that competitive advantage is founded mainly on intangible resources, especially on human, organizational, relational, and informational capital. Organizational capital covers a firm's policies and norms, whereas human capital covers business skills and the knowledge of a firm's employees. Informational capital constitutes a firm's knowledge about its products, production processes, customers, and resources on one side, and also a firm's knowledge about competitors' products, production processes, customers, and resources. Relational capital includes firms' stock of relationship with customers, suppliers, competitors, government agencies, and unions (Hunt, 2000). Also, the ability to effectively manage information within the firm while successfully gathering new information about the environment,



customers, and competitors have become critically important since it may provide a basis for gaining a competitive advantage similar to other invisible assets possessed by firms (Sampler, 1998). The ability to obtain information about markets and customers helps to ensure that firms are more attuned to changes in the environment and can result in a competitive advantage over slower, ill-informed competitors (Barney et al., 2001).

In this chapter we will focus on the role played by informational and relational capital, and the role of information and communication technology (ITC) in Albanian firms. More precisely, we will investigate their size and also the effect they have on productivity.

The chapter begins with a brief description of relational capital, informational capital, and capital connected with the investment in ITC, with an emphasis on the measurement of each. Next, we present the size of all types of capital in Albania and their effects on productivity. In the last section we present our conclusion.

## **2 Measuring Relational, Informational and ITC Capital**

Our main hypothesis is that informational capital, relational capital, and ITC capital positively affect a firm's performance, which we measure by productivity. As shown by Griffith et al. (2010), higher levels of relational and informational capital positively influence marketing capabilities (abilities in selling/marketing, product development/research, and the art of distribution), which in turn positively affects firm performance. Regarding investment in information and communication technology, a number of studies show that on the macro level ITC is an important factor in productivity growth (van Ark et al., 2002; van Ark, 2004). However, micro

economic studies on the effect of information technology (IT) on firm performance have presented no conclusive evidence (Tippins and Ravipreet, 2003; Huang et al., 2009). According to a resource-based view, ITC per se may not generate a sustainable advantage because competing firms could adopt the same technology (Clemons and Row, 1991). The advantages of ITC can be protected, however, by embedding them in an organization through complementarity and cospecialization (Powell and Dent-Micallef, 1997). In this respect, knowledge represents an important intangible resource for the firm. Most of the mixed results about the effect of information technology on firm performance can be attributed to the fact that most studies examined IT as a stand-alone resource, neglecting the role of complementarity and cospecialization.

We measured relational and informational capital in firms using a three-part questionnaire. The structure of the questionnaire is as follows: In the first part there are questions about a firm's customers, the second part deals with a firm's competitors, and the third section has questions about a firm's suppliers. Each question (factor) consists of three sub-questions, to which managers were able to give either a YES or NO answer. We will first briefly describe each factor, then the sub-questions of each factor that are shown in Table 2 will be described in detail in the result section.

Let us start with factors dealing with informational and relational capital. The first factor deals with export orientation. This is the only factor that is not measured by YES or NO answers. We have rather measured the share of sales to different regions. These regions are shown in Table 1. Export orientation belongs to a firm's informational capital. Based on the literature on exports and productivity, firms that export more are more productive (Wagner, 2007), and also firms that export to more destinations are more productive (Anderson et al., 2008). The second factor,

monitoring customers, is part of a firm's informational capital since it measures how closely a firm monitors its customers and whether or not it engages customers in the development of new products. More precisely, we asked firms if they meet regularly to exchange views and observations about relationships with their customers, and, if they do, whether or not they meet with their customers to find out about their needs. Finally, we asked firms if they engage their customers in the process of new product development.

The next factor is concerned with the business environment in which a firm operates. Does competition enhance productivity? In economic literature both positive and negative effects from competition on innovation have been found (Cohen et al., 1989). As argued by Aghion et al. (2006), there is an inverse U relationship between competition and innovation. Increasing competition can either enhance or reduce innovation depending on the initial level of competition.

The last factor in relational and informational capital deals with a firm's suppliers, more precisely the origin of suppliers. There is an increasing amount of empirical literature that focuses on the affects of imported inputs on productivity. Kasahara and Rodrigue (2008), Halpern et al. (2009) show that imported intermediates improve a firm's productivity. Intermediate imports allow firms to adapt to technology from abroad (especially if they come from developed markets) and so benefit from foreign research and development. They also allow a firm to focus resources and specialize in activities where it has a particular strength (Anderson et al., 2008). We asked firms about the origin of their suppliers (local markets, Albania, or developed markets). If more than 50 percent of a firm's suppliers (based on the value of total material costs) were from developed markets, the firm should be more productive.

We have analyzed the effect of ITC capital on a firm's productivity by four groups of factors (questions). Each factor focuses on the particular determinant of ITC system in the firms. We will briefly describe each factor while the sub-questions of each factor are shown in Table 3 and will be described in detail in the result section.

The first factor analyzes the share of revenues that the firm invested in ITC in the year 2009. Firms that invest more in ITC should, in general, be more productive. The second factor investigates the hierarchical level of the IT manager in the firm. The higher the position of the IT manager in the firm, the more productive the firm should be. With the next factor we investigate if the firm has a strategic plan for IT development and how this plan is implemented. More active implementation of an IT plan should result in higher productivity. The last factor deals with the role of informatics in current activities, business reorganization, or in achieving a competitive advantage.

### **3 Results**

Our analysis is built only on 40 questionnaires. We obtained a statistically significant difference between the group of more productive and less productive firms for only a few questions. In interpreting the results, we emphasized the direction of the difference.

Albania is still not an export-oriented country even though their exports have increased significantly from the end of 1990. At that time exports represented around 10 percent of GDP, while today this share is around 30 percent (World Bank, 2010). Most of Albania's exports end up in the EU. This is illustrated in Table 1 where we also show the mean value of the share of sales by different regions in the years 2008 and 2009 for the entire sample of firms and two sub

samples i.e. more productive and less productive firms. The mean firm from Albania generates only slightly more than 10 percent of its revenues from exports (not much difference between the years 2008 and 2009). Hence, almost 90 percent of a firm's revenues are generated in the domestic market. This implies that the typical Albanian firm is insider oriented. In comparison with Slovenia and the Republic of Srpska, the mean firm from Albania exports substantially less. The mean Slovenian manufacturing firm and the mean firm from the Republic of Srpska exported around two-thirds and one-third of firm revenues in the year 2009, respectively (Koman et al., 2010, Prašnikar et al., 2012). Table 1 also shows that the more productive firms in Albania export less compared to the less productive firms. Hence, market niches exist in domestic markets and allow firms, due to no market saturation or monopoly position, to acquire rents that result in higher productivity. In the year 2008 this difference is also statistically significant. On average, less productive firms exported around 18 percent of their revenues in the year 2008, while more productive firms exported only three percent of their revenues. In the year 2009, the less productive firms exported approximately the same share of revenues as in the year 2008, while more productive firms exported more (eight percent). The same qualitative result holds for firms from the Republic of Srpska, while the result is just the opposite for Slovenian firms. It seems that in less developed countries export is mainly due to distressed export (loan deals), where value added and, thus, productivity are small (see as an example the case of Dafinor Ltd in Redek et al., 2012, in this book). While in the year 2008 both more and less productive firms in Albania created most of their export revenues from the EU-15 countries, this was not the case for 2009. For less productive firms, the greatest export in the year 2009 was still generated by the EU-15 countries (13 percent of total revenues), but for more productive firms the largest export markets were countries of the former Yugoslavia, with around 6 percent of the share of total revenues. The more productive firms exported only 2 percent of their

revenues to markets of the EU-15 countries in the year 2009, which is statistically significantly less compared to less productive firms (13 percent). This again suggests that exports to developed markets created by less productive firms are mainly the result of “loan” deals. For example, in Slovenia more productive manufacturing firms export more, on average, to the EU-15 markets than less productive firms i.e. 42 percent versus 37 percent (Koman et al., 2010).

*Table 1: Mean values of shares of sales by different regions in year 2008 and 2009 between more and less productive firms*

	All firms		More productive firms		Less productive firms		T-test	P-value
	n	Mean	n	Mean	n	Mean		
<b>2008</b>								
Albania	40	0.897	20	0.970	20	0.825	1.937	0.060*
Other countries of former Yugoslavia	40	0.027	20	0.013	20	0.041	0.990	0.328
EU-15	40	0.064	20	0.017	20	0.110	1.507	0.140
Countries of former Soviet Union	40	0.0004	20	0.0008	20	0	1.371	0.178
Rest of the world	40	0.012	20	0	20	0.025	1.600	0.118
<b>2009</b>								
Albania	40	0.863	20	0.918	20	0.807	1.252	0.218
Other countries of former Yugoslavia	40	0.054	20	0.064	20	0.04	0.362	0.719
EU-15	40	0.076	20	0.018	20	0.134	1.693	0.099*
Countries of former Soviet Union	40	0.0003	20	0.0005	20	0	1.446	0.156
Rest of the world	40	0.008	20	0.00005	20	0.015	1.185	0.243

\* Significant at 10 percent

In Table 2 we show the results of the three remaining factors (monitoring customers, business environment and origin of suppliers) that measure relational and informational capital in Albanian firms. More precisely, we show the share in

percent of positive answers for each sub-question for the factor in the more and less productive groups of firms.

The factor monitoring customers consist of three sub-questions that measure how closely firms monitor and engage their customers in business decisions. Seventy-three percent of firms in the entire sample regularly exchanged views and observations on customers, and seventy-eight percent of firms planned changes in their supplies. Forty-three percent of firms also engaged their buyers in new product development. The value of this factor is smaller for the more productive group as compared to the less productive group, since the share in positive answers to each sub-question is higher in the less productive group compared to the more productive group even though the differences are not statistically significant. We observed the same in the Republic of Srpska. A larger share of the less productive firms (85 percent versus 70 percent) meets with their customers to find out about their customers' needs. Also, a greater proportion of less productive firms engage their customers in new product development (50 percent versus 35 percent). The most plausible explanation for this is that among less productive firms most of them produce products that are used by upstream firms in their production processes. For them a closer relationship with their customers and customer involvement in product development is nowadays a quite common practice. This explanation is consistent with previous observations on export orientations (distressed export), since a less productive firm in Albania, on average, exports significantly more to the EU-15 countries than the average more productive firm, and with case studies presented in this book (see the case of Dafinor Ltd and the case of Stella Company in Redek et al., 2012, in this book).

With respect to sub-questions that measure business environment, there are also statistically significant differences between less and more productive firms in

Albania. Seventy percent of more productive firms stated that the activities of their competitors have an impact on their business, compared to 75 percent of less productive firms. This could imply that less productive firms are operating in a more competitive environment. As shown in the case of Stella Company (Redek et al., 2012, in this book), the company is facing strong competition from firms in China and Pakistan. However, when we asked firms how they respond to their competitors' strategic moves, 60 percent of more productive firms stated that they respond aggressively, while only 50 percent of less productive firms stated this response. Since more productive firms operate mainly in domestic market and some of them probably have a monopoly position in their respective market niche, their aggressiveness can be the result of preventing their (potential) competitors to (enter) expand their market share. The results in table 2 also show that 65 percent of less productive firms operate in an environment where at least one company in their core business had more than 20 percent of the market share; compared to only 35 percent in more productive firms (the difference between groups is statistically significant).

With the last three sub-questions we measured the origin of suppliers. In 45 percent of firms in the entire sample more than 50 percent of suppliers (based on the value of total material costs) are from developed markets. This is basically the same as in the Republic Srpska (42 percent) and substantially less than in Slovenian manufacturing firms, where this number was 73 percent. Table 2 also shows that in all three sub-questions, which measure the origin of suppliers, the differences between more and less productive firms are not statistically significant. Although the percentage of suppliers (based on the value of total material costs) from countries other than Albania is larger in more productive firms (80 percent versus 75 percent), both groups of firms have the same percentage of suppliers from developed countries (45 percent).



Table 2: Share in percent of positive answers for each sub-question in the more and less productive groups of firms for relational and informational capital

	All firms		More productive firms		Less productive firms		Chi-square	P-value
	n	Share (%)	n	Share (%)	n	Share (%)		
<b>Monitoring customers (Customers)</b>								
People from different functional areas of our company meet regularly in order to exchange views and observations about what's going on with our customers.	40	73	20	70	20	75	0.125	0.723
We regularly meet with our customers in order to find out about their needs.	40	78	20	70	20	85	1.290	0.256
Consumer representatives of our products are engaged in the process of developing new products.	40	43	20	35	20	50	0.927	0.337
<b>Business Environment (Competitors)</b>								
The activities of our major competitors have an impact on our business.	40	73	20	70	20	75	0.125	0.723
Our company aggressively responds to the strategic moves of our main competitors.	40	55	20	60	20	50	0.404	0.525
At least one company in our core business has a more than 20% market share.	40	50	20	35	20	65	3.600	0.058*
<b>Origin of suppliers (Suppliers)</b>								
Most of our suppliers are not local.	40	88	20	90	20	85	0.229	0.633
More than 50% of suppliers (based on the value of total material costs) are not from Albania.	40	78	20	80	20	75	0.143	0.705
More than 50% of suppliers (based on the value of total material costs) are from developed markets.	40	45	20	45	20	45	0	1

\* Significant at 10 percent.

Results in Table 3 indicate the relative position of informatics within the firms tested by different qualitative measures. In our sample only 88 percent of firms invest at least one percent of their revenues in IT. Also, 35 percent of firms in our sample invest at least three percent of their revenues in IT. The above numbers are substantially low if compared to more developed countries like Slovenia (Domadenik et al., 2010). They are, however, higher than in the Republic of Srpska where only 15 percent of firms invested at least 3 percent of their revenues in IT. Both groups of firms (more productive and less productive) invest relatively the same amount of revenues in IT. Thirty-five percent of firms in both groups have a strategic plan for IT. Although this plan is updated every two years in more than 70 percent of firms that have it, the plan and its revisions exist mainly on paper, as only 10 percent of more productive firms (which is 30 percent of firms that have a plan) and an even fewer percentage of less productive firms (5 percent of all less productive firms or 14 percent of firms that have the plan) implement them. This suggests that IT should not be a source of competitive advantage. However, when we asked managers if IT is a source of competitive advantage, almost 50 percent of them said that it is. Hence, managers believe that IT can be a source of competitive advantage, but they are not practicing it in their firms. One possible explanation for this can be the lack of funds that are required to set IT as a source of competitive advantage.

Table 3: Share in percent of positive answers for each sub-question in more and less productive groups of firms for ITC capital

	All firms		More productive firms		Less productive firms		Chi-square	P-value
	n	Share (%)	n	Share (%)	n	Share (%)		
<b>Investment in IT</b>								
At least 1% of revenue.	40	88	20	90	20	85	0.229	0.633
At least 2% of revenue.	40	48	20	45	20	50	0.100	0.752
At least 3% of revenue.	40	35	20	35	20	35	0	1.000
<b>Position of the IT manager</b>								
IT manager is within the company hierarchical structure ranked higher than on the 4th hierarchical level.	40	45	20	45	20	45	0	1.000
IT manager is within the company hierarchical structure ranked higher than on the 3rd hierarchical level.	40	33	20	30	20	35	0.114	0.736
IT manager is a member of the board of directors (highest management level).	40	18	20	10	20	25	1.558	0.212
<b>The IT strategic plan in the company</b>								
Exists.	40	35	20	35	20	35	0	1.000
Is being implemented.	40	8	20	10	20	5	0.360	0.548
Is being updated at least every second year.	40	25	20	35	20	15	2.133	0.144
<b>The role of IT in the company</b>								
IT is NOT considered only as a supporting business service.	40	48	20	40	20	55	0.902	0.342
IT stimulates business processes reengineering.	40	38	20	35	20	40	1.067	0.744
IT is a source of competitive advantages for the company.	40	48	20	50	20	45	0.100	0.752

## 4 Conclusion

Our results indicate that the level of relational, informational, and ITC capital in Albanian firms affects the productivity of firms. Results show that the share of revenues from the domestic market and the share of exports to the EU-15 markets have a statistically significant effect on productivity. However, the effect is not as expected. Firms who export more are less productive, and share of revenues created from developed countries (EU-15) is smaller in more productive firms compared to less productive firms. Anecdotic evidence suggests that this can be due to distressed export (loan operations). Due to low labor costs in less developed countries, firms from developed countries engage firms from less developed countries to do basic operations for them. We found additional support for the above observations mainly in questions dealing with the monitoring of customers and the origin of suppliers. In the case of loan operations, the firm that is producing 'loan' products gets instructions on how to produce from its buyer. As a result the buyers generally provide the firms with raw materials and only inspect if the end products are of good enough quality.

In the long term the distressed export will not be able to persist. As Albania progresses, their low labor cost will increase, which will cause Albanian companies to become uncompetitive. Since export currently represents around 30 percent of Albania's GDP, this will result in a substantial slow down of the Albanian economy. To prevent this scenario from occurring, the Albanian government should focus more on the export-led growth model, in which intangibles play a very important role. The government should create an environment that will be beneficial for establishing firms such as GPG Company and Xherdo Ltd that are described in Redek et al. (2012, in this book).

Our results also show that the typical Albanian firm is inside oriented since it creates most of its revenues from its domestic market. The insider-oriented firm is also more productive since it is able to extract rents. As long as the government does not put substantial effort into improving the business environment, which will result in stronger competition in the domestic market from abroad, Albanian firms that operate mainly in the domestic market will continue to extract rents.

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# BRANDING AND BRAND CAPITAL

## 1 Introduction

Albania is a country little known to consumers from more developed countries, which typically hold prejudiced, convenient and shallow narrative about the country. Modest progress and growing stability do not receive mass media attention outside the country. Therefore, Albania's reputation and perceptions lag significantly behind the reality of the country's notable economic and social development since the early nineties (see Redek et al., 2012, in this book). The exceptions are probably 'professional' audiences such as business investors, bankers, and tour operators in tourism, who seem to be better informed and enthusiastic about the country's prospects (Anholt, 2007). As a former Eastern-bloc country, the country has been rebranding itself as 'a new Mediterranean love,' was named to the top of Lonely Planet's (2011) 'countries to visit,' and was named as an 'emerging destination' by the Financial Times (2011), although the majority of visitors still come from neighboring states (Balkans.com, 2011).

Before discussing branding and brand capital in companies in Albania, it is necessary to explain the country in terms of its development of marketing infrastructure and support services. Namely, distribution and promotion

infrastructure reflect the ease of marketing goods in a country and for businesses, successful execution of distribution and promotion decisions greatly depend on the marketing infrastructure of the country. Among Central and Eastern European countries, Albania was ranked among low attractiveness countries together with Bosnia–Herzegovina and Macedonia in 2001 (Manrai et al., 2001). More recent sources (e.g. Pici and Goga, 2007) show tremendous growth in terms of development of marketing infrastructure. For example, the availability of advertising media improved significantly from low initial numbers in less than a 10-year period (Table 1). Pici and Goga (2007) report that the media market in Albania included more than 260 media outlets (outdoors not included). Major media groups have established an Internet presence and actively pursue audience interaction and engagement through prize competitions, on-line forums, surveys etc. Sevrani and Gorica (2011) and Sevrani et al. (2010) report that the Internet is seen as a way of building an image in the long run and as a complementary tool to traditional marketing methods. Pici and Goga (2007) point to a paradox where on one hand the country has very low landline telephone penetration, but with growing PC ownership & internet usage, the country is, on the other hand, an early adopter of mobile TV and HDTV. According to Bedalli (2012), the present advertising structure is the following: in TV more than 60-65 percent, outdoor more than 18-22 percent, press up to 5 percent, and radio about 1.5-2 percent.

*Table 1: Advertising media availability in Albania*

Year	Advertising media availability in Albania					
	Newspapers		Radio		Television	
	#	Circulation (per 1000)	#Stations	#Radio sets (per 1000)	#Stations	TV sets (per 1000)
1998	4	39.59	18	151.03	9	74.78
2007	27		54		73*	

\*includes free-over-the air TV stations, does not include additional 47 cable TV platforms, A DTH platform and 1 mobile TV platform

Source: for 1998: Manrai et al., 2001, for 2007: Pici and Goga, 2007.



In terms of advertising spending, Pici and Goga (2007) provided an estimation of 23-25 million euros spent on print, electronic and outdoors. This estimation covers the top 50 major ad spenders for the first half of 2007. Advertisers were mostly from industries with more intensive competition, e.g. producers of fast-moving consumer goods and retailing, as well as advertisers from newly established banking organizations and mobile telecommunication operators. Manrai et al. (2001) considered the retailing sector in Albania, particularly in the capital city of Tirana, as already well developed due to large-scale foreign aid and remittances from friends and relatives abroad, combined with a speedy privatization.

Regarding the development of the advertising industry and acceptance of advertising, Manrai et al. (2001) had no information available on the number of advertising agencies available in the country, advertising expenditures by media, or consumers' attitudes toward advertising in Albania. The advertising industry in Albania was considered to be one of the least developed. Pici and Goga (2007) report that the first Albanian advertising agencies developed no earlier than the mid-1990s as small sole proprietary shops owned and operated by practitioners with limited marketing education and advertising experience. In the late 1990s, some of these small 'boutiques', focusing mainly on creative products, were contracted by international full-service agencies to support the local needs of major advertisers. More intensive competition after the year 2000 contributed to the development of a new specialized group of agencies (sales promotion, PR) and advertising groups providing integrated marketing services. New players affiliates of large international agency groups were established, e.g. McCann Erickson Tirana (2012). Pici and Goga (2007) report a growing need to establish trade associations for professional advancement and adoption of common ethical guidelines and widely accepted best practices. Also, there was a lack of use of any consumer insight, brand valuation, or media research tools although such tools are available.

Most the major domestic advertisers tend to rely on the marketing expertise of their employees, while most of the major international advertising brands rely on lead advertising agencies. The market lacks experience and expertise in the part of marketing and media services departments.

The purpose of this chapter is to present branding and brand capital as part of intangible investments in Albanian companies, and to discuss specifics for companies in Albania. According to Corrado et al. (2009), advertising expenditures represent a large part of investments in brand equity and business investments in intangibles. Advertising expenditures have asset/investment-like characteristics: advertising effects on firm intangible assets are accumulative and sustainable (Wang et al., 2009). Our main hypothesis is that branding and brand capital positively affect a firm's performance, which we measure by value added per employee.

*Branding* is seen as an essential tool that enables price premiums in the market, leading market positions, or market penetration (Kapferer, 2008). Since there is no active market in brands that would provide comparable values, brands are very special intangible assets (Interbrand, 2004). In many businesses, brands influence choices that are crucial to firm performance and the creation of shareholder value (Morgan and Rego, 2009). In competitive markets, branding includes a number of decisions relating to brand expansion, co-branding, participation in trade brands, and the overall brand architecture (Petromilli et al., 2002). Thus, branding includes various aspects of brand awareness (recall and recognition), perceived quality, and level of loyalty (Keller, 2003).

Brand management strategy refers to brand development, brand measurement and control, as well as concern for brand value. *Brand development* includes several aspects of brand management activities, including whether the company develops its own brands (product/services brands and corporate brands) and whether it has

developed brand architecture. *Brand value* related activities start with legal protection of company brands (with patents, trademarks), and build with activities to increase brand value and measure brand value (brand investment or the share of sales for activities to increase the value of brands). Innovations are related to branding and company growth and productivity (Tellis et al., 2009, O'Mahony and Vecchi, 2009). Companies that rank higher on branding and brand-related activities should also implement more innovation within their marketing mix. In terms of a company's future, different channels and media impact company sales and brand equity effects (Keller, 2010).

The chapter presents an overview of brand-related marketing activities. The structure is the following: following a brief explanation of Albanian specifics and development in terms of the development of marketing infrastructure and supporting services, activities related to brand capital, brand development, and brand value in Albania are examined together with reported marketing activities to sustain branding activities and ensure a company's future. A comparison of companies from different industries, with legal forms, export orientation, size, and value added are reported. Results are discussed and conclusions are taken from the findings.

## **2 Data analysis of branding and brand capital in Albania**

The analysis of branding and brand capital in companies in Albania relies on responses from 40 Albanian managers representing companies of different size, industry, legal form and export orientation. Brand development was measured through brand management activities, including the development of own brands, corporate brands in addition to brands for own products/services, and the

development of brand architecture. Based on the answers provided in the questionnaires, there are two distinct clusters of companies: companies with at least two of the above three aspects are ranked higher in brand development (50 percent of companies in the sample, see Table 2), while the others are ranked lower on brand development (50 percent of companies in the sample).

*Table 2: Brand development marketing activities for companies in Albania*

Frequency	Clusters		Percent
	Brand development activities	Lower	
	Higher	20	50.0
	Total	40	100.0

Brand management activities related to brand value were estimated through investigation whether companies have legally protected company brands (with patents, trademarks), whether they finance activities to increase brand value, either corporate brands or product/services brands and, finally, whether they measure brand value, either corporate brands or product/services brands. Again, companies with at least two of the three activities related to brand value were classified as companies high on brand value measurement (38 percent of companies in the sample, see Table 3), while companies with one or none of brand management activities related to brand value were classified as low on brand value measurement (62 percent of companies). Brand development and brand value activities are correlated (symmetric measure phi has a value of 0.671, sign. 0.00). Only 15 percent of companies are high on brand development and low on brand value, while only 2.5 percent of companies are high on brand value and low on brand development. For all other companies there is a congruency between both dimensions of brand management (both low are 48 percent of companies, both high at 35 percent of companies).

*Table 3: Brand value marketing activities for companies in Albania*

	Clusters	Frequency	Percent
Brand value activities	Lower	25	62.5
	Higher	15	37.5
	Total	40	100.0

Brand investment or share of sales for activities to increase the value of brands (including external costs of advertising and marketing activities of advertising agencies and media) was examined. Only a fraction of companies responded (Table 4). The reported investments are in the range of 0 to 30 percent and are growing in the period 2006-2009.

*Table 4: Brand investments for companies in Albania (as percentage of sales)*

Year	N	Mean	Std. Deviation
2006	18	6.7	7.9
2007	18	7.6	9.6
2008	19	9.6	11.3
2009	19	9.5	11.4

In terms of marketing innovations, 68 percent of companies reported innovations in terms of marketing communications (new media or promotion techniques), the same percentage (68 percent) in product design or packaging, 65 percent in marketing channels and 83 percent in new forms of pricing, while 12.5 percent of companies reported no marketing innovation. Regarding marketing innovation, clusters of companies according to brand development activities and brand value activities were compared. Companies in the cluster with more developed brand development activities reported significantly more areas of innovation and also, regarding brand value clusters, companies in the cluster with more brand values activities reported significantly more areas of innovation (see Table 5 for reported mean values and t-test statistics).

Table 5: Marketing innovations for companies in Albania\*

	Cluster	N	Mean	Std. Deviation	Std. Error Mean	T	Sig. (2-tailed)
Brand development activities	Lower	20	2.15	1.565	.350	-3.250	.003
	Higher	20	3.50	1.000	.223		
Brand value activities	Lower	25	2.24	1.535	.307	-4.596	.000
	Higher	15	3.80	.560	.145		

\*Scale for marketing innovations: number of areas for reported innovations (for four 4Ps), range 0-4

Preparations for future marketing seem to be very high for companies in Albania: 73 percent of companies reported that they have a strategy about the further development of brands, 63 percent of companies do see possibilities for expanding their brands to new markets, 70 percent of companies see possibilities for establishing a leading market position with their brands in the future, while only 22.5 percent of companies did not report any of the above activity. Again, regarding preparations for future marketing the clusters of companies according to brand development activities and brand value activities were compared. Again, companies in the cluster with more developed brand development activities reported significantly better preparation for future marketing. Also, regarding brand value clusters, companies in the cluster with more brand values activities reported significantly better preparation for future marketing (see Table 6 for reported mean values and t-test statistics).

Table 6: Preparation for future marketing for companies in Albania\*

	Cluster	N	Mean	Std. Deviation	Std. Error Mean	t	Sig. (2-tailed)
Brand development activities	Lower	20	1.45	1.394	.312	-3.325	.002
	Higher	20	2.65	.812	.182		
Brand value activities	Lower	25	1.60	1.384	.277	-3.841	.001
	Higher	15	2.80	.560	.144		

\* Scale for preparation for future marketing orientation includes brand development strategy, new markets planning or leading market position; range 0-3.

Furthermore, differences in branding and brand capital are analyzed for companies according to their value added. As a measure for company value added, a dummy variable for company value added in a selected year (2009) was taken, where the median value added per employee was taken as a cut-off value (0=below median, 1= median and above). When comparing clusters of companies according to their brand development activities (Table 7), the analysis showed significant negative correlation between the brand development cluster membership and value added per employee ( $\Phi = -.300$ ,  $\text{sign.} = 0.05$ ).

*Table 7: Brand development marketing activities and value added per employee for companies in Albania*

			Value added		Total
			lower	higher	
Brand development activities	lower	Count	7	13	20
		% of Total	17.5%	32.5%	50.0%
	higher	Count	13	7	20
		% of Total	32.5%	17.5%	50.0%
Total		Count	20	20	40
		% of Total	50.0%	50.0%	100.0%

A comparison of value added to brand value activities (see Table 8) revealed that two clusters of companies according to their brand value activities do not differ significantly in terms of value added ( $\Phi = -.155$ ,  $\text{sign.} = 0.327$ ).

*Table 8: Brand value marketing activities and value added per employee for companies in Albania*

			Value added		Total
			lower	higher	
Brand value activities	lower	Count	11	14	25
		% of Total	27.5%	35.0%	62.5%
	higher	Count	9	6	15
		% of Total	22.5%	15.0%	37.5%
Total		Count	20	20	40
		% of Total	50.0%	50.0%	100.0%

Similarly, a comparison of marketing innovations and preparation for the future in terms of branding and brand capital reveals that the differences between companies with lower and higher value added are not significant (Table 9).

*Table 9: Marketing innovations and preparation for the future for companies with different value added per employee for companies in Albania*

	Value added	N	Mean	Std. Deviation	Std. Error Mean	t	Sig. (2-tailed)
Marketing innovations	Lower	21	2.95	1.283	.280	.565	.576
	Higher	19	2.68	1.668	.383		
Preparation for marketing future	Lower	21	2.33	1.155	.251	.148	.147
	Higher	19	1.74	1.367	.314		

Finally, the effects of industry, company legal form, export orientation, and size on branding and brand capital were examined. Companies were divided into two industry groups: manufacturing and services companies. The analysis did not reveal significant differences in terms of industry structure for companies with lower and higher brand development and brand value activities in terms of their marketing innovations or preparation for future marketing. Although services companies seem to report more marketing innovations (mean for manufacturing = 2.7, for services 3.0), t-test for means does not report significant differences ( $t=0.59$ , sig. (2-tailed) =.55).

For company legal form, limited companies were compared to joint stock companies. Differences in legal forms structure were significant for companies with lower and higher brand development ( $\Phi=-.327$ ,  $\text{sign.}=0.038$ ) so that joint stock companies are predominantly companies with high brand development activities, while limited companies are to a higher degree low brand development companies (see table 10). For brand value activities, differences are not significant ( $\Phi=-.282$ ,  $\text{sign.}=0.075$ ). Joint stock companies reported more innovations (3.4, compared to 2.6 for limited companies,  $t=1.91$ , sig. (2-tailed) =.06).



Table 10: Brand development marketing activities and company legal form for companies in Albania

			Legal form		Total
			Ltd	Joint stock	
Brand development activities	lower	Count	17	3	20
		% of Total	42.5%	7.5%	50.0%
	higher	Count	11	9	20
		% of Total	27.5%	22.5%	50.0%
Total		Count	28	12	40
		% of Total	70.0%	30.0%	100.0%

For export orientation, companies with revenues from exporting were compared to companies that earned most of their revenues in the domestic market. Again, the differences were not significant for companies with lower and higher brand development and brand value activities. There were no significant differences among exporters and non-exporters in terms of their marketing innovations, nor preparations for future marketing.

Finally, the impact of company size on branding and brand capital was analyzed. Two groups of companies were formed: companies with less than 50 employees and companies with more than 50 employees. The analysis revealed no significant correlations between measures of branding and brand capital and company size.

### 3 Discussion

Overall, our research synthesizes and tests branding and brand capital for Albania. The following conclusions can be taken from the sample of companies that could serve as examples of practice among companies in Albania. A substantial number of companies report activities related to brand development. This means that they report activities related to the company's own brand, corporate brands in addition to brands of product/services, and in-one third of cases even developed brand

architecture as a system of organizing company brands. However, the majority of companies report only a limited amount of activities related to brand value. They lack either legal protection of their brand or do not finance activities to increase brand value, and have no measurement of brand value as such.

In terms of brand capital, the investments in activities to increase the value of brands were examined. The reported investments are very sound, in the range to 30 percent of sales, which highlights the importance of investments in the field in investigated companies. As already stated, the sample of companies included in the analysis includes selected companies that can serve as role models. Many of the selected companies report marketing innovation and preparation for future marketing. Also, it is not surprising to find that brand management activities in these companies are related to continuous improvement, innovation, and the future orientation of companies.

Nevertheless, the comparison of brand development activities for companies with different value added per employee showed higher value added for companies with lower brand development activities. Differences were not significant for other branding activities. Brand development activities as intangible investments are therefore more significant for companies that, in principle, reach lower value added per employee. This could show that these companies recognize the value of branding and brand related activities, while high value added comes from companies enjoying the privilege of an unsaturated market or market niches. Such privileged companies can reach high value added per employee without trouble and worries over brand development, brand capital, or other forms of intangible capital.

No significant differences in terms of industry structure show that branding activities among companies in the sample can be found between services firms and

manufacturing companies. In terms of legal form, joint stock companies are predominantly companies with high brand development activities, while limited companies are to a higher degree low brand development companies. Joint stock companies are in principle larger companies (in terms of their assets and revenues, not necessary in terms of employees), and therefore employ more resources necessary for brand development. The size of companies in terms of assets in revenues could in general play an important role in terms of sources available for brand management activities. Another comparison according to the number of employees did not reveal significant differences. Labor intensive companies could be among those companies that have little branding activities present (e.g. the herb collecting and processing company Xherdo Ltd., see company case in Redek et al., 2012, in this book), or very successful companies (e.g. the plastic products company Golden Pen Generation (GPG), see company case in Redek et al., 2012, in this book) can be in principle very small in terms of their employees. In terms company size, small and medium-sized enterprises (SMEs) represent the majority of all companies located in Albania and employ more than two-thirds of the overall workforce. SMEs are in principle customer-oriented organizations; however they lack branding related knowledge necessary to transmit value to customers. Loca and Ceku (2010) report that the concept of brand and branding becomes more significant for Albanian SMEs since it helps them compete and increase market share. Although their understanding of branding is often limited to a unique name or logo that is shown on their products, and not necessarily related to the attributes or values of the products/company to customers, they do mostly perceive branding as equal to quality.

Consistent to findings for relational, informational, and IT capital in Albanian firms (Koman and Lalović, 2012, in this book), our results show that export orientation does not play a significant role, as the majority of companies in the sample are

oriented to the domestic market: their products and services (agricultural products, patriotic tourism, herb collection) lack the quality necessary for efficient export. These companies perform “refinement operations” without quality and control standards of branded European producers and, therefore, cannot compete for business from these companies (e.g. Stella, a textile company, or Dafinor, a wood panel production company, see company cases in Redek et al., 2012, in this book). However, some export-oriented companies (e.g. the plastic materials company GPG, see Redek et al., 2012, in this book) managed to gain knowledge about foreign markets and a competitive edge through a foreign trade partner.

In general, companies that started in the 1990s and remained in business had to learn about business practices with intense competition in the market. With more exposure to marketing practices from their partners and elsewhere, they are improving their own marketing and branding activities. However, as shown by Strizhakova et al. (2008), global companies possess the advantages of developed and well-managed brands that can be a serious threat to companies that are used to less intense competition. Companies in Albania will need to deliver to the set standards of branding in order to strengthen their market positions and brand equities.

Last but not least, the success of marketing and branding activities will depend on two sources: the supply of qualified people with relevant marketing skills on how to facilitate brand management, and access to reliable data on market development, market share, and media audience. Branding is not only about spending on advertising and media, but mostly about differentiation and reaching out to the target audience.

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# THE CASE OF R&D

## 1 Introduction

The key elements of growth and competitiveness in the EU are knowledge and innovation, both very important cornerstones of intangible capital, and today one of the most researched determinants of productivity. Innovation is often related to R&D and economic growth. R&D generates knowledge that enables firms to develop either superior products or more efficient production processes (Ramirez and Hachiya, 2008).

The purpose of this chapter is to examine the characteristics of R&D and innovation in Albania. The study is based on a detailed survey in a sample of 40 Albanian companies. The research applies new methodology, based on the analysis of intangible assets, which employs cascading techniques on modified standardized international questionnaires adapted for the characteristics of developing countries.

At the moment the situation in Albania is grim, but improving.<sup>1</sup> According to the National Strategy of Science, Technology and Innovation 2009-2015 (Republic of Albania, 2009, p. 11), Albania was estimated to have a gross domestic expenditure on R&D of about 15 million euro in 2009, which represented around 0.2 percent of

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<sup>1</sup> The data on research and development in Albania was not collected systematically and in accordance with international standards (OECD, 2002, aka Frascati manual). The lack of reliable data complicates international comparisons.

GDP. Also, this is funded primarily by the public sector and foreign sources. According to the World Bank data (2011), 1.3 percent of Albanian manufacturing exports are high-tech exports. This is significantly less than the exports in developing Sub-Saharan Africa countries (5.3 percent). The comparison with the OECD (19 percent), Euro area (16 percent) and developing upper middle-income countries (21.4 percent) is even more revealing. The majority of Albanian exports represent clothing, iron and steel industry products and machinery and transport equipment. The World Bank report 'Building Competitiveness' (2009, pp. 26-37) states that 59 percent of manufacturing firms in Albania reported in 2007 to have introduced a new/improved product. This fact ranked Albania second in the region and behind Croatia (67 percent). Primarily firms in the textiles and garment industry are more likely to introduce new products, while firms in the metal industry are more likely to use upgrading. Foreign firms and exporters are more likely to innovate, and also smaller firms are less likely to innovate. In terms of process innovation, the most common method of introducing new technology is through the purchase of new technology, followed by the hiring of skilled personnel. Of the companies that introduced new technology, 95 percent of them did so by purchasing new machinery, 64 percent by hiring skilled personnel, and 29 percent through internal sources. And given that better technology usually indicates foreign technology, larger companies are more likely to introduce technological upgrading (54 percent of larger firms compared to 27 percent of small firms). Exporters also have better access than non-exporter to new technology (65 percent of exporters licensed new technology compared to 29 percent of non-exporters).

Albania has been improving in terms of innovation and the environment for innovation, and some of that progress and focus was provided from governmental programs (Republic of Albania, 2009 and 2011, various funding programs, institutional support and other). Improvement is evident also from international



comparisons, although Albania is still ranked low. The Global Innovation Index (2011) ranks Albania as the 80<sup>th</sup> economy among 125 economies (121<sup>st</sup> in 2009), and acknowledges the structural reforms implemented during transition, especially those strengthening the legal system and financial system. The country's economic progress is also important and stimulating in terms of innovation. Namely, growth provides additional stimulus and funding for R&D. But the country has significant weaknesses in many relevant aspects. It has low expenditure on education, poor quality of research institutions and low cooperation of universities and industry, low high tech imports, and poor trade and transport infrastructure.

This chapter is structured as follows. First, the theoretical background to the analysis is provided, followed by research design. Third, the results are presented, followed by the conclusion.

## **2 Research methodology**

Innovation activity in Albania reflects the innovation situation in Albanian companies. The study extends the research and results of the 2009 World Bank study. To further examine and find causes of the rather grim overall situation, a study of the microeconomic characteristics of innovation was conducted. The study was a part of research on the characteristics of intangible assets in Albania. Namely, the research stems from the definition of innovation in terms of intangible capital, and the survey is based on a detailed questionnaire adapted for developing countries.

## ***2.1 Research methodology: theoretical background***

Innovation is increasingly important in growth literature today. Although innovation and growth have been linked since (pre)classical economics, R&D and innovation is the focus of endogenous growth theory and intangibles research, showing a clear linkage between innovation, R&D and growth (e.g. Romer, 1990, Aghion and Howitt, 1998, Corrado et al., 2009, Fukao et al., 2007, Van Ark et al., 2009). Increased R&D expenditure will lead to increased innovation activity and thus higher economic rents, to the spillover effect of R&D knowledge across the economy and enhanced absorption capacity for acquiring knowledge from the environment (Griffith et al., 2003). Empirical research confirms the importance of R&D and innovation for growth. According to Klenow and Rodriguez-Clare (1997) or Easterly and Levine (2002), countries with larger R&D as a share of GDP grow faster. The firm level effect has also been confirmed via positive influence of innovation on firm productivity (e.g. Wakelin, 2001, Mairesse and Sassenou, 1991, Griliches and Mairesse, 1983).

Is the question of intangible capital, innovation, and R&D relevant also for developing economies? R&D and innovation have direct and indirect effects on the economy. Innovation that is achieved by investment in intangibles is a major change-driver, as innovation primarily stimulates productivity (Griffith et al., 2003). Similarly as other elements of intangible capital, R&D increases the productivity and value added of firms, thereby increasing their (international) competitiveness, opening their potential for exports, and increasing their potential for future growth. This is the most obvious direct impact on companies. Also important is the impact on other companies (e.g. value chain or competition) through spillover.

The nature of innovation naturally depends on country development. According to Forbes and Wield (2000), innovation and technology management are very important and active also in technological followers and in smaller companies, not just global players. Forbes and Wield (2000) also stress that for innovation success the type of R&D and its focus is most important, not the level of R&D spending. In technological followers the focus is on incremental innovation, also process innovation is often more important than product innovation given that competition is more cost oriented. In this context, shop floor innovations are the major source of savings. Last, it is highly important to recognize also the importance of organizational, cultural and managerial innovation to close the loop of incremental innovation.

The majority of developing countries exploit the export-based model of growth, and consequently growth depends on several sectors. Intangible capital in general, not just innovative intangible capital, can increase productivity in general and consequently also value added. In this context, the absorption capacity mentioned by Griffith (2003) is also relevant. Given that knowledge transfer (growth by imitation and adjustment) is very important for technological followers, absorption capacity determines the potential for such growth and convergence based on this model. According to the World Bank (2009), technological development is driven primarily by two factors: exposure to more advanced (foreign) technical knowledge and the capacity (and incentive) to absorb it. Exposure to more advanced technologies happens primarily through foreign trade, FDI and brain circulation. On the other hand, adoption and actually benefiting from it depend on a wider environment, including taxation, regulation, competition, government policies, financial resources to adopt and adapt it, having the necessary skills, and other factors.

Last, it should be acknowledged that despite the fact that growth in developing countries is normally driven by just several sectors, other sectors should not be neglected during the favorable growth cycle. Therefore, innovation is important not just in the tradable sector, but also the non-tradable sector (e.g. Prašnikar et al. 2003, Bole, 2009, Chinn and Johnston, 1999). Balance is crucial for stable and balanced future growth.

## ***2.2 Research design***

The questionnaire was developed by using the aforementioned theoretical background and existing standardized questionnaires (CIS by OECD/Eurostat). Also, the questionnaire was adapted to incorporate the characteristics relevant for developing countries (Prašnikar et al., 2011).

Innovation and R&D were examined through a series of statements comprising 10 questions. First, the companies were asked in which domestic and foreign markets they operate, then they were asked about the intensity and success of their innovation in comparison with the competitors in their relevant (most important) market. Product and process innovation were examined later, followed by the organization of the R&D department and the size of R&D expenditure. Technological, marketing and complementary competences as a precondition for successful innovation were examined next, and finally we focused on the source of ideas for innovation, where the sources could be either internal or external. The structure of the questions is revealed in the results section. Thus, a detailed description is omitted here.

## 3 Results

The analysis of innovation activity as part of intangible capital in Albania focused on the following aspects: product and process innovation, characteristics of R&D in the company, company competences, and capabilities. Also, company characteristics and R&D activity links are examined.

### *3.1 Overview of R&D activity in the sample companies*

Innovation is the essential driver of growth as has been noted by many (Griffith et al., 2000, Rodríguez-Pose, 1999, Baumol, 2000, Romer, 1990 and other). Schumpeter (1942, pp. 82-83) well captured the importance of innovation for growth: 'The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers' goods, the new methods of production or transportation, the new markets, ... This process incessantly revolutionizes the economic structure within, incessantly destroying the old one, incessantly creating a new one. This process of creative destruction is the essential fact about capitalism.'

The innovation intensity is driven by many elements, internal and external. One of the most important external elements is the quality and the characteristics of the competition. According to Schumpeter (1942) it is the new products, processes, and innovation themselves that create the competition. The innovation is an ever-present threat. The fiercer the competition in the firm's target market, the more driven the firm is to innovate in order not to lose its market share<sup>2</sup> (see also Aghion et al., 2002, Blundell et al., 1999, Gilbert, 2006). Also, company innovativeness and

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<sup>2</sup> Schumpeter (1942) believed that the standard market structure approach to competition is less important. But nonetheless, he preferred some degree of monopoly. He never made it clear whether innovation leads to monopoly or the opposite, but the literature normally assumes monopoly to be a reward for innovation.

technological advancement depends crucially on the firm's presence in international trade (e.g. Bloom et al., 2009, De Loecker, 2007, Aw et al., 2009, Damijan and Kostevc, 2006).

The companies were therefore first asked in which markets they are present, what their most important target market is, and what percentages of sales they sell in a specific market (Table 2). Thirty-two companies (80 percent) claim the domestic market (including those that listed regional) to be their most important market, 7 companies even listed the local market as their most important market (17.5 percent). On average, the firms that operate in the local and regional markets also sell the vast majority of their products in that market, 8 companies sold their entire produce locally. On average companies sell over 85 percent of products in Albania. The European markets were the most important export regions for the sample with 9.7 percent.

A company's largest, most important market was the focus of our further analysis (referred to as relevant market). The companies were asked to evaluate their position in comparison with other companies in only their relevant market<sup>3</sup>. For the majority of companies, their relevant market was the local and domestic market. Only two companies explicitly stated that their most important market is abroad: the first company stated the Balkan market and the second company specified the American market.

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<sup>3</sup> It must be noted that when companies were evaluating their performance, they evaluated themselves only in terms of their relevant market. To further elaborate: if a company sells primarily in the domestic market, it only compared itself with other domestic companies. In this context also 'globally new products' must be explained or understood as new (only, although not necessarily) in the national market.

Table 2: Target market\*

Target market	Please, mark in which of the following markets did your company sell products/services in 2009? (% of companies)	Average sales in a specific market (%)
Local/regional market in Albania?	85.0	58.2**
National market?	60.0	86.3
Other European markets (excluding countries of Western Balkan)?	27.5	7.5
Western Balkan markets?	37.5	5.5
Other markets?	5.0	0.75

\* Data differ slightly from data in the chapter on relationship and informational capital, due to a slightly different division of markets.

\*\* If companies did not provide data on regional sale, but provided only data on national sales, the information on regional sale was treated as a missing value in calculating the regional sales average. There is no mechanism available to break down national sales. In total, data on regional sales was missing for 15 companies.

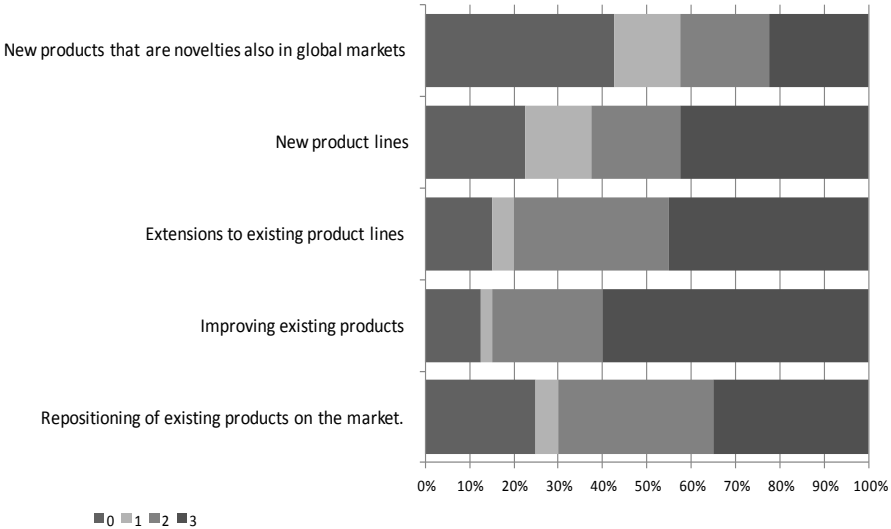
One of the first innovation drivers is the quality of competition. Given that the majority of sales are conducted in the domestic market, the nature of competition is largely determined by the characteristics of domestic (even local) competition. Sixty percent of companies feel to be on average at least as successful in introducing new products as their competitors in the past 5 years, one-third feel more successful, while even 27.5 percent (11 companies) feel that they are of the leading companies in the industry. Except for one company, all other companies (10 companies) reported their most important market to be the domestic or even regional market (3 companies) (Table 3).

Table 3: Introducing new products: comparison with competitors (percent of companies)

Introducing new products and competitors	NO	YES
We were as successful as our competitors were on average in introducing new products in the last five years.	40	60
We were more successful than our competitors were on average in introducing new products in the last five years.	67.5	32.5
We were one of the leading companies in the industry in introducing new product in the last five years.	72.5	27.5

Innovation can either denote product or process innovation. Product innovation is defined as an introduction of new goods or services or an introduction of significantly improved goods or services. Process innovation, on the other hand, consists of the implementation of a new or significantly improved production process, distribution method, or support activity for the goods or services (OECD, 2002). Innovation is based on the results of new technological development, new combinations of existing technologies, or the use of other knowledge by the enterprise (OECD, 2002).

Figure 1: Answers to the question 'Please, mark the relevance of the following types of new products in your company.' \*+, in percent



Answers on a scale of 0-3: 0 denotes 'not used', while 1-3 denotes low (1), medium (2), and high (3) relevance.

+ Global market should be explained with care. Companies were asked to evaluate themselves only in terms of their relevant market. For some companies it is global, but for the majority it is the national market.

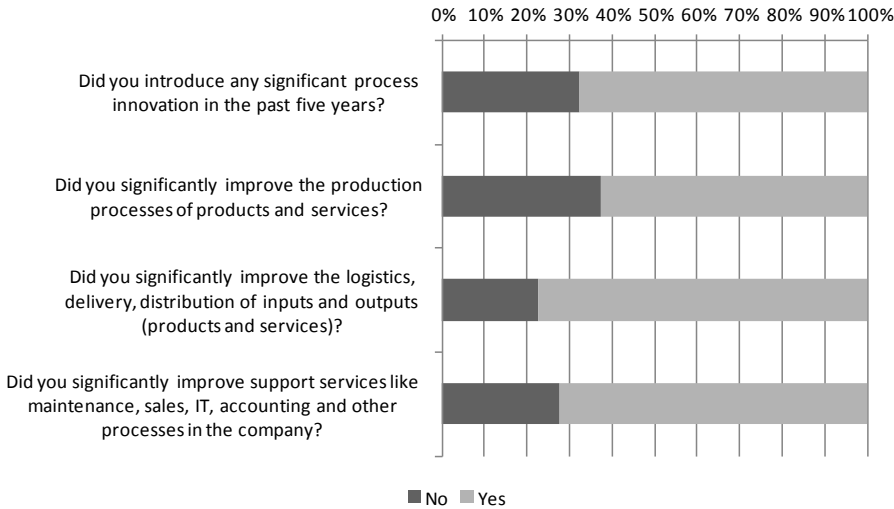
The most important type of product innovation is improving existing products (Figure 1). Sixty percent of companies claim this to be very important for them.



This is followed by extensions to existing product lines and new product lines. But even over 20 percent of companies feel that introducing new products that are novelties also globally is very important for them.<sup>4</sup>

The companies were very active in process innovation (Figure 2). Over 67 percent introduced significant process innovation, over 60 percent significantly improved production, over 70 percent significantly improved support services like maintenance, IT, sales, and similar, and 77.5 percent improved logistics, delivery, distribution of inputs, and outputs.

Figure 2: Characteristics of process innovation, in percent of companies

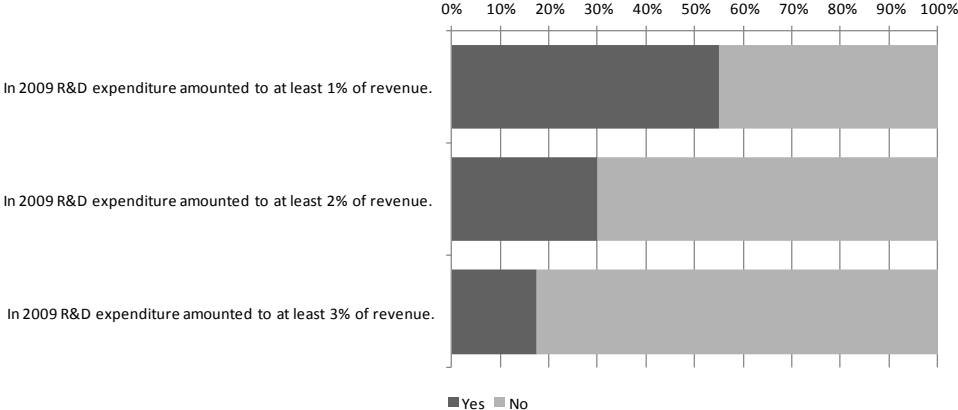


Characteristics of innovation activity and the outcomes or success of innovation depends primarily on the quality and organization of the R&D department, which is closely related to funding and human capital. We first examine the problems of R&D department existence and R&D activity funding.

<sup>4</sup> See footnote 2.

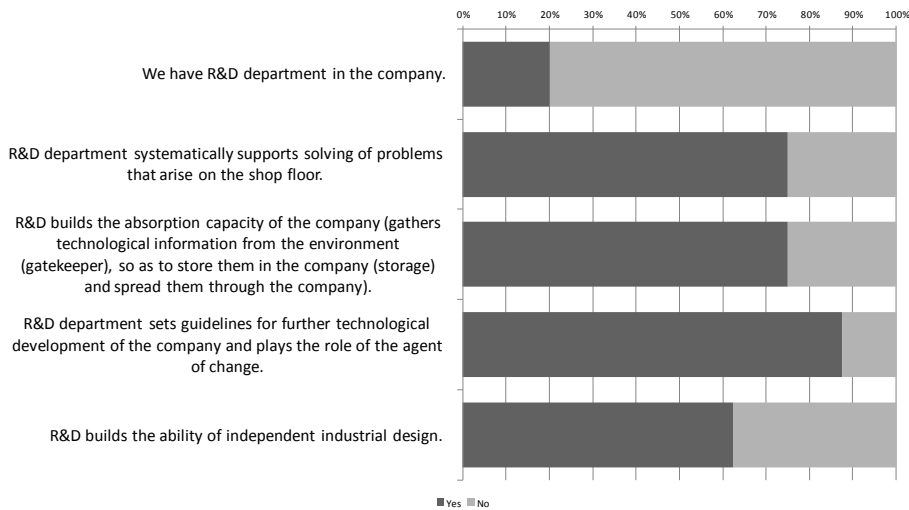
Almost half of the companies (45 percent) spent less than 1 percent of revenue on R&D. Fifty-five percent spent at least 1 percent of revenue or more. Close to one-third of companies spent 2 percent or more, while 17.5 percent spent 3 percent or more (Figure 3).

Figure 3: R&D expenditure, in percent of companies



Only 20 percent of companies reported to have an R&D department: that is only 8 out of the sample of 40 companies had an R&D department (Figure 4). In the companies where it does exist, the R&D department is well organized and in the majority of companies it works in an absorption and development capacity.

Figure 4: Organization of R&D department\*, in percent of companies



\* If a company reported not to have an R&D department, then it did not answer other sub-questions. Therefore, only the companies that have R&D departments provided answers about the characteristics of their R&D departments.

Companies can get information and ideas for innovation from many different sources. These can be divided into internal sources (e.g. suggestions from employees, own research activities, etc.) and external sources (market, institutional, and other sources). Albanian companies obtain the majority of ideas from inside the company (Table 4). Namely, over 67 percent of companies reported internal sources as highly important. It is also important to note that conferences, market fairs and exhibits are a highly important source of information to over 50 percent of the sample, more than competition and other companies in the field (43.6 percent) and suppliers of equipment (42.5 percent). This indicates the increasing importance also of external sources of information and the value chain.

Table 4: Sources of innovation ideas, percent of companies

Mark the relevant sources of information, evaluate importance		Not used	Low	Medium	High	Mode
		0	1	2	3	
Internal sources	Inside the company	2.5	2.5	27.5	67.5	3
Market sources	Suppliers of equipment	10.0	15.0	32.5	42.5	3
	Suppliers of materials, components, program equipment	12.5	2.5	47.5	37.5	2
	Buyers	5.0	7.5	55.0	32.5	2
	Competitors and other companies in the field *	5.1	15.4	35.9	43.6	3
	Consultants, private research or R&D facilities *	17.5	17.5	27.5	35.0	3
Institutional sources	Universities or other higher education institutions	25.0	30.0	20.0	25.0	1
	Government or public research institutions	27.5	32.5	17.5	22.5	1
Other	Conferences, market fairs, exhibits	15.0	5.0	27.5	52.5	3
	Scientific, commercial and technical journals	22.5	30.0	27.5	20.0	1
	Industrial associations and chambers	12.5	12.5	50.0	25.0	2

\* Percentages do not add up to 100 percent, but to 97.5, given that in both cases 1 case is missing.

Competences are crucial for successful innovation. Grant (1991) defines competences as the ability to utilize resources that spread across multiple functions, products and markets in a sustainable and synchronized manner. They are broader and not strictly industry specific. Competences are also defined as a set of related abilities, commitments, knowledge, and skills that enable a person (or an organization) to act effectively in a job or situation (BusinessDictionary.com). One could also say that competences mean that you generally have the knowledge to do something, but do not know whether you could perform a task (merge the information together correctly), while capability means that you actually can perform a specific task. Grant (1991) defined capabilities also as repeatable patterns

of actions in the use of assets to create, produce and/or offer products to a market. Simplified, one could say that competences mean that one possesses the knowledge, but capabilities mean that the knowledge can be actually put together and used in order to create something.

Table 5: Firm competences (Answers to 'Evaluate performance of your company compared to your main competitors in the following aspects on a scale from 1 to 5')\*, percent of companies

<b>Technological competences</b>							
	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>Avg</b>	<b>Mode</b>
Research and development in the firm is advanced.	42.5	2.5	32.5	7.5	15.0	2.50	1
Number of available technological capabilities inside the firm or through strategic partnership is quite large.	37.5	5.0	27.5	12.5	17.5	2.68	1
We are good at predicting technological trends.	42.5	12.5	12.5	17.5	15.0	2.50	1
<b>Marketing competences</b>							
Obtaining information about changes of customer preferences and needs	25.0	2.5	12.5	22.5	37.5	3.45	5
Acquiring real time information about competitors	17.5	5.0	22.5	22.5	32.5	3.48	5
Establishing and managing long-term customer relations	25.0	5.0	12.5	15.0	42.5	3.45	5
Establishing and managing long-term relations with suppliers	27.5	2.5	10.0	12.5	47.5	3.50	5
<b>Complementary competences</b>							
Activities of the business units are clearly defined in the corporate strategy of our firm.	25.0	10.0	17.5	15.0	32.5	3.20	5
Good transfer of technological and marketing knowledge among businesses units.	27.5	10.0	15.0	17.5	30.0	3.13	5
The intensity, quality and extent of research and development knowledge transfer in co-operation with strategic partners.	22.5	10.0	15.0	22.5	30.0	3.28	5
Product development is cost efficient.	30.0	2.5	17.5	20.0	30.0	3.18	1 and 5

\* 1=considerably worse than the main competitors, 2=worse than the main competitors, 3=same as main competitors, 4=better than the main competitors, 5=considerably better than the main competitors

Results reveal that the sample of Albanian companies acknowledges the lack of technological competences, but in terms of marketing and complementary competences, the sample is divided (Table 5). Quite a large percentage (30 or even more) believes to be considerably better than their competitors, but over 20 percent of the sample or more believes to be considerably worse than their main competitors. In terms of future development the lack of technological competences, which can in part explain the nature of product and process innovation, will impede progress. Also, the duality in the quality of the companies could (depending on industry) be an obstacle to creating strong value chains and clusters. Competences and capabilities depend largely on human capital, which is according to the World Bank (2010) one of the major problems of Albanian development.

### ***3.2 R&D and company characteristics***

The sample can be broken down by legal type (limited liability and joint stock), sector (construction, manufacturing and services (trade and other)), size, export orientation, and by whether the company operates in the final market or is a business-to-business type of company.

We first focus on the introduction of new products and R&D expenditure related to company characteristics. Interestingly, the results show that the share of export<sup>5</sup> was not related to the importance of the introduction of new products. Even more, out of the 3 companies that sold more than 50 percent abroad (10 percent of the sample), only 1 claimed to be on par with competition, and only 1 claimed to be among the leading companies in introducing new products in their relevant market.

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<sup>5</sup> Companies were asked to state whether they earn more than 0, 25 and 50% of sales abroad. It is an example of a cascading question, values 1, 2, 3 and 4 were assigned to: not more than 0, more than 0, more than 25 and more than 50, respectively.

Those that exported between 25 and 50 percent of sales (4 companies) were similarly unconfident: 3 reported to be on par and 1 to be one of the leading companies. Trade was also not related to R&D expenditure. How could this controversy between trade and innovation be explained? According to Memaj (2012), Albania is a small country and not well known in other countries for innovation and new products. The exporters are trying to be in line with the needs of their clients, and only in few cases are they in a position to introduce new products in the export markets. Albanian companies are usually exporting traditional goods and this is one of the features of Albanian export. Many exporting companies also export due to their sub-contracting deals (Koman and Lalović, 2012, in this book), where value added and productivity are both low (see also the case studies of Stella and Dafinor in Redek et al., 2012, in this book). But in the future the economy will need to shift focus, similarly as some companies are already doing (see the case study of Xherdo in Redek et al., 2012, in this book).

Although overall, companies with higher share of trade do not implement product innovation statistically significantly more often (importance of innovation, see above), and there are differences by specific types of product innovation. Companies that trade were more persuaded that it was more important (evaluate on a scale 1-3) to improve existing products or to extend existing product lines (significances were 0.028 and 0.043) in comparison with those that trade less or not at all. It is also indicated that the relationship with trade could exist also with process innovation<sup>6</sup>. Companies with higher share of trade were more inclined towards having more types of process innovation (production, logistics, etc., and support services). The results are insignificant, but the significance levels are much higher (around 0.3 in cases of logistics, delivery and distribution and support

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<sup>6</sup> Otherwise, the introduction of process innovation could not be systematically linked to any of the other grouping variables.

services) than in case of other questions conditional on the share of trade (where significances can be as low as 0.9).

The introduction of new products in comparison with competition is also not related to whether the company operates in the final market or is a B2B company; similar is true also for the size of R&D expenditure. Also, the sector (construction, manufacturing, services other and trade) is not in any way related to the introduction of new products or R&D expenditure. Companies were also divided into two groups by productivity in 2008 and 2009. Both median and average productivity were used to divide the companies. The results indicate that neither R&D expenditure nor the success in introducing new products in comparison with competition had any systematic significant relationship with productivity. According to Memaj (2012) the expenditures in R&D and success of new products have no significant relationship with productivity even because the companies are newly created (have no historical background) and the R&D expenditures are not very high. The fact that there are a few companies (and not highly established in the markets) competing with each other in the same markets (trading similar products) brings the focus of the companies more to competition than to R&D and new products.

The types of new products in relation to different groups were also examined. Repositioning, improving existing products, extensions to existing product lines, new product lines and 'globally'<sup>7</sup> new products could be selected and their importance evaluated on a scale of 1 to 3 (0 if not relevant). Besides the results conditional on the importance of trade (see above), business-to-business type companies also rate extensions to new product lines as significantly more important

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<sup>7</sup> Again, note that 'globally' refers to company relevant market. Consequently, for the majority of firms, this is the domestic market, but for a few also the foreign market.



than the rest. The service sector also claimed new product lines to be significantly more important than the manufacturing sector did (sig. 0.063). There is also a weak inclination towards B2B companies claiming 'globally<sup>8</sup> new products' to be more important than other companies (final market) (sig. 0.121).

Competences and technological marketing, as well as complementary, are very important in determining R&D potential (companies were asked to evaluate their agreement with the statements on a scale of 1 to 5). Companies that do not trade statistically significantly (0.01) report in a lesser extent that the number of available technological capabilities inside their firm or through strategic partnerships is quite large and also evaluate their ability to predict technological trends lower (0.07). This speaks in favor of the hypothesis that trade and innovation and technological development are positively related. Data also shows that there is a slight inclination of companies in the services sector claiming to have advanced R&D in their firms in comparison to firms in the manufacturing sector (sig. 0.112). Similarly, there is a significant difference between companies that were above average productive in 2008 and those below average. The companies that were above the productivity median in 2008 evaluated the claim to 'higher number of available technological capabilities inside strategic partnership and within the firm' higher than those below the median (sig 0.047). Similarly, also median productivity in 2008 gives a signal of difference, but it is still insignificant (sig. 0.153).

In marketing competences, B2B companies are more inclined towards regarding themselves as capable of establishing and managing long-term relationships with suppliers (0.091). Also, companies that do not trade evaluate their ability in this same context (long-term relationships) lower with both suppliers (0.144) and customers (0.077). In complementary competences, the companies that do not

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<sup>8</sup> Similarly as footnote 6.

trade evaluate their 'intensity, quality and extent of research and development knowledge transfer in co-operation with strategic partners' lower than those that trade (0.08).

Overall, the results indicate that innovation characteristics differ among companies, and the market (export-oriented companies seem to be more active) and the type of company in the value chain (B2B seem to be more innovative) determine the differences. Also, there is an indication that innovation is linked to productivity since companies more than average or median productive were in some cases (weakly) more active in R&D.

Although the results are in many cases insignificant, they do nonetheless indicate the existence of the expected relationship.

## **4 Conclusion**

Knowledge and innovation are important also in the development of developing countries like Albania. But the benefits should not be expected to bring the desired results unless sufficient focus is provided in both companies and in the business environment in general, also in terms of policy measures.

According to the World Bank (2011), the Albanian growth strategy is to become an upper-middle-income country. Economic growth and productivity rise until now resulted primarily from inter-sectoral shifts of labor, but in the future this process will become largely dependent on intra-industry changes. And the literature suggests that innovation is an important source of productivity growth.

This chapter focused on the characteristics of R&D activity in a sample of 40 Albanian firms selected from the best companies. The results show that at the

moment, innovation and R&D do not yet carry the weight they could. Overall innovation expenditure in Albania is very low, only 0.2 percent of GDP and funded primarily by the public sector and foreign funds. The result is a reflection of the Albanian economic structure, with the majority of exports representing low value added products like textiles, leather products, and ore.

Sample results confirm that R&D and innovation in Albania at the moment are still not at satisfactory levels. The majority of responding companies chose the domestic market as their prime market. The domestic market is still offering significant growth (rent) opportunities with rather insufficient competition. The exporting companies are involved primarily in low value added sub-contracting jobs. These two factors could also explain many of the characteristics of innovative activities in Albania. Companies did introduce product and process innovation, but the majority of companies reported improving existing products, extension to existing product lines and new product lines to be their most important types of product innovation. Almost half of companies spent less than 1 percent of revenue on R&D and only 20 percent of the sample companies had an R&D department. On the other hand, the companies were quite active in process innovation, as two-thirds introduced some process innovation. Research also shows that companies lack competences, primarily technological, while the situation is slightly better in terms of marketing and complementary competences.

Currently, Albanian companies are oriented primarily towards the domestic market. But in order for the companies as well as the economy as a whole to become more export oriented and succeed in the international competition, intangible capital, including innovative property, is crucial. As case studies in the first part show, this fact is already successfully exploited by some companies, and is growing successfully at home and expanding abroad.

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# **SOCIAL CAPITAL AND CORPORATE GOVERNANCE**

## **1 Introduction**

In this chapter we analyze social capital as a part of intangible capital in firms. More precisely, we study the relationship between internal cohesion among the main stakeholders in firms and connect it with firm productivity. The main stakeholders are workers, owners, and managers, where managers play the role of intermediaries between the interests of workers and owners. Each group of stakeholders has a different role within the firm, and also has different goals and expectations. Merely having goals though is not enough; a group must also have the power to achieve its goals. As the common goals of groups are not disputable, the challenge is rather in finding a joint solution when these goals diverge. Each group tries to achieve its own goals over other groups, but to what extent a group is able to achieve its goals is up to that group's bargaining power. By understanding the goals and bargaining power of the three main interest groups, we can further understand firm behavior.



This chapter consists of three sections. First we elaborate on social capital and how to measure it. In the next section we interpret the results of our analysis. The last section concludes.

## 2 Measuring social capital

A cooperative game of internal bargaining (Aoki, 1984, 2010) allows workers, managers, and owners to determine firm goals together and, therefore, achieve higher productivity, efficiency, and organizational rent than would be achieved in a competitive market. Cooperation can only be achieved through informing the other stakeholders about own interests. Internal cohesion can be understood as a basic principle of social capital theory. Social capital is defined by norms, trust, and networks that help achieve higher firm efficiency (Putnam, 1993). If workers want to actively participate in the bargaining game, they must also be prepared to accept a part of business risk (Williamson, 1975, Ricketts, 2002). The main hypothesis of this chapter is that building a cooperative game between the main constituencies of a firm (building social capital) is positively correlated to firm productivity.

The questionnaire for studying social capital in Albanian firms consists of eight question sets. Forty firms were selected from different industries, sizes, export orientation, and customer orientation (B2B vs. B2C) in order to generate a representative sample. We were able to get responses from the top managers in selected firms.

The first question set (*the decision making*) focuses on the fundamental division between owners (control rights, residual rights) and managers (decision rights). Strategic function is usually in the hands of top management, and everyday

operational function is given to middle and lower management levels. The choice for their separation is in the realm of corporate owners (Wheelen and Hunger, 2010). They are also indirectly responsible for the consolidation of owners' and managers' interests and influence cooperative behavior through building trust between main stakeholders of the firm: owners, managers and workers (Aoki, 1984, Essen et al., 2012). Firms must strive to constantly formulate strategies and organizational goals, and position products and services in the market. These have to be jointly discussed and spread through the firm (Holt, 1992, Flamholtz and Randle, 2000).

In the second question set, dynamic firm behavior was taken into consideration by constructing questions pertaining to *labor adjustment*. Firms are able to restructure employment defensively in the short term (employing through agencies, hiring part-time workers, hiring students, using overtime, etc., or strategically in the long term (adjusting the number of full-time employees). Firms that base their competitive advantages on human capital develop core employees employment relationship (Lepak, Takeouchi and Snell, 2003, Aoki, 2010, Zupan et al., 2010).

An important element of bargaining is also *determining wages*, which is the topic of the third question set. Albania has a very liberal type of labor market. Wage size is associated with collective bargaining processes only in rare cases when collective agreements exist and are also enforced. An answer of “No” to the first question in the question set on wages leads to the conclusion that workers are paid at the reservation wage.<sup>1</sup> Furthermore, answering “Yes” to the second question implies a deviation from the earnings assured by collective agreements. This could be the result of either the higher bargaining power of unions, or of firms building their compensation policies on the efficiency wage philosophy. If wages in the firm are

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<sup>1</sup> The reservation wage is defined as the second best alternative under which workers would be willing to work.

among the highest in the country, then either the first or second strategy was escalated to achieve those wages.

In order to achieve higher bargaining power, workers can choose to concentrate their efforts in the form of *unions*. How unions influence firm productivity is an ongoing debate. This question set tested the cooperative behavior of unions. The first question inquires about the existence of unions in the firm, the second about the number of unions organized in the firm, and the third about the unions' concern for the firm's success.<sup>2</sup> If several unions exist, collaboration among them may be lowered due to competition for membership (Ferner and Hyman, 1998).

There is a lot of literature on the contribution of *workers' participation* to firm success; literature that both neglects their contribution to firm performance (property rights theory, agency theory, transaction cost theory) and supports their contribution to firm performance (better exchange of information between employees and employers, reduced monitoring costs, improved efficiency of resource allocation) (Allen and Gale, 2002), and literature that fosters a culture of consensus and cooperation (Freeman and Lazear, 1995, Aoki, 2010). If workers want to play a role in a firm's decision-making process, they must accept a part of the business risk (Williamson, 1982).

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<sup>2</sup> After the fall of the socialist regime in Albania in 1991, two bigger unions have been formed: Konfederata e Sindikatave të Shqipërisë (KSSH) (*Albanian Trade union Confederation*), as the successor of the Communist Professional Union, founded on 5 June 1991, which is politically more affiliated with the Socialist party, and Bashkimi i Sindikatave të Pavarura të Shqipërisë (BSPSH) (*The Union of Albanian Independent Syndicates*), which was initially founded as a political opposite to the communist regime on 11 March 1991, and is therefore more affiliated with the Democratic Party. Besides these two main unions, there is another smaller union: Federata Sindikale e Tregtisë, Bankave dhe Shërbimeve (FSTBSH) (*The Union Federation of Trade, Banks and Services*).

The fifth question set, *workers' risk aversion*, deals with the employees' inclination toward corporate risk sharing. First, we ask if most of the workers are prepared to do "something more" for the firm. "Something more" is a broad concept that entails deeds and actions by employees that they choose to do willingly, not forcefully (physically or psychologically), for the benefit of the firm. Second, we pose the question, "Do you believe most workers would stay with the firm even if they were offered better employment somewhere else?" This signals the workers' loyalty to the firm. The third question relates to workers' inclination toward accepting a part of the financial risk.

The sixth question set tests *worker participation in decision making*. Bernstein (1982) distinguishes between four degrees of workers' control: 1) employee consultation, 2) employee co-influence, 3) co-determination, and 4) self-management. Since legal acts in Albania do not support workers' participation, questions focus on the first two forms. Employee consultation is examined by asking if workers are informed about key decisions for the firm. Employee co-influence is expressed in the second question by asking if there is an established open dialog with the workers about key decisions for the firm. The third question is informative and inquires about workers' membership in governing bodies.

Lucas (1988) described investment in human capital as a driving force of the endogenous growth theory. It was later recognized as an important source of competitive advantage (Barney, 1991). Firm-specific human and structural resources were later identified as the largest subpart of a firms' intangible investment (Corrado et al., 2009, for the US and the UK; Fukao et al., 2009, for Japan). Bloom and Van Reenen (2010) derived similar conclusions. *Internal training* is thus the topic of the seventh question set. With the first question we can identify a company's collaborative efforts, through the second question we can learn about

the share of employee involvement in training, and with the third question we determine the level of complexity of a firm's measurement system for training effectiveness.

The eighth question set deals with firm-specific human resource practices as well. More precisely, it focuses on *on-the-job training*, where its presence is identified by the first question. The second question reveals the level of a firm's involvement in spreading knowledge within the firm. The third question shows the readiness of a firm to replace key employees quickly, if needed.

### 3 Results

In the previous section we explained the theory behind every question set and questions in the question sets to show how we measure social capital in the firm. Here follows the interpretation of results from analyzing 40 firms that participated in our study. Results are presented in Table 1, where we can observe the share of positive answers and standard deviations for the total sample, higher productive firms, and lower productive firms (by median value) by individual question. We tested the differences between higher and lower productive firms with Chi square and corresponding P-value.

Table 1: Firms in Albania: social capital by productivity

	Total			More productive			Less productive			Chi <sup>2</sup>	P-value
	N	% of firms	sd	N	% of firms	sd	N	% of firms	sd		
<b>1. DESISION-MAKING</b>											
operation/strategic management separation	40	67.5	47.4	20	50.0	51.3	20	85.0	36.6	5.584	0.018
managers and owners act unanimously	40	57.5	50.1	20	40.0	50.3	20	75.0	44.4	5.013	0.025
owners, managers and workers coord.	40	50.0	50.6	20	35.0	48.9	20	65.0	48.9	3.600	0.058
<b>2. ADJUSTING EMPLOYMENT</b>											
short-term adjust. to shocks	40	87.5	33.5	20	95.0	22.4	20	80.0	41.0	2.057	0.151
achieving target level of employment	40	75.0	43.9	20	85.0	36.6	20	65.0	48.9	2.133	0.144
core group of employees	40	72.5	45.2	20	80.0	41.0	20	65.0	48.9	1.129	0.288
<b>3. DETERMINING WAGES</b>											
higher than alternative wages	40	77.5	42.3	20	85.0	36.6	20	70.0	47.0	1.290	0.256
wages higher than collective agreement	40	50.0	50.6	20	50.0	51.3	20	50.0	51.3	0.000	1.000
wages among the highest in the country	40	40.0	49.6	20	45.0	51.0	20	35.0	48.9	0.417	0.519
<b>4. THE UNION ROLE</b>											
workers organized in unions	40	15.0	36.2	20	10.0	30.8	20	20.0	41.0	0.784	0.376
one union organization	40	15.0	36.2	20	10.0	30.8	20	20.0	41.0	0.784	0.376
unions concerned with a firm's success	40	10.0	30.4	20	10.0	30.8	20	10.0	30.8	0.000	1.000
<b>5. WORKERS' RISK AVERSION</b>											
prepared to do "more" for the firm	40	85.0	36.2	20	90.0	30.8	20	80.0	41.0	0.784	0.376
would stay with the firm in bad times	40	47.5	50.6	20	50.0	51.3	20	45.0	51.0	0.100	0.752
willing to make finan. Invest. in a firm	40	17.5	38.5	20	30.0	47.0	20	5.0	22.4	4.329	0.037

Table 1 (continued): Firms in Albania: social capital by productivity

<b>6. WORKERS PARTICIPATION</b>											
workers are informed	40	<b>70.0</b>	46.4	20	<b>70.0</b>	47.0	20	<b>70.0</b>	47.0	0.000	1.000
open dialog with managers	40	<b>55.0</b>	50.4	20	<b>60.0</b>	50.3	20	<b>50.0</b>	51.3	0.404	0.525
workers are members of gov. bodies	40	<b>25.0</b>	43.9	20	<b>35.0</b>	48.9	20	<b>15.0</b>	36.6	2.133	0.144
<b>7. INTERNAL TRAINING</b>											
existence of organized forms in the firm	40	<b>57.5</b>	50.1	20	<b>55.0</b>	51.0	20	<b>60.0</b>	50.3	0.102	0.749
more than 50% of workers participate	40	<b>47.5</b>	50.6	20	<b>45.0</b>	51.0	20	<b>50.0</b>	51.3	0.100	0.752
other methods of evaluation than survey	40	<b>42.5</b>	50.1	20	<b>40.0</b>	50.3	20	<b>45.0</b>	51.0	0.102	0.749
<b>8. ON-THE-JOB TRAINING</b>											
existence of organized forms in the firm	40	<b>77.5</b>	42.3	20	<b>75.0</b>	44.4	20	<b>80.0</b>	41.0	0.143	0.705
knowledge transfer among employees	40	<b>67.5</b>	47.4	20	<b>75.0</b>	44.4	20	<b>60.0</b>	50.3	1.026	0.311
successors for most of key employees	40	<b>60.0</b>	49.6	20	<b>70.0</b>	47.0	20	<b>50.0</b>	51.3	1.667	0.197
<b>ADDITIONAL INFORMATION</b>											
B2B	40	<b>40.0</b>	49.6	20	<b>20.0</b>	41.0	20	<b>60.0</b>	50.3	6.667	0.010
more than 25% of export	40	<b>17.5</b>	38.5	20	<b>5.0</b>	22.4	20	<b>30.0</b>	47.0	4.329	0.037
more than 100 employees	40	<b>20.0</b>	40.5	20	<b>15.0</b>	36.6	20	<b>25.0</b>	44.4	0.625	0.429
services vs. Manufacturing	40	<b>37.5</b>	49.0	20	<b>30.0</b>	47.0	20	<b>45.0</b>	51.0	0.960	0.327
state ownership	40	<b>0.0</b>	0.0	20	<b>0.0</b>	0.0	20	<b>0.0</b>	0.0	.	.
blockholdings	40	<b>85.0</b>	36.2	20	<b>85.0</b>	36.6	20	<b>85.0</b>	36.6	0.000	1.000

*Decision-making.* The first question set is the only one where answers are clearly differentiable between the groups of more and less productive firms in our sample. Fifty percent of higher productive firms and 85 percent of lower productive firms have confirmed that the decision-making process about strategic questions of the firm is separated from the operational decision-making process at different levels of the firm. Forty percent of higher productive firms and 75 percent of lower productive firms have answered positive to the second question that top managers and owners made strategic decisions unanimously in the last five years. The third question was answered “yes” by 35 percent of more productive firms and 65 percent of less productive firms, that basic strategic decisions in the firm are coordinated among owners, managers and workers. Differences in the shares of positive answers between the groups of firms are statistically significantly different in all three cases. These results can partly be explained with the difference in size of the firms in the groups. More productive firms are somewhat smaller in terms of how many people they employ, and owners as entrepreneurs do not wish to lose control over key decision-making areas. This way management is delegated tasks nominally, not given any effective empowerment (Wilson and Bates, 2003). Many studies so far have shown that owners of SMEs are often very reluctant to delegating their powers and in the process surrendering a level of control (Smith, 2003, Boeker and Karichalil, 2002).

*Adjusting employment.* We can observe 88 percent of all firms’ adjusted short-term employment to fluctuations in demand in the last five years. Seventy-five percent already approached the desired number of workers. Seventy-three percent of all firms recognize core groups of employees as their competitive advantage. In terms of groups of firms, nearly all higher productive firms (95 percent) used short-term adjustment of employment versus 80 percent of lower productive firms, 85 percent of higher productive firms and 65 percent of lower productive firms approached



the desired number of employees and 80 percent of higher productive firms distinguish the core group of employees as their competitive advantage compared to 65 percent of lower productive firms. Even though we can clearly see that more productive firms have a higher share of positive answers for all three questions, the first two answers are different at close to a 15 percent statistical significance level, while the third one is not statistically significantly different between less and more productive firms. This shows that high productive firms are more effective in adjusting employment to desired levels.

*Determining wages.* Seventy-eight percent of all firms in the sample have higher wages than the reservation wage. Since the level of unemployment compensation, which is low in Albania, determines the level of reservation wage, this might be the reason for a high share of positive answers in the above category. Workers in 50 percent of all firms also get higher payment than required by the collective agreement contract for the industry. Forty percent of sample firms claim that wages are among the highest in the country. Differences in answers between groups are small and statistically not significant.

These results reflect very dynamic labor market conditions in Albania. Collective agreement contracts exist on a national or regional level for separate industries, but more as exceptions than rules. They are formed between the representative union branch (sometimes a federation agreement between two of the biggest unions is made) on one side and business associations on the other. These contracts determine the minimum wage, compensations for lay-offs, overtime hourly wage rate, length of contract validity and freedom of union activity, on a general level. Enterprises that have been privatized and remained a monopoly (i.e. the energy sector) are not included in these contracts, but instead bargain individually with unions and the government. There are only a few cases of such firms in our sample.

*The unions' role.* This question set is interesting because the position of unions in Albania is different compared to most of the other countries in the Western Balkan region. Let us first briefly explain the situation in the past to better understand the present situation: During the communist period (until 1991), labor relations were managed in a centralized manner by one labor (union) organization under the lead of the Communist Party, which (supposedly) represented the voice of workers and their interests. The union's function was also to transmit the Party's ideas and instructions to the working class. Labor Law, which managed labor relations, did exist. The main principle was collectivism, but there were also some individualist tendencies in everyday life. A considerable number of workers tried working privately (illegally) subject to their qualifications (tailors, carpenters, bricklayers, painters, etc.).

Not many firms have unions operating as worker representatives at present, which is clearly evident from the results in Table 1. Only 15 percent of firm has workers organized in unions, and all of these firms have workers organized in only one union.<sup>3</sup> In 10 percent of cases the union leadership is concerned with increasing productivity and, thus, the firm's competitive position. There are two main reasons for low union membership across the country: 1) workers have no desire to be part of a bureaucratically functioning union organization (this view stems from past experience), and 2) workers do not understand the purpose and importance of joining a union. Unions were oriented more toward political struggles of the past instead of the protection of labor relations. It is also not surprising that unions met great resistance from company owners when they started to depend on private companies.

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<sup>3</sup>If there is more than one union operating in an enterprise, the union that bargains over the collective agreement is the one that has more members. Of course it is prudent for the biggest union to join other unions in the firm, in order to increase bargaining power in bargaining with employers.

*Workers' risk aversion.* Workers in Albania seem to be very motivated to do “something more” for their firm. This is true for 85 percent of firms. Forty-eight percent of firms have employees that would stay with the firm even if they were offered better employment elsewhere. There are no differences between productivity groups. The last question asked was whether or not most workers would be willing to accept part of their firm’s business risk. Workers in both groups were very unsupportive of this notion. Thirty percent of higher productive firms have workers that would be willing to accept part of their firm’s business risk, while only 5 percent of lower productive firms have workers willing to accept this type of proposition. The difference is statistically significant at the 5 percent level.

*Workers' participation.* Seventy percent of firms in the whole sample inform workers about key decisions for the firm. Fifty-five percent have an established open dialogue with workers about key decisions for the firm, and 25 percent of total firms have workers’ representatives as members of governing bodies. These percentages are lower than in Slovenian firms, where 94 percent of firms are estimated to regularly inform workers, 83 percent claim to have an established open dialogue with workers, and almost 60 percent of firms have worker representatives in governing bodies (Prašnikar et al., 2010).

The decision makers in Albanian firms are usually managers and owners, rather than workers. Generally, employee-employer relations in a competitive environment are more short-term oriented because workers are often treated (and regard themselves) as a production factor. They generally do not participate in discussions and are not commonly in governing bodies to deliberate on performance and progress of the company. Splitting the sample of Albanian firms, we find 35 percent of higher productive firms and 15 percent of lower productive firms have workers involved in governing bodies, with a statistically significant

difference at the 15 percent level. Previous legislation regarding the management of companies and various public organizations assured a level of workers' participation in governing bodies, but this was later changed.

Although the Labor Law regulates labor relations well, it is commonly violated (i.e. large scale of informal economy). The European Commission demands many improvements in national legislation, also in laws regulating labor relations. In focus are specifically the laws defined by EU directives that regulate the rights of workers' representation in the firm (Communication from the Commission to the European Parliament and the Council, 2010).

*Internal training.* Almost 58 percent of all firms claim to provide organized training to their employees based on identified needs of the company. When it comes to involving more than half of employees in training programs annually, 48 percent of firms do so. Forty-three percent of firms measure training effectiveness with other methods rather than solely conducting a survey at the end of the training program. There are no statistically significant differences between the groups of higher productive firms and lower productive firms on the topic of internal training.

*On-the-job training.* Both groups, more and less productive firms, answered very similarly that providing regular on-the-job training (apprenticeship, mentorship, job rotation, etc.) is done in 78 percent of cases, on average. Sixty-eight percent of firms in the whole sample systematically induce knowledge transfer among employees. Out of all firms, 60 percent have successors for most of their key employees, allowing successors to swiftly and effectively replace employees in key positions as needed. Higher productive firms have a share of 70 percent of such firms and lower productive firms have a share of 50 percent of such firms, but these differences are not statistically significant.

By observing additional information in Table 1, we can see some differences in the export orientation and customer orientation of the firms, where higher productive firms export less and make more revenues by selling to end customers (B2C) than do lower productive firms. Only five percent of higher productive firms earn more than 25 percent of total revenues from exports and 20 percent of total revenues from selling to other businesses (B2B). On the other hand, 30 percent of less productive firms make at least 25 percent of revenues from exports and 60 percent of total revenues from selling to other businesses. Thirty percent of higher productive firms belong to the service industry versus 45 percent of less productive firms. There is no diversification in ownership structures because no state-owned companies are in the sample.

## 4 Discussion

Higher productive companies are operating mostly in the domestic market, exposed to less competition, which may be one of the reasons for achieving higher productivity, if productivity is expressed by value added per employee. Taking into account that higher productive firms in Albania are to some extent smaller in terms of how many people they employ, owners might operate as entrepreneurs that control key decision-making areas.

Differences in wages between the groups of more and less productive firms are not significant. An explanation for such a result might be that firms in Albania operate under very dynamic labor market conditions with owners and/or managers having higher bargaining power than workers, which is also evident in low workers' corporate governance participation. Workers have small bargaining power due to high unemployment and low unemployment benefits (low alternative wage) on one side, and the lack of union representation on the other side. Consequently, the

decision makers in Albanian firms are usually owners and/or managers. Workers are often treated solely as a production factor and generally do not participate in discussions on company performance and progress. Despite this situation, our study has shown that higher productive firms have less (business) risk averse workers, and also involve workers in governing bodies more often than lower productive firms, suggesting that workers in smaller (middle-sized) firms are none the less more intertwined with the life of the (entrepreneurial type of) firm.

There are no significant differences between the groups of higher and lower productive firms on the topic of internal training and on-the-job training even though both groups claim they invest in firm-specific human capital.

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# INVESTMENT IN HUMAN CAPITAL

## 1 Introduction

As Albania is one of the least developed European countries that entered transition from a closed communist system to a market economy two decades ago, the importance of human capital development for economic growth came to be recognized as a top priority by most international organizations, such as the World Bank, EBRD, IMF, and OECD. Many of these organizations prepared country reports and looked at macroeconomic data, which revealed a lack of skilled labor and unsatisfactory levels of education (e.g. World Bank, 2006; EBRD, 2009). Reforms in the education system and the expansion of vocational training have been seen as necessary means for human capital development (Nikolovska, 2008). Conversely, not much has been done to analyze human capital investments and HRM practices at the micro level in Albanian enterprises, even though it has been proven that these practices are positively linked to productivity and sustainable competitiveness (Siebers et al., 2008; Combs et al., 2006).

Therefore the aim of this chapter is to close this gap and shed light on human capital investment at the enterprise level. Following a theoretical framework, which is explained in the next section, we will first look at employment and training practices in Albanian enterprises. Then we will evaluate HRM, management

practices and organizational flexibility, which have also not yet been properly discussed in published research due mostly to difficulties in acquiring the data and the informality of these practices in small size endeavors. While performing the literature review, we found only one systematic study of enterprise level HRM practices by Çuçllari et al. (2010) who analyzed enterprises in one region (Korça). They report that the main HRM challenges for enterprises with regard to employment seem to be replacing workers (about 50 percent of enterprises), then hiring new employees (27 percent), and reducing the number of employees (the remainder), which would suggest that enterprises are not satisfied with current employee performance and/or knowledge and skills. They observed low levels of motivation, which they explained to be linked to high turnover. While the majority of enterprises (70 percent) reported that finding, recruiting, and retaining skilled employees is crucial to them, most companies did not provide any training to upgrade employee skills (but training seemed to increase with the size of companies). Rather than invest in training, enterprises prefer to hire trained employees. They also found that small enterprises use mostly informal HRM methods.

These results suggest that HRM is not well developed among Albanian enterprises, and thus gives validity to our approach to study the best companies across economic sectors to explore the link between human capital investment (and supporting HRM, management practices and organizational flexibility) and productivity<sup>1</sup>. Our sample consists of 40 Albanian enterprises, of which 25 are manufacturing companies and the remaining 15 are service companies. The average number of employees was 147, with the smallest company employing 4 workers and the largest employing 990 workers (median is 47 workers). Ten companies are

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<sup>1</sup> The link between human capital investment (and supporting HRM, management practices and organizational flexibility) and productivity should be investigated with caution, which is later explained.

foreign owned and 17 companies sell more than half of their products on foreign markets. Besides surveying 40 enterprises to gather both qualitative and quantitative data, we greatly appreciate the insight and feedback from prof. Fatmir Memaj, University of Tirana, who served as a local expert and helped us understand the context and behavior of enterprises. This was especially useful due to the lack of published materials in the English language.

## **2 Theoretical background**

There are many definitions of human capital, but most of these definitions share commonality in employee knowledge and skills, which can be obtained through education and training activities, and also through experience from performing different work-related activities. In the broadest sense, human capital can be defined as all the capabilities (knowledge, skills and abilities) of individuals that are the source of innovation and renewal within enterprises (Stewart, 1997). As such, human capital was recognized as an important source of sustainable competitive advantage (e.g. Barney, 1991) and several researchers in different parts of the world have identified human capital to be an element of the largest subcategory of businesses intangible investment (e.g. Corrado et al., 2009, for the US and the UK; Fukao et al., 2009, for Japan). However, according to Fukao et al. (2009) the effectiveness of these investments largely depends on management practices at the firm level. Thus, we may speculate that if investments are supported by HRM and management practices, which promote further development and productive use of human capital, we may find a stronger impact on productivity and competitiveness. The findings of Bloom and Van Reenen (2007), who gathered firm-specific human capital and organizational change data and explored effects of firm-level activities on the link between human capital and productivity, support this line of thinking.

Another theoretical concept that is useful in exploring human capital and performance link is the widely used AMO (abilities, motivation, opportunity) (Boxall and Purcell, 2008). This model suggests that the greatest effects on performance seem to be achieved when high human capital (abilities) is combined with high levels of motivation and opportunities, which are available to employees to use their human capital effectively. Therefore human resource and general management practices are crucial for increasing the value of human capital through first effective recruitment and selection of highly capable employees, then through training (on and off-the-job) and development, and finally by the retention of valuable employees, especially those with high firm-specific human capital. Also, HRM and other managerial practices such as performance management, motivation, compensation and rewards, leadership, communication, organizational climate, and culture play an important role for effectively managing the productive use of human capital.

Miyagawa et al. (2010) took the research one step further and suggest that besides management and human resource management, practices related to human capital investment and organizational reform as an element of building organizational flexibility may contribute significantly to firm productivity, as was the case for the Japanese firms in their sample. According to the Amiri et al. (2010), with the increase in organizational flexibility and change in organizational structure towards more organic forms, human capital and knowledge productivity also increase.

### 3 The context of human capital in Albania

With its 2.8<sup>2</sup> million people, Albania belongs to a group of small European countries. Due to declining mortality and fertility rates, the age structure has changed significantly in the past decades, but compared to other European countries it still has a large share of young population. The median age in Albania is 28.3 years compared to 39 years for the EU (World Bank, 2006). An important phenomenon with regard to population relates to large internal (from rural to urban areas) and external migratory waves (Nikolovska, 2008). Although figures for Albanian emigrants vary (from 600,000 to almost 1,100,000), the fact remains that it is much higher than in other European countries (Vullnetari, 2007). Also, Albania is heavily affected by brain drain since highly educated and skilled employees represent a significant portion of external migrants (Aliaj, 2010).

Of course, migration is closely linked to poverty (as described in the macroeconomic outlook in Redek et al., 2012, in this book) and the labor market, which is marked by relatively high unemployment with the official number of registered unemployed at around 14 percent (World Bank, 2012). It seems that young people and women have the most difficulties in finding jobs, and there is a great deal of long-term unemployment. Although the number of unemployed has been fairly stable over the last decade, local expert suggest that actual unemployment of the working age population is much higher because rural areas

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<sup>2</sup> Preliminary Census of Population and Housing 2011 results show that Albania's population is 2,831,741 inhabitants. The population from the 2001 Census was 3,069,275. It is noted that the population in 2011 decreased by 7.7% in 10 years. It is assumed that the main causes of population decline are large-scale migration and fertility decline (Institute of Statistics, 2012).

are not well covered by statistics, and many people do not even declare themselves as job seekers because they do not believe in existing job opportunities. According to the European Training Foundation's (EFT) labor market analysis, it seems that job creation in formal sectors is rather slow, and labor demand is mostly restricted to the public sector and some private businesses such as banking and, to a smaller extent, construction and tourism (Nikolovska, 2008).

In general most people, especially educated people, consider the public sector attractive for employment because of job security, stability, and better training opportunities, despite lower salaries than in the private sector (Kasimati, 2011). The private sector, on the other hand, consists mostly of micro and small enterprises with simple structures and strong owner influence (usually the owner is also acting as the manager), which diminishes career prospects for educated and skilled workers (Lame and Çela, 2004). The private sector also has a large proportion of informal employment, which is another important characteristic of the Albanian labor market (Nikolovska 2008). It is believed that the majority of workers in the private sector are employed in informal arrangements without proper working contracts and outside the coverage of labor legislation (including getting paid less than minimum wage according to a local expert's observations) and social insurance. Balliu (2010) prepared a report on undeclared labor for ILO and found that three-quarters of people surveyed support informal employment. Only 33 percent of the respondents have concluded employment contracts with their employers (in this estimation is included also the public sector), 28 percent are working without employment contracts, and the rest are unemployed or self-employed. As was explained by the local expert, formality and concluding contracts are not a part of the Albanian culture, and this may importantly contribute to the fact that 'the Albanian business environment is characterized by the co-existence of rules and spontaneous behavior, informality and formality ...' (Lame and Çela, 2004,

p. 127). It seems that this culture of informality is also maintained by the labor legislation, as there is a provision that employment contracts can be either oral or written. If the contract is oral, the employer has to provide a written contract in 30 days, and if not, the oral contract bears the same validity as a written contract and the employer is fined for not providing a written contract (ICGL, 2011).

Compared to other European countries, Albania has a very high proportion of self-employed individuals. According to EFT labor market survey data, two-thirds of employment pertains to self-employed, and only one-third is remunerated by an employer (Nikolovska, 2008). Self-employment has family business characteristics and can be found mainly in trade and crafts handed down through generations of families. Albania also stands out regarding the proportion of temporary to permanent employees, which has been found to be 3.68:1, while most other transition countries in the region had fewer temporary than permanent employees (Sahadev and Denmirbag, 2010). One reason for this can be that there is no time limit for temporary contracts in legislative provisions (World Bank, 2011).

Albanian labor legislation has evolved throughout the transition period and in many ways emulates ILO standards and provides a relevant basis for the protection of employee rights and employee well being. The new Labor Code was adopted in 1995, and later amended in 1995 and 2004. Some other important provisions are stipulated in the Law on Employment Promotion adopted in 2006, the amended Health and Safety Law in 2010, and the ratification of several ILO conventions (ICGL, 2011). Despite extensive legislation, the local expert has emphasized that many provisions are not easily enforced due to prevailing tradition and practices, as well as due to a large portion of informal or undeclared labor that is not even covered by these legislations. Nowadays, the leading institution for developing policy and legislation in the area of employment is the Ministry of Labor and Social

Affairs and Equal Opportunities (MoLSAEO). This institution tries to enforce better adherence to legislation by organizing supervision and inspection bodies. However, the effects are still rather limited due to corruption in inspection practices (Balliu, 2010).

With regard to employment protection, Albania's legislation is fairly flexible compared to other South East European countries, especially when we look at hiring (for non-permanent employees) and firing practices (World Bank, 2006). Institutions of industrial relations are evolving slowly and there is not much evidence about the effectiveness of a social dialogue at the national level, or about collective bargaining and management – trade union relations at the company level. According to the opinion of our local expert, the effectiveness of industrial relations at both macro and micro levels is relatively low, mostly due to the lack of tradition of trade unions and employer associations and specifics of the business context (small size of companies and high levels of informality with regard to employment relations).

## **4 Investments in human capital**

Qualitative data was collected for 40 firms in three areas considering HRM and organization: (1) data on human capital and motivation that include data on employee training, regular on-the-job training and knowledge transfer, and employee performance measures and rewards. (2) Data on the organizational climate include data on the general level of satisfaction and loyalty, whereas data on (3) organization flexibility include data on developments in the last five years with respect to the number of hierarchical levels, number of managers, rules and tasks prescribed, job specialization, and autonomy at work.



Regarding the number of employees, data are available from 2002 to 2010 and range from data on 9 firms (in 2002) to data on 40 firms (2009 and 2010). On average we can observe employment growth during the years, except for the year 2007 when the number of employees in the observed firms on average decreased. For example, in 2002 the average number of employees in the sample was 78, where the smallest company employed only 4 employees and the largest 461. In 2010 the average number of employees was 148, the smallest company again employed 4 employees and the largest 990. In 2010 the total number of employees in the sample was 5,901. Due to a very small number of companies in the sample in 2002, we rather focus on the last few years. Overall, 19 companies in the database increased the number of employees in all of the observed years and, out of those companies, more than half (11) were small companies. Twenty-one companies decreased the number of employees in at least one of the observed years (half of them were small companies).

First, we were interested in how investment in human capital differs with respect to independent variables: legal status (limited company, joint stock), industry (manufacturing, service), ownership (domestic, foreign), size (less than 50 employees or more, less than 100 employees and more), market orientation (domestic, foreign), and availability of resources to invest in people (here we presume that those companies that have their employees among the best paid in Albania also have in general more resources to invest in people). Second, we explore how supporting practices differ in the sample of 40 Albanian firms. We focus on performance measurements, organizational climate, and organization flexibility. These management practices are again investigated with respect to independent variables. Third, we investigate the productivity of the firms in the sample and the relationship of independent variables, as well as investments in human capital, supporting management practices, organizational climate, and flexibility with productivity. We report only the significant effects and relationships.

As mentioned above, we observe 40 companies that together employed 5,901 employees in 2010, and the majority of these companies experienced a steady growth in number of employees in the observed period. The majority of companies (85 percent of them) used some kind of flexible employment arrangements, mostly employees working overtime or hiring part-time workers. Because institutional framework allows high levels of flexibility in part-time employment, some companies, such as Golden Pen Generation (see the case study of GPG in Redek et al., 2012, in this book) use employment flexibility as the main element of their competitiveness. With the help of these flexible employment measures, about three-quarters of companies (29) claim that they have achieved the target number of employees. Nearly all companies in the sample (37 of them or 93 percent) claim to use the core employees' model (for more discussion on this model see Prašnikar et al., 2012, in this book).

*Table 1: Investment in organized training and on-the-job training with respect to different independent variables.*

Type of investment activity	NO	YES		t-stat
Organized training based on company needs	38%	62%		
		Not among the highest paid in Albania 0.388 (0.501)	Among the highest paid in Albania 0.818 (0.394)	-3.030***
		Domestic owners 0.566 (0.504)	Foreign owners 0.800 (0.421)	-1.315*
More than 50% of employees participate in training programs	57%	43%		
		Not among the highest paid in Albania 0.222 (0.427)	Among the highest paid in Albania 0.590 (0.503)	-2.463***
		Less than 50% trade abroad 0.304 (0.470)	More than 50% trade abroad 0.588 (0.507)	-1.825**

SD in brackets. \*\*\* significant at 1%, \*\* significant at 5%, \* significant at 10%.

Table 1 (continued): Investment in organized training and on-the-job training with respect to different independent variables.

Type of investment activity	NO	YES		t-stat
Measuring effectiveness of training programs	47%	53%		-3.087***
		Not among the highest paid in Albania 0.277 (0.460)	Among the highest paid in Albania 0.727 (0.455)	
Regular on-the-job training	23%	77%		
Systematic knowledge transfer	35%	65%		-2.431***
		Less than 100 employees 0.562 (0.504)	More than 100 employees 1.000 (0.000)	
Successors for most of the key employees	23%	77%		-1.488*
		Not among the highest paid in Albania 0.666 (0.485)	Among the highest paid in Albania 0.863 (0.351)	

SD in brackets. \*\*\* significant at 1%, \*\* significant at 5%, \* significant at 10%.

In investigating organized training and on-the-job training, we observe that companies are more devoted to on-the-job training (Table 1). Around two-thirds of the companies in the sample (62 percent) are aware of the importance of investment in external employee training to assure long-term competitiveness. The companies that invest in training are also very keen to measure the training effectiveness, as half of the companies (53 percent) also measure the effectiveness of training programs. How companies with an ambitious vision are aware of the need for training to increase value added has been described in the cases of EWH and Stella companies in Redek et al. (2012, in this book).

Measuring the effectiveness of training is mostly done through different tests or actual implementation of gained knowledge at work. However, looking at the scope

of training results are less encouraging, as only a small proportion of employees are involved in the training activities. Less than half of the companies (43 percent) annually involve more than half of their employees in training programs.

When we look at on the job training, there are even more companies which regularly provide this kind of training to their employees (77 percent). Sixty-five percent of the companies also report having a systematic way of knowledge transfer among employees, mostly through assigning supervisors to new employees in order to guide them and help them acquire necessary experience. From the listed descriptions of knowledge transfer practices, we could speculate that companies mostly use them for new hires and that there is not much organized knowledge transfer activities for other employees who have already been in the company for some time. Interestingly, a very high proportion of 77 percent of the companies believe they have qualified successors for key employees. This would suggest that they do not see systematic knowledge transfer as an important practice for developing successors.

In comparing investment in organized and on-the-job training, we find that there are not many significant differences with respect to independent variables, especially regarding the industry. The most significant differences are regarding the wages of employees. We find that companies with workers who are among the highest paid in the industry invest more in organized training, which is also more often organized for more than half of the employees (in 60 percent of companies more than half of the employees are included in organized training). They also more often measure training effectiveness and have successors for key employees. With respect to ownership, we find that foreign-owned companies are on average more likely to invest in organized training based on the company's needs. Companies that sell more than 50 percent of their products abroad on average

invest in a higher proportion of employees, as we find that those companies invest significantly more to train more than half of employees. Regarding the size of the company, we find that bigger companies, measured by the number of employees, have developed systematic knowledge transfer more than smaller companies.

## **5 Supporting HRM and management practices**

Following research findings by Fukao et al. (2009) and Bloom and Van Renen (2007), it is important to explore human resource and management practices, which are supposed to support the effective development, allocation, and deployment of human capital. In our study we focus on three people-related elements that may affect employee motivation and commitment: performance management, reward systems, and organizational climate (especially employee loyalty).<sup>3</sup> The fourth element is organizational flexibility, where we explore if organizational characteristics are evolving into more organic forms, which are characterized by reduced hierarchy and number of managers, less specialization and formalization, and more autonomy.

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<sup>3</sup> One of the supporting management practices is also participative leadership style (discussed in Prašnikar et al., 2012, and omitted from this analysis) where workers have the option of giving comments, are involved in open dialog when deciding on key issues, or have a representative in a governing body in the firm. We find that a higher proportion of firms that have a more participative leadership style pay higher salaries to their workers.

### 5.1 Performance management and reward system

From Table 2 we can observe that 75 percent of companies claim that they measure performance in such a way that they can clearly distinguish between high and low performers.

Table 2: Performance management and rewards

Measuring performance	NO	YES		t-stat
Performance evaluation to be able to distinguish between high and poor performers (n=40)	25%	75%		
Rewarding high performance (n=40)	10%	90%		
		Less than 50% trade abroad 1.000 (0.000)	More than 50% trade abroad 0.764 (0.437)	2.592***
Using other measures than oral notice for poor performers (n=40)	13%	87%		
		Less than 50 employees 0.809 (0.402)	More than 50 employees 0.947 (0.229)	-1.311**
		Domestic owners 0.833 (0.379)	Foreign owners 1.000 (0.000)	-1.378*
	Less than 50% trade abroad 1.000 (0.000)	More than 50% trade abroad 0.705 (0.469)	3.017***	

SD in brackets. \*\*\* significant at 1%, \*\* significant at 5%, \* significant at 10%.

Interestingly, 90 percent of companies claim to reward better performing workers, although some of those firms have no systematic measures of performance. When it comes to low performance, a very high proportion of companies (88 percent or 35 companies) apply warning signs other than oral reprimands for low performers to let them know of their substandard performance. These are especially companies with more than 50 employees, which have foreign owners and sell in the domestic market. Companies that sell in the domestic market are also more likely to reward high performers. However, we find no significant differences about measuring

performance by some standard procedure of evaluation for different sized companies, different ownership, or legal status.

## ***5.2 Organizational climate***

With regard to organizational climate, 36 companies, or 90 percent as reported in Table 3, claim that their employee satisfaction is at similar levels as in comparable companies. Companies that are bigger and are more domestically oriented report that the general level of satisfaction would not reach the level of comparable companies. Managers of 31 companies think that their employees are willing to do “something more” for the company, mostly by working overtime or working during holidays. These are mostly companies in the service industry. However, the reported loyalty of employees is relatively low. Namely, in only 15 companies does management believe that employees would remain working even if they received an offer for better employment elsewhere. It seems that employees would be on average more likely to stay in large domestic companies in the service industry and quit jobs in companies that are smaller and with foreign ownership.<sup>4</sup> As it has been described in case studies in Redek et al. (2012, in this book), many companies intentionally pay employees above the Albanian average to maintain good relations and employee satisfaction, but because even higher than average salaries are still relatively low, it is understandable that perceived loyalty is also low and employees would move to better paying jobs (in or out of Albania) should the opportunity arise.

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<sup>4</sup> If we compare the organization climate of Albanian companies with Slovenian companies, we find that the general level of satisfaction and loyalty perceptions are very similar, but the willingness to do something more is perceived at a slightly lower level in Albania (Zupan et al., 2010). When compared to companies in the Republic of Srpska (BIH), results of Albanian companies are a little better for all three variables (Petković and Zupan, 2012).

Table 3: Organizational climate

Organizational climate	NO	YES		
General level of satisfaction in the company is similar to that in other similar companies	10%	90%		
		Less than 100 employees 0.937 (0.245)	More than 100 employees 0.750 (0.163)	1.591*
		Less than 50% trade abroad 0.956 (0.208)	More than 50% trade abroad 0.823 (0.392)	1.384*
Most of the employees are willing to do "something more" for the company	23%	77%		
		Manufacturing 0.680 (0.476)	Service 0.933 (0.258)	-1.894**
Most of the employees would remain working for the company even if they got an offer for better (for example better paid) employment elsewhere	63%	37%		
		Manufacturing 0.280 (0.458)	Service 0.533 (0.516)	-1.614*
		Less than 100 employees 0.312 (0.470)	More than 100 employees 0.625 (0.517)	-1.647*
		Domestic owners 0.433 (0.504)	Foreign 0.200 (0.421)	1.315*

SD in brackets. \*\*\* significant at 1%, \*\* significant at 5%, \* significant at 10%.

### 5.3 Organizational flexibility

Table 4 shows investments in organizational flexibility through changes in the characteristics of organizational structure. On average, companies tended to not



change much or even decrease organizational flexibility by increasing the number of hierarchical levels (40 percent of companies) and increasing formalization through imposing more rules. The majority of companies increased the number of tasks prescribed and also increased job specialization. In nearly half of the companies the number of managers remained about the same, and in nearly half of the companies the number increased. Thus, the overall picture does not show that companies would believe in organizational flexibility as an important element of increasing productivity.<sup>5</sup>

*Table 4: Changes in organizational characteristics related to organizational flexibility*

Organizational characteristic	Lower/less	About the same	Higher/more
Number of hierarchical levels (n=40)	2	22	16
Number of managers (n=40)	2	19	19
Job specialization (n=40)	2	12	26
Number of rules (n=40)	4	12	24
Number of tasks prescribed (n=40)	1	13	26
Autonomy at work (n=40)	3	22	15

We find that flexibility in the observed years deteriorated the most for domestically oriented companies with more than 50 employees (Table 5). Job specialization, number of rules, and number of tasks prescribed increased for larger companies (also those with some kind of employee participation and lower payment). We do not observe other independent variables that would influence changes in organizational flexibility.

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<sup>5</sup> These results are very similar to those for the Republic of Srpska (BIH), where organizational flexibility has also not improved in the observed period (Petković and Zupan, 2012). However if we compare these results with research on Slovenian manufacturing companies, for example, we find that in contrary organizational flexibility is one of the core management practices supporting HRM (Zupan et al. 2010). In this previous literature we find that in Slovenian manufacturing companies the number of hierarchical levels from 2006 to 2009 had on average decreased, and workers autonomy increased.

Table 5: Organizational flexibility

Number of hierarchical levels		
Less than 50 employees	More than 50 employees	t-stat
1.190 (0.511)	1.526 (0.611)	-1.889**
Less than 50% trade abroad		
1.521 (0.593)	1.117 (0.485)	2.296**
Job specialization		
Less than 50 employees	More than 50 employees	t-stat
1.363 (0.674)	1.689 (0.541)	-1.589*
Average payment	Significantly higher payment	t-stat
1.739 (0.448)	1.411 (0.712)	1.780**
Number of rules		
Less than 50 employees	More than 50 employees	t-stat
1.238 (0.768)	1.789 (0.418)	-2.774***
Average payment	Significantly higher payment	t-stat
2.000 (0.000)	1.411 (0.701)	2.032**
Not among the highest paid in Albania	Among the highest paid in Albania	t-stat
1.666 (0.594)	1.363 (0.726)	1.421*
Number of tasks prescribed		
Less than 50 employees	More than 50 employees	t-stat
1.476 (0.601)	1.789 (0.418)	-1.891**
Less than 50 employees	More than 50 employees	t-stat
1.521 (0.593)	1.764 (0.437)	-1.425*
Average payment	Significantly higher payment	t-stat
1.782 (0.421)	1.411 (0.149)	2.256**

SD in brackets. \*\*\* significant at 1%, \*\* significant at 5%, \* significant at 10%.

## 6 Investments in human capital and productivity

Investigating the relationship between productivity measured as the mean productivity in 2008 and 2009 and classifying the companies below and under this mean productivity and medium productivity in 2008 and 2009, we find that above average productive companies in 2008 had more loyal employees than below average productive companies.<sup>6</sup> Those companies are also more likely to use measures other than oral notices for poor performers. Companies that had above median productivity in 2008 invested more in systematic knowledge transfer than other companies. When investigating productivity in 2009, we find that on average less productive firms in 2009 invested more in regular on-the-job training than more productive, and the employees of these companies were more willing to do something more for the company. We find that none of the measures of organizational flexibility has any relationship with the productivity.

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<sup>6</sup> The investigation of productivity should be explored with caution. As mentioned, our sample consists of the more productive companies, and among those are companies that are operating in niche markets and thus have higher returns and profits. Most of them are export oriented, and the company Golden Pen Generation (GPG) described in Redek et al. (2012, in this book) can serve as an example of one such company. On the other hand, companies are less productive due to refraining from lay-offs. This is mostly motivated by bad publicity and for foreign-owned or privatized companies. One of these examples is the steel producing company Kürüm International described in Redek et al. (2012, in this book).

Table 6 Relationship between productivity and HRM, motivation, and organizational climate

Below mean productivity in 2008	Above mean productivity in 2008		
65.79%	34.21%		
	Using only oral notice for poor performers	Using other measures than oral notice for poor performers	t-stat
	0.960 (0.200)	0.769 (0.438)	1.852**
	Employees would leave a company for better paid job	Loyal employees	
	0.280 (0.458)	0.615 (0.506)	-2.066**
Below median productivity in 2008	Above median productivity in 2008		
	No systematic knowledge transfer	Systematic knowledge transfer	t-stat
	0.578 (0.507)	0.789 (0.418)	-1.395*
Below mean productivity in 2009	Above mean productivity in 2009		
52.50%	47.50%		
	No on-the-job training	Regular on-the-job training	t-stat
	0.857 (0.358)	0.684 (0.477)	1.303*
	No willingness to do something more for the company	Willingness to do something more for the company	t-stat
	0.857 (0.358)	0.684 (0.109)	1.303*

SD in brackets. \*\*\* significant at 1%, \*\* significant at 5%, \* significant at 10%.

## 7 Discussion and conclusions

The aim of this chapter was to assess the investment in human capital in Albanian enterprises. In our sample we deal with some of the leading companies in their respective sectors, thus we may speculate that on average Albanian companies are lagging behind our observations. On the other hand, looking at the best companies proves advantageous because we are able to depict some patterns of intangible investment with regard to independent variables.

In observing direct investments in human capital, there is a bit less activity with regard to organized training compared with on-the-job training. Around two-thirds of companies claim to provide organized training, and 75 percent provide on-the-job training. However, involvement in training programs does not seem to be wide spread across companies. Only 40 percent of companies reported that they involve more than half of employees in training programs. An inclination towards informality, which we mentioned while describing the context, can also be shown in our results. For example, many companies report to have qualified successors for key positions, even though some of them do not organize training or support formal knowledge transfer. Not surprisingly, we found that larger companies and companies with foreign ownership, or companies exposed more to foreign markets, invest more in human capital. This would suggest that some good practices are already in place and other companies can benefit through sharing knowledge and experience. Here the newly established association of HR professionals (Albanian Human Resource Society) can play an important role (see AHRS, 2012).

Pervasive informality and a reliance on intuition when making people-related decisions are especially evident with reported performance management and reward systems. Namely, almost all companies claim that they reward better performers,

however the number of companies that report to have a performance evaluation mechanism in place to help them distinguish between high and low performers is much lower. Besides rewarding high performance, almost the same high proportion of companies (close to 90 percent) uses more than just an oral notice to deal with poor performers. A similar group of companies that is investing more in training (with foreign ownership, markets abroad and of larger size) also seem to handle poor performance more promptly than others.

A participative leadership style as an important practice supporting human capital use is discussed in Prašnikar et al. (2012, in this book). Here we would like to comment that it is not surprising that the service sector is more open to a participative leadership style than the industry sector. However, it is a bit unexpected that smaller companies (with less than 50 employees), which usually have more informal relationships and more open lines of communication, report lower levels of employee involvement in decision making. It can be that the power of the owner, who is usually also acting as the director in small companies and making important decisions, could present an obstacle for employee involvement. Nevertheless, a general level of satisfaction has been reported as being at a similar level to comparable companies, and even more frequently for smaller companies than for larger ones, which may suggest that employees who go to work for small business owners accept their authority and do not perceive not being involved in decision making as negative. However, investing in human capital without then providing opportunities to employees to express their opinions may not bring full returns on these investments, and even owners of small businesses should consider implementing less authoritarian managerial styles, especially if they deal with highly skilled employees.

Despite a fairly high assessment of employee satisfaction and commitment (willingness of employees to do something more for the company), employee loyalty is not perceived to be high, as about two-thirds of employees would change employers if they received an opportunity for a better paying job. It seems that employees are less loyal to foreign owners than they are to domestic owners. This suggests opportunistic behavior in the Albanian labor force, as laborers would easily change jobs if a better-paid option emerged. Therefore retaining employees obviously presents one important challenge for companies investing in human capital. Or, alternatively, companies should consider options to minimize the risk of losing employees in which they invested.

Among all supporting practices, the most evident obstacle for the more efficient use of human capital lies in company organization. Here we can observe trends pushing organizations further from organic structures. In one way this can be explained by the growing size of companies, which then need more formalization, specialization, and hierarchy (including higher number of managers). But nevertheless, companies should envision ways to increase organizational flexibility. At the moment, the only positive trend pertains to employees getting more autonomy at work.

When we explore the links between productivity and investment in human capital and supporting HRM/management practices, results are mixed and only a few correlations can be depicted. There are some indications that investment in human capital and performance management improve productivity, but further research would be needed to make a stronger case.

We may conclude that the more advanced Albanian firms seem to recognize the need for investment in human capital and that they are also slowly developing

supporting HRM/management practices. Exposure to the foreign business environment and practices (either through foreign ownership or by serving foreign markets) seems to intensify these intangible investments. At the same time, companies still follow the tradition of informality and intuition-based decision making, which could present a problem when businesses experience further growth. Owners/managers will not be able to control their businesses in the same way, and a more professional management approach will be needed. That is why it is important that there is also investment in management training and development in Albania, as well as development in the HRM profession. At this time we did not explore how the HRM function is organized in companies and how it follows professional standards, so this remains one of the areas for further study. Because we have also experienced difficulties in gathering data, maybe another means of obtaining quality information would be through a qualitative case study approach. Namely, there are certainly many opportunities for Albanian companies to further improve effective management of human resources and turn investments in human capital into improved business results. However, due to many specifics of their business context and strong traditions, it would be important not only to import knowledge from the international milieu (as many international organizations are trying to do), but also to identify and transfer Albanian best practices. Our research suggests that there certainly are cases from which other companies can learn.

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# **FIRMS' FINANCIAL POLICIES**

## **1 Introduction**

This chapter presents an analysis of financial policies of a sample of 40 firms in Albania characterized by market imperfections that encompass concepts such as asymmetric information and imperfect capital markets that are widely present in developing and peripheral economies such as Albania, and reflect the level of development of financial markets.

The main elements of the financial policies studied were capital structure and capital budgeting. Using the analysis of financial policies, the goal of the study was to explain the financial behavior of the observed firms and to suggest the level of development of financial markets in Albania. The chapter is structured as follows.

Firstly we searched for evidence of the pecking order hypothesis and financial hierarchy of sources for financing future investments.

Secondly, we observed the importance of capital budgeting methods used in financing decisions and imposed concerns over ranking and usage of methods.

Thirdly, we compared the financial behavior of Albanian firms with the behavior of firms in the Republic of Srpska based on observations in a similar study. The goal was to compare elements of financial policies to observe where Albania can place itself in terms of financial sophistication and development of financial markets compared to the Republic of Srpska, which has also recently undergone transition to a market economy.

## **2 Pecking order hypothesis and financial hierarchy**

Modern capital structure theory began with Modigliani and Miller in 1958. Until then, capital structure theory consisted of loose assertions about investor behavior rather than constructed models that could be statistically tested (Brigham and Daves, 2004). In their study, Modigliani and Miller (1958) addressed capital structure in a rigorous and scientific way and, under several simplifying assumptions<sup>1</sup>, proved that a firm's value is not unaffected by its capital structure.

Although both academicians and practitioners have addressed concerns over the validity of their models, Modigliani and Miller have set off a series of studies and research concerning capital structure. Recognizing and considering factors disregarded by Modigliani and Miller, such as asymmetric information, bankruptcy costs, agency costs, and imperfect capital markets, modern capital structure theory has developed into two categories: trade-off theory and pecking order hypothesis.

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<sup>1</sup> Assumptions encompass the following: no taxes, no bankruptcy costs, perfect capital markets, symmetric information, riskless debt, firm's EBIT not affected by use of debt. After the first study published in 1958, Modigliani and Miller have altered the original assumptions and incorporated corporate tax into their study published in 1963.

The trade-off theory implies trading off the benefits of debt financing (tax advantage) against agency costs and the risk of bankruptcy (Brigham and Daves, 2004).

The pecking order hypothesis implies financial hierarchy in the use of raising funds, but does not explain a firm's optimal capital structure. It originated from Donaldson's description of financial practices in 1961, in which he observed that firms preferred internal financing and avoided issuing stock. Myers (1984) and Myers and Majluf (1984) theoretically justified the pecking order hypothesis using concepts such as asymmetry of information. According to the pecking order hypothesis, a firm will follow a financial hierarchy due to information asymmetry, where internally generated financing is preferred to external financing, and when external financing is required, debt is preferred to equity.

### ***2.1 Evidence of financial hierarchy and the pecking order hypothesis in Albania***

Our purpose was to observe financial hierarchy and evidence of the pecking order hypothesis in the sample of 40 firms that returned questionnaires with a completed capital structure section. In it respondents were asked to evaluate the attractiveness of 6 long-term financing sources for financing future investment projects on a 1 to 5 scale, 5 meaning the most attractive. Results are presented in Table 1.

*Table 1: Financial hierarchy of sources for financing future investments*

Sources of capital by order of preference (40 firms)	Average importance on a 1 to 5 scale
Internal equity (retained earnings)	3.00
Long-term bank loans	2.00
External equity (issuance of new shares)	1.73
Convertible debt	1.40
Preferred shares	1.25
Convertible preferred shares	1.20

On average respondents ranked retained earnings as the most attractive long-term financing source for financing future investment projects, which is according to the pecking order hypothesis (internal sources are preferred to external sources). Long-term bank loans were on average ranked as the second most attractive source with an average importance significantly lagging behind internal equity, and external equity was ranked as the third most attractive source on average, which is again in accordance with the hypothesis (external debt before external equity). Other remaining sources, convertible debt, preferred shares, and convertible preferred shares follow in a corresponding order, each having a low average importance. Results imply the existence of financial hierarchy in the financing decisions of sample firms in Albania in complete accordance with the pecking order hypothesis.

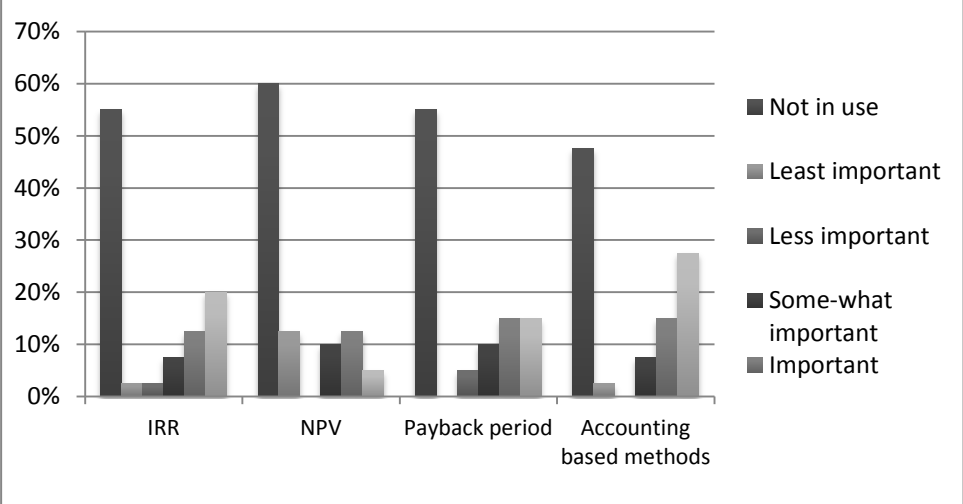
## ***2.2 Capital budgeting procedures***

Capital budgeting is an important tool in deciding which investments add to the firm's value and in choosing the right investment option given other alternatives. Capital budgeting is therefore the most important task for financial managers and their staff. Poor capital budgeting can have severe financial consequences: if a firm invests too much, it will incur unnecessarily high depreciation and other expenses, however if it does not invest enough, inadequate capacity and outdated equipment can lead to a reduction in market share and the loss of customers and competitiveness (Brigham and Daves, 2004). Therefore, it is of crucial importance that firms use appropriate methods to screen for projects that add value, and to reject projects that undermine firm value.

Our purpose was to observe the importance of the evaluation methods used in financing decisions in the sample of 40 firms. We asked the respondents to state which of the 4 evaluation methods (internal rate of return (IRR), net present value

(NPV), payback period and accounting-based methods) are in use in their companies. If a particular method was used, respondents were asked to mark the importance of the method on a 1 to 5 scale, 5 meaning the most important. Results are presented as a frequency distribution in a following figure.

Figure 1: Frequency distribution of importance of evaluation methods used in financing decisions



Using the frequency distribution data in Figure 1, we evaluated the average importance for each evaluation method. Results are presented in the following table.

Table 2: Average importance of evaluation methods used in financing decisions

Capital budgeting method (40 firms)	IRR	NPV	Payback period	Accounting-based methods
Average importance of a method on a 1 to 5 scale	4.00	2.94	3.89	4.24
Percentage of companies using a method	45.0	40.0	45.0	52.5



Results indicate that the most frequently used methods are accounting based with 52.5 percent, or 21 firms, using the method, followed by internal rate of return and payback period, both used in 45.0 percent, or 18 firms. The least frequently used method was net present value, which was used in 40.0 percent, or 16 firms. Only 2 firms stated that they also use other types of evaluation methods when evaluating financing decisions.

Accounting-based methods are the most important methods with an average importance of 4.24, followed by internal rate of return with an average of 4.00, payback period with an average of 3.89, and net present value with an average importance of 2.94. The results of our study raise three concerns.

The first concern is the relatively low percentage of firms that use methods in general. Looking at similar recent studies, carried out in countries in the same Balkan region, concerning the importance of capital budgeting methods, Albania falls behind both: the Republic of Srpska and Slovenia. The study of 58 companies in the Republic of Srpska carried out by Prašnikar et al. (2012a), as presented in the table below, shows that 63.8 percent to 72.4 percent (depending on the method) of observed firms on average use evaluation methods. The study of Valentinčič et al. (2010) of 56 Slovenian manufacturing firms shows a considerably higher percentage of evaluation method usage<sup>2</sup>; internal rate of return and net present value are both used by 87.2 percent of firms on average, and payback period is used on average by 94.4 percent of firms.

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<sup>2</sup> Only relatively less important accounting methods have a relatively lower percentage (60.0 %).

*Table 3: Comparison of the usage of capital budgeting methods in firms by countries of the Balkan region*

Percentage of companies using a method by country	IRR	NPV	Payback period	Accounting-based methods
Albania	45.0	40.0	45.0	52.5
Bosnia (Republic of Srpska)	63.8	63.8	72.4	63.8
Slovenia	87.2	87.2	94.4	60.0

The study of capital budgeting methods used by the Fortune 500<sup>3</sup> industrial companies, carried out by Bierman (1993), indicate a relatively high usage of capital budgeting methods. According to the study, payback period was used by 84 percent of surveyed companies, net present value was used by 85 percent of companies, and internal rate of return was used by 99 percent of the surveyed companies. Furthermore, most companies gave the highest weight to the discounted cash flow methods (NPV and IRR). Similarly, Kester et al. (1998) in a multinational study of the Asia-Pacific found that internal rate of return and net present value were the most popular capital budgeting methods for large firms in that region.

The second concern is the popularity of accounting-based methods compared to internal rate of return and net present value in terms of average importance and percentage of companies using a method. Accounting-based methods (such as accounting rate of return) are not considered superior evaluation methods in neoclassical financial theory<sup>4</sup>, namely accounting-based methods ignore the time value of money and often focus on net income rather than cash flow and, therefore, is considered a flawed measure. Most early studies, like the one by Miller

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<sup>3</sup> The Fortune 500 is a list that ranks the top 500 U.S. closely held and public corporations as ranked by their gross revenue after adjustments. The list is constructed and published by Fortune magazine annually; the first list was published in 1955.

<sup>4</sup> Neoclassical financial theory regards net present value as the best single measure, followed by internal rate of return, which many decision makers prefer. Literature nevertheless points out that firms should consider all of the measures, which nowadays, with the use of modern technology, can easily be obtained since each gives a different piece of important and relevant information.

(1960) and Schall et al. (1978), report payback technique as the most popular and preferred capital budgeting method, which was attributed to the lack of financial sophistication and limited use of computer technology, while the early study of Istvan (1961) reports a preference for accounting rate of return as a superior method of capital budgeting. Later studies, like the one by Bierman (1993), indicate that no firms used any accounting-based methods, nor did firms use payback period as their primary method. Firms instead gave the greatest weight to discounted cash flow methods such as internal rate of return and net present value.

Although Ryan and Ryan (2002) claim that throughout the literature net present value has always trailed internal rate of return in management preference our survey shows a large discrepancy between the methods' average importance (IRR having average importance of 4.0 and NPV having average importance of 2.9). Our survey also shows that the correlation between the usage of internal rate of return and net present value, measured as Pearson's correlation coefficient, is 0.8, indicating a strong, linear and positive correlation. In other words, not every company that uses internal rate of return uses net present value and vice versa, which is odd considering the conceptual nature of both methods and the calculation procedures of obtaining outcomes based on these two methods. Other studies, like the one of Prašnikar et al. (2012a) show that the correlation between the usage of internal rate of return and net present value, measured as Pearson's correlation coefficient, is 1, meaning a perfect, linear and positive correlation. In other words, all firms in the sample that used internal rate of return also used net present value and vice versa, which is in accordance with financial theory and the conceptual nature of both methods.

Our study shows a relatively low percentage of companies that use methods in general. When using methods, firms on average give relative importance on

accounting-based methods. Our study also shows a discrepancy in the correlation between the firms' usage of internal rate of return and net present value, which poses a concern over the conceptual understanding of both methods by firms. The findings reflect the level of development of financial markets in Albania. While firms in the United States in 1993 showed a relatively high usage of capital budgeting methods and emphasized the importance of discounted cash flow methods, as indicated by Bierman (1993), which is attributed to the long period of market economy that existed in the United States even as early as 1993, our analysis of capital budgeting methods in Albania suggest a level of development of financial markets closer to transition economies in the Balkan region. The next section compares the elements of financial policies of firms in Albania to a similar study of firms in the Republic of Srpska to observe where Albania can place itself in terms of financial sophistication and development of financial markets.

### **3 Financial policies in Albania in comparison with the Republic of Srpska**

This section compares the financial behavior of Albanian firms with behavior of firms in the Republic of Srpska that were observed in a similar study carried out by Prašnikar et al. (2012a). Our purpose was to compare elements of financial policies to observe where Albania can place itself in terms of financial sophistication and development of financial markets compared to the Republic of Srpska, which has also recently undergone transition to a market economy.

Comparisons of firms' financial policies in Albania to policies of firms in the Republic of Srpska are summarized in Tables 4 and 5.

*Table 4: Comparison of financial hierarchy of sources for financing future investments by country*

Sources of capital by order of preference (average importance on a 1 to 5 scale)	Albania	The Republic of Srpska
Internal equity (retained earnings)	3.00	4.00
Long-term bank loans	2.00	2.64
External equity (new shares)	1.73	2.14
Convertible debt	1.40	1.93
Preferred shares	1.25	1.53
Convertible preferred shares	1.20	1.52

Source: Prašnikar et al. (2012a); own calculations.

Table 4 shows a comparison of financial hierarchy of sources for financing future investments. Albanian firms show equal financial hierarchy and presence of the pecking order hypothesis as the sample of firms in the Republic of Srpska. In terms of contrasts in average importance, Albanian firms and firms in the Republic of Srpska give, by far, the highest preference to internal equity, and much less to long-term bank loans and external equity capital.

*Table 5: Comparison of usage of evaluation methods used in financing decisions*

Percentage of companies using a method	Albania	The Republic of Srpska	Cluster (manuf. firms)
IRR	45.0	63.8	44.4
NPV	40.0	63.8	44.4
Payback period	45.0	72.4	61.1
Acc. based methods	52.5	63.8	55.6

Source: Prašnikar et al. (2012a); own calculations.

Table 5 shows a comparison of usage of evaluation methods used in financing decisions. Albanian firms on average use evaluation methods much less than firms in the Republic of Srpska. This suggests that Albanian financial markets are less developed than markets in the Republic of Srpska. Even more, the usage of evaluation methods in Albania resembles the usage of methods of a cluster of

manufacturing firms<sup>5</sup> in the Republic of Srpska identified by Prašnikar et al. (2012b) and presented in the fourth column of Table 5. The cluster represents the poorest performing group of firms among all identified clusters in the Republic of Srpska today, and illustrates the strongest form of market imperfections and lowest end in the level of development of financial markets in the Republic of Srpska. Of the firms in the cluster, 44.4 percent used internal rate of return and net present value, 61.1 percent used payback period, and 55.6 percent of firms used accounting-based methods as evaluation methods, which is closer to Albanian firms than the whole sample of firms in the Republic of Srpska. This implies that the level of development of financial markets in Albania resembles the lowest end in the level of development of financial markets in the Republic of Srpska as noted in its cluster of worst performing firms.

*Table 6: Comparison of average importance of evaluation methods used in financing decisions*

Average importance of a method (on a 1 to 5 scale)	Albania	The Republic of Srpska
IRR	4.00	4.00
NPV	2.94	3.59
Payback period	3.89	4.05
Acc. based methods	4.24	3.59

Source: Prašnikar et al. (2012a); own calculations.

Table 6 shows a comparison of average importance of evaluation methods used in financing decisions. While payback period is the most important method in the Republic of Srpska, on average, and accounting-based methods are the most

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<sup>5</sup> The cluster of manufacturing firms consists of mainly manufacturing firms that, on average, have lower productivity rates, lower investment in human capital, lower worker wages, and show high short-term adjustment of labor to shocks. A common characteristic of a cluster is low coordination of basic strategic decisions between owners, managers, and workers on average. The prevailing legal status of firms in a cluster is limited company. The ownership structure shows that the majority of firms are privatized, former socially owned firms.

important in Albania, on average, both samples attribute less importance to discounted cash flow methods.

Albania, originating from a very rigid social model with strict central controls, was one of the last countries that stepped on the path of transition. The first serious steps were initiated in 1991 with price liberalization, investment deregulation, macroeconomic stabilization, land distribution and small scale privatization, followed by the privatization of larger firms in 1995 and invitation of foreign capital at the end of the decade. The second decade was marked by a continuance of reforms improving the business environment and rule of law. Even today, the process of transformation has yet to be finished, especially in the field of liberalization, privatization, structural reforms, business environment, and infrastructure (Redek et al., 2012, in this book). Although Albanian firms show resemblance to firms in the Republic of Srpska in terms of financial behavior, the comparison, especially of the usage of evaluation methods, implies that Albanian financial markets are less developed and market imperfections are more widely present. This is attributed to the fact that Albania is still in the process of transition, and according to Redek et al. (2012, in this book) has a comparative closed market and underdeveloped financial system.

## **4 Conclusion**

Our analysis of financial policies of 40 firms in Albania shows that an average firm does not pursue the goal of maximization of shareholder value; rather it shows the existence of market imperfections that are widely present in developing and peripheral economies such as Albania. Two main elements imply such financial behavior.

Observing capital structure, firms rank internal equity (retained earnings) as the most attractive long-term financing source for future investment projects on average, followed by long-term bank loans and external equity (issuance of new shares). Other sources, convertible debt, preferred shares, and convertible preferred shares follow in a corresponding order, each having low average importance. Results indicate the existence of financial hierarchy of sources and existence of the pecking order hypothesis that contradicts the goal of maximization of shareholder value because reliance on costly equity does not lead to minimal cost of capital, but rather implies information asymmetry.

In observing capital budgeting and the importance of four evaluation methods that were used in financing decisions, an average firm ranks accounting-based methods as the most important and most frequently used methods (52.5 percent of all firms use it). In terms of importance, internal rate of return was ranked second, payback period third, and net present value fourth. In terms of usage, internal rate of return and payback period were used in 45.0 percent of firms, while net present value was used in only 40.0 percent of firms in the sample. Our study indicates a relatively low percentage of firms that use methods in general; popularity of accounting-based methods compared to internal rate of return and net present value in terms of average importance and percentage of companies using a method; and discrepancies between usage and importance of internal rate of return and net present value. Our conclusions reflect the level of development of financial markets in Albania.

Finally, we compared the financial behavior of Albanian firms with the behavior of firms in the Republic of Srpska and found that although Albanian firms show resemblance to firms in the republic of Srpska in terms of financial behavior, especially in the usage of evaluation methods, the comparison implies, however,



that Albanian financial markets are even less developed and market imperfection is more widely present. Albanian firms have a difficult time making financial decisions. It seems that the firms rely mainly on the capital of their owners who are striving to achieve the highest short-term profit.

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