

CENTER FOR THE STUDY OF DEMOCRACY

*Policy and Legal Environment for the  
Growth of the SME Sector in Bulgaria*

Policy Paper

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Sofia

## INTRODUCTION

### 1. General Orientations

The Policy Forum aims to identify those factors that will improve the economic and legal environment for the growth of the small and medium sized enterprise ("SME") sector in Bulgaria. The forum has brought together some of the country's most influential individuals, representing various institutional and independent bodies, to discuss the constraints that are hindering the development of the SME sector and to propose and review various recommendations to overcome these obstacles.

The paper attached hereto is a compilation of those recommendations contributed and discussed at the forum. By preparing recommendations in advance of forum meetings based on the topics to be discussed, participants were able to provide a greater number of feasible recommendations for the development of the SME sector. In addition, by discussing the recommendations in an open forum setting, immediate feedback was provided for proposals and it also created wide support and acceptance of the report.

### 2. The Background Paper

The background paper is broken into three main sections. Section 1 discusses the actions needed to improve the economic climate to support the SME sector. Section 2 discusses the actions needed to improve the institutional and legal environment for SMEs. Section 3 describes a monitoring system to determine whether or not the proposed actions from Sections 1 and 2 have been implemented with the desired results obtained. Each section is further divided into ACTION LINES. BACKGROUND information is given under each Action Line followed by its OBJECTIVES. Then, specific ACTIONS are described to achieve the objectives of the Action Line.

### 3. The Importance of the SME Sector

The success of Bulgaria's SME sector is essential to the development of the economy as a whole. Foremost, SMEs are labor intensive and capable of creating many new jobs at low costs. These jobs will be necessary to absorb new unemployment created by restructuring former State Owned Enterprises ("SOEs"). Among other important SME contributions to the economy are:

1. SMEs service the needs of larger corporations and provide services that facilitate business. One role that SMEs can play is as suppliers to larger companies thus contributing to the external competitiveness of these firms.

2. SMEs are a source of innovation on the basis that they are more flexible, more dynamic and more sensitive to shifts in demand than larger firms.
3. SMEs contribute as "Seed-Beds" from which large companies can grow.
4. SMEs will provide an additional market for the purchase of second-hand equipment from SOEs.
5. SMEs train entrepreneurs needed to develop the private sector and foster private investment.

As a result of these factors, the larger and more developed the SME sector, the greater the SME contribution to the growth of the economy.

Therefore, it is imperative that during this time of concern, that the Bulgarian authorities take into consideration the role of SMEs in the economic development of the country.

The product of this policy forum will provide a guideline for officials to adhere to when developing the overall plan for the country so that the proper recognition of the important role of SMEs in the development of the Bulgarian economy is included.

## **1. ACTION LINE 1: IMPROVING THE ECONOMIC CLIMATE, POLICY AND SUPPORT FOR SMALL AND MEDIUM SIZE ENTERPRISES**

### **1.1 ACTION LINE 1.1: ECONOMIC STABILIZATION AND IMPROVING OF THE BUSINESS CLIMATE**

#### **1.1.1 BACKGROUND**

The economic destabilization and deterioration of the Bulgarian business environment has seriously restricted the development of the SME sector. Moreover, not only has the sector experienced serious governmental neglect, but it has also undergone direct evolutionary oppression as a result of various official policies, including the anti-competitive practice of subsidizing the public sector. While such macro-economic failures affect all private enterprises, the impact on the SME sector is compounded due to its general inability to access capital and information.

#### **1.1.2 OBJECTIVES**

The objective of this action line is to address the development of the SME sector vis-a-vis the stabilization and improvement of the Bulgarian economy. More importantly, this action line emphasizes the importance of including specific policies and measures in such macro-economic actions that address the specific concerns and needs of SMEs. *The purpose is not to propose those specific macro-economic actions necessary to stabilize the economy, but rather to acknowledge conditions that are essential for the development of the SME sector and to stress the importance of addressing SMEs in such macro-economic actions..* These actions are viewed as a function of several parameters, namely, the acceleration and expansion of economic reforms, anti-crisis regulation and stimulation, and the opening of the country to foreign investors and partners.

#### **1.1.3 ACTIONS**

The actions foresee:

1. the development of an anti-crisis program in which the place and role of SMEs will be clearly and responsibly stated (*ANTI-CRISIS PROGRAM*).
2. the development of a strategy for accelerated, full-scale privatization, with maximum broadening of the applied privatization techniques (*ACCELERATION OF THE PRIVATIZATION PROCESS*).
3. the development of a national strategy for mobilizing domestic investment and attracting foreign capital, including decisive measures for improving the general business climate in the country (*DOMESTIC AND FOREIGN INVESTMENT STRATEGY*).

4. the implementation of measures designed to increase the absorption capacity of the country with respect to international programs that provide financial aid and support for the SME sector (*ABSORPTION CAPACITY*).

the implementation of decisive measures (legislative and organizationally-administrative) for establishing steady tax policy and practices (*TAX MEASURES*).

6. the implementation of measures for narrowing the perimeter of activity and influence of the shadow economy and the creation of a competitive environment without distortions (*ACTIONS AGAINST SHADOW ECONOMIC AND CRIMINAL ACTIVITIES*).

*D.*

## *ANTI-CRISIS PROGRAM*

### *Background*

Since the restructuring of the economy which began in 1989, there has been no consistent and long term strategy for the development of economic priorities. While continuously stating the need for structural reform, the government still cannot point out the sectors it plans to prioritize. All this deprives the private sector, and SMEs in particular, of the ability to work out their own strategy, relevant to national economic policy. In addition, the dialogue between the authorized state institutions and private businesses has been disrupted, which deprives entrepreneurs of the ability to influence national economic priorities.

### *Recommendation*

In recent months, structural reform in Bulgaria has been spoken of widely. While a discussion of the proposed currency board extends beyond the scope of this report, SMEs will face serious consequences either as a result of the board's implementation, or lack thereof. Furthermore, the board and various other structural reform measures that have been independently mentioned are only several of the essential elements of an anti-crisis program.

In light of these measures, the successful development of the SME sector depends largely on how thoroughly anti-crisis actions embrace the crucial role of SMEs. Specifically, all measures stated below must incorporate objectives designed to strengthen the SME sector. While a basic anti-crisis program that successfully stabilizes the economy will undoubtedly benefit the SME sector as well, such a process, without specific SME consideration, will result in a lost opportunity to

concurrently build a strong foundation of SME support and promote its expansion into the strategic industries of Bulgaria.

To establish a favorable working climate in which SMEs can thrive, such a program must contain several key components that also specifically recognize

the special needs of SMEs: fiscal and monetary actions *to* lower interest rates, inflation and taxes (particularly of the profit tax); measures to stabilize and promote the development of the banking system; policies and support for the benefit of strategic industrial sectors; export programs which include financial backing and insurance; and foreign investment strategies that support the overall goals of the anti-crisis program.

In the framework of common measures, the development of a real and expedient structural reform package is of critical importance. In order to finally realize this reform, which for all these years remained in the sphere of promises and political speculation, what is needed is a clear, practical and transparent program for its carrying out.

### *ACCELERATION OF THE PRIVATIZATION PROCESS*

#### *Background*

Experts estimate that the percentage of state owned property is still well above 90 per cent. Non-competitive state owned enterprise ("SOE5") business practices crowd out SMEs from competing in their common industries. SOEs also encumber the success of SMEs in developing industries by creating a deficiency of competitive suppliers, distributors, and industrial consumers. In addition, the slow privatization process has curtailed international interest in the SME sector and the Bulgarian market in general. Failure to carry out privatisation measures has provided fewer opportunities to purchase Bulgarian companies and to form joint ventures. It has also provided an unfavorable investment climate since maintaining significant public ownership runs counter to a free market system.

Further, budget losses continue to pileup from SOE employee benefit payments and foregone tax revenues. Also, maintaining state ownership of companies continues to erode both the value of their assets and their competitiveness. Thus, the longer an SOE is held, the greater the cost to the state and lower the price of the sale.

#### *Recommendation*

In addition to accelerating the privatisation process, as a whole, for the well being of the Bulgarian economy, SME privatisation must be made a priority of the process. While significant attention has been paid to the "gems" of Bulgarian industry, the privatisation of most state owned SMEs has been neglected. Within the economy, only a relatively small portion of the total national capital assets are "large" enterprises (statistically, these companies have constituted only 10-15% of the enterprises of centrally planned economies). SMEs should be sold off quickly and expeditiously. Consequently, in addition to its importance to the development of the SME sector, selling such enterprises will make the privatisation of large SOEs easier.

The relevant authorities need to adopt a simple policy for the immediate sale of SMEs and other small properties. Specifically, an accelerated system of sale, similar to those implemented in most Eastern European countries, must be established. This includes the establishment of a break even cost of holding the businesses and a minimum sales price for the enterprise. Then, following an impartial auction procedure, a competitive bidding process should be created which would result in prices at least above the break even level. The break even price can be estimated by determining the liquidation value of the assets of the company and subtracting the costs associated with keeping the company state owned, such as welfare benefits for employees, financing and other administrative costs. In addition, alternative forms of sale, such as management buyouts, must be administered. In many Eastern European privatisation programs, management was granted the business in return for the preparation of a sound business plan and long term commitment.

However, while emphasis needs to be placed on SME privatisation, this does not mean that SME privatisation should commence at the expense of accelerated large scale privatisation. The need for a fully functioning market economy is not only essential to the development of the SME sector, it is imperative for the success of the Bulgarian economy as a whole.

## *DOMESTIC AND FOREIGN INVESTMENT STRATEGY*

### *Background*

Since developmental aid and government-initiated capital formation have become difficult to acquire, equity capital for SME development, and the development of the Bulgarian economy as a whole, must come from the private sector, both indigenous and foreign.

Commercial bank liquidity problems, a lack of experience lending to SMEs and poor economic conditions have created a credit shortage in the country. While SMEs are not the only businesses suffering from a lack of start up or development capital, their capital needs are presently being neglected in favour of large companies. Owners of such enterprises usually rely on self-generated capital, family or friends. Enterprises can not establish a long term, stable financial basis from the personal savings of the entrepreneur, nor does self financing provide sufficient capital accumulation.

As Bulgaria currently has little or no domestic risk capital available, it needs to attract capital from abroad. And therefore, foreign capital must be actively solicited. The Bulgarian banking system can not currently support the development of the SME market and other sources of funds, such as the Ministry of Industry's Small Business Fund, established in 1991, remain underutilized. Foreign investment in which effective managerial control is established also serves to bring badly needed technologies and managerial techniques to SMEs. Unfortunately, according to data provided by BNB, foreign investments for the



first half of 1996 amount to USD 49 million, USD 27.6 million less than the first six months of 1995.

### *Recommendation*

Three areas must be targeted to develop the domestic investment structure:

1. pension and insurance funds investing,
2. capital market development, and
3. savings mobilization.

Pension and insurance funds maintain large surplus capital balances which must be invested and often constitute a large percentage of the investment capital in developed and developing countries. However, without adequate investment ■ vehicles, such capital will remain idle or be invested abroad. While it is unlikely that pension or insurance funds have the expertise to invest in SME development directly, the creation of a financial infrastructure in the country will draw large amounts of currently uninvested assets into financial intermediaries.

Coupled with a committed privatisation process, the country must turn its focus to creating a liquid and transparent capital market to provide a mechanism through which public and private enterprises can raise capital to invest in projects.

Capital markets must be created that offer liquidity and transparency in each of the following areas:

1. the market for government securities;
2. the market for stocks and bonds of privatized enterprises;
3. the market for securities issued by commercial banks;
4. the market for municipal bonds; and
5. the market for securities issued by private, non-bank businesses formed outside the privatisation process, such as private investment funds and other collective investment vehicles.

This development requires attention to each of the following areas, many of which are addressed in this paper in greater detail:

1. Legal Development
  - Securities laws (fiduciary responsibilities, truth in new issues and due diligence requirements, and resistance to market manipulation)
  - Structure of a securities agency (government and self regulation by association, clear establishment of powers, law making and enforcement, and staffing)
  - Tax basis for companies (laws and regulatory agencies)
2. Company Development

- Privatisation (elimination of government control and subsidies, separation of ownership and management, establishment of corporate by-laws, definition of role of boards and accounting standards)
3. Securities Industry Formation
- Information and disclosure (accessible, high quality and timely)
  - Laws governing securities firms (capital requirements, management fitness and responsibility, employee registration and requirements)
  - Roles and regulations of banks (universal, subsidiary or holding company)
  - Market structure (intermediaries, trading exchanges, registration, clearing and settlement, price disclosure, and policies towards foreign investors regarding joint ventures and traded firms, ownership limits)
4. Perpetration and Training
- Time schedule for implementation
  - Training people for jobs
  - Industry infrastructures (attorneys, accountants, and dispute settlement/ arbitration)

Developing the capital markets of Bulgaria will reduce the risk of the excessive expansion of the country's already fragile banking system. Specifically, Bulgarian commercial banks are unable to meet credit demands because of a country-wide lack of savings. Policies such as reserve requirements, state or private banking insurance and other practices to increase the level of savings in the country must be reviewed and where necessary, implemented.

The improvement of the institutional conditions allowing easier access by SMEs to capital markets is extremely important. However, the commercial bank will ultimately be the largest source of financing for SMEs. As evidenced by the obvious interdependency between commercial banks, capital markets and pension and insurance funds, simultaneous development of all sectors is required to provide financing and credit for SMEs.

In addition, to attract investment in SMEs from abroad, Bulgarian policy makers must make Bulgaria an attractive investment for international investors. This success relies heavily on the stabilization of the economy and political system, privatisation of existing SOEs, reduced inflation, and the basic building of a better economic climate for investing. Recent political and economic events had diverted foreign investors attention to other Central and Eastern European Countries and foreign markets. In the midst of heavy competition from other developing economies for foreign investment/ the availability of capital for aiding the SME sector from abroad may be difficult to attract in large quantities. And therefore, concrete actions must be executed under the umbrella of a comprehensive national economic plan.

As an adjunct to attracting foreign investment, the authorities must focus attention on the process for effecting such investments. Investors seek returns, which can be dramatically eroded by a cumbersome investment process that

lacks transparency. Market potential and economic and political climates are all factored into foreign investment decisions. Governments that ignore the needs of investors and undermine their confidence risk losing local SME attractiveness as opportunities for investment. Investors want well developed capital markets, including a stable banking system in which commercial banks are capable of assessing risks and providing capital. In addition, the availability of other forms of financing, quality information, liquidity, hedging vehicles and an overall degree of stability add to the attractiveness of a market. Investors are also attracted to markets in which fiscal and monetary policies favor stability and policy makers have good governmental relationships with international donor organizations and banks.

Stable economic indicators are also a sign of a stable government and governmental policies. Investors want to know that governments are committed to the well-being of the nation as a whole. Fears of expropriation, changing regulations, and lack of support for private business increase as the stability of the government decreases, regardless of what is written in the laws. Signs such as frequent changes in Ministers responsible for the decisions regarding foreign investment in SMEs will cause foreign investors to reconsider the opportunities available for them.

### *ABSORPTION CAPACITY*

#### *Background*

In light of recent changes in the international interest in the promotion of SMEs' and their role in the development process, focus must be placed on the implementation of programs designed to increase the absorption capacity of the country. For example, the European Investment Bank recently announced that it would allocate 25 per cent of its investment capital for the development of the SME sector in developing economies. However, previous international aid for Bulgarian SMEs has not been allocated in an efficient or timely manner. Unfortunately, the lack of an appropriate institutional framework, frequent changes in government and the crisis in the banking system led to inadequate utilization of those resources. Specifically, a 22.5 million ecu PHARE sponsored local structure development program established in 1992 (the only SME support program financed by the European Union thus far), has been met with serious delays and most of the funds have been reallocated to other projects within Bulgaria. Further, of the amount still left for SME development, 7 million ecu designated for direct firm level financial assistance, (the loan grant was designed to be disbursed in two tranches to the BNB: one tranche of 4 million ecu disbursed in the middle of 1995, and the second tranche to be disbursed pending the allocation of the first tranche to SMEs before the end of 1996), only 900,000 ecu has been allocated so far.

## *Recommendation*

Several lessons can be learned from the PHARE program to increase absorption capacity. First, participation by competent and committed banks must be sought. The inability for banks to adequately determine the credit capacity of SMEs not only leads to bad loans, but is also responsible for the overly cautious lending habits that result in funds remaining idle. While the banks that participated as administrators under the BNB in the disbursement of the SME credit may have been competent, criticisms have been raised that they have been extremely "credit-shy," despite their indemnity from default risk. Second, there must be adequate demand for the credit on the terms offered by the lending banks. The problem of overly cautious banks was compounded by inappropriate loan candidates. Companies that do not have the credit capacity to accept current lending terms create log jams of applications and increase bank costs. Applications should include self screening tests and minimal processing fees that would be reimbursed upon the issuance of loans to cut down the number of bad applicants. Third, banks must maintain the flexibility to set interest rates to reflect market risks and to cover costs. Fourth, a time horizon should be set that is large enough to properly develop such a program. With respect to the PHARE program, the majority of the 900,000 ecu in loans has been disbursed within the last two months of 1996, possibly reflecting both the approaching deadline and movement on the learning curve.

New trends indicate that international donor organisations, such as USAID, are increasingly turning to non-governmental organizations ("NGO") to administer funds and provide assistance to SME development. Similar initiatives are being followed by the World Bank and the European Union. It is clear that Bulgarian authorities need to develop a system for involving NGOs in their attempt to increase the absorption of international funds, including those supplied by bilateral programs. To increase the cost effectiveness of such programs, support should be managed by NGOs similar to programs implemented in Greece under which absorption capacity was increased significantly. Fortunately, the implementation of an NGO absorption program in Bulgaria is a matter of regulation, not legislation. Specifically, it can be enacted by a decree of the Council of Ministers that directs the use of NGOs to administer and assist the absorption capacity of the country. Absent adequate NGO infrastructure, such funding will bypass Bulgarian businesses.

## *TAX MEASURES*

### *Background*

The most characteristic feature of the widely accepted practice of carrying out state collections (taxes, excises, tariffs, customs duties, and other duties) is its chaotic nature. The inconsistent state policy in this sphere and the actions of the administration bring about tax disorder, rather than the required tax culture and discipline.

## *Recommendation*

To increase budget revenue, the priority tax policy change must be the creation of a steady and predicable tax environment. It is imperative to finally abolish the practices of back dated taxes and the constant amendment of tax policies. Expedient and decisive measures for tightening the financial discipline must also be carried out, particularly in improving the work of the tax administration and other financial control authorities. Finally, as previously stated with respect to the privatization of SOEs, prompt and resolute cuts in the losses of the public sector must be completed thought mass privatisation.

Specific action must be taken to address the following obstacles SMEs face because of current tax policy:

1. The regulation of the annual taxation results (taxable and nontaxable expenses) is decreed by an act of the Council of Ministers, which allows its easy and perpetual revision;
2. The range of expenses which reduce the annual amount to be taxed deductible expenses constantly diminishes;
3. The use of negative results from previous years is no longer used in the tax loss carry forward formation of the positive financial result for the current year;
4. Depreciation and amortization schedules are problematic and should include accelerated depreciation for long term material assets;
5. A practice of accepting limitations introduced with old dates is being widely accepted;
6. Only 10% of education expenses are accepted as nontaxable expenditure, which is a serious drawback for SMEs, where education is crucial to their survival and stabilization;
7. Expenses common to SMEs, such as the reconstruction and office, machine, and other improvements are not being reduced;
8. The process of advanced payment of taxes must be developed and stabilized;
9. There is an incredibly slow procedure of recovering VAT credit with no interest accumulation for blocked funds;

An additional burden for SME activity is the ineffective and inconsistent work of the tax authorities. In this respect the following problems must be addressed:

1. Arbitrary interpretation of the laws and other normative regulations by public officers;
2. Lack of control mechanisms for the structure of the tax administration to be used by the MF in supporting the interests of the economic entities;
3. In many cases, tax inspectors are hostile and aggressive. Errors are sought deliberately, and a percentage reward is given for every "erred amount."

## *ACTIONS AGAINST SHADOW ECONOMIC AND CRIMINAL ACTIVITIES*

### *Background*

During the last few years, shadow economies and criminality have gained considerable influence within the Bulgarian economy. Among other problems, inadequate tax policies have pushed SMEs into shadow economics and entrepreneurs are being squeezed between the so-called "power organizations" and high-level institutional corruption. Thus, entrepreneurial spirit is being destroyed by pseudo market conditions. These factors are also extremely harmful to the activity of foreign investors. For example, United States Federal racketeering laws prevent American businesses and persons from engaging in activities such as bribery outside the United States. Therefore if local business practices include such activities as part of the modus operandi, American businesses are effectively excluded from the market.

### *Recommendation*

Resources need to be allocated to protect upstanding businesses. The problems of corruption needs to be addressed by both the state and local SME organizations. Educational programs should be implemented within SME associations to inform member companies of the economic benefits created in a business environment which recognizes business integrity and mutual trust among its members. Specifically, credible accounting procedures and legitimate business practices provide opportunities to access additional sources of long-term funding.

### **1.1.4 EXPECTED RESULTS**

This action line will result in governmental recognition of the important role of SMEs in the development of the Bulgarian economy, outline the necessary macro-economic conditions that are necessary for their development, and underline the importance of including measures that specifically address the needs of the SME sector in whatever macro-economic actions are undertaken. The stabilization of the Bulgarian economy through an anti-crisis program and accelerated privatisation program will lay the foundations for the development of Bulgaria's SME sector. Additional business climate improvements will result from the availability of financing from international sources, consistent and enforced tax laws, and credible and legitimate business practices. Ultimately, The SME sector will become a major contributor to the economic growth of the country. Providing an environment suitable for SMEs to conduct business will lead to the creation of many new jobs necessary to absorb new unemployment created by restructuring former SOEs, and will also serve to redistribute income-SMEs will also provide an additional market for the purchase second-hand equipment from SOEs. They will also contribute to the success and efficiency of Bulgaria's large corporations by providing services that facilitate business. As a result of these factors, the larger and more developed the Bulgarian SME sector, the greater the SME contribution to the growth of the economy.

## **1.2 ACTION LINE 1.2: POLICY FOR ENCOURAGING AND SUPPORT OF THE SMALL AND MEDIUM ENTERPRISES**

### **1.2.1 BACKGROUND**

The state administration has not implemented a consistent, long term strategy for the creation of the appropriate environment to promote SME development, and for the attainment of competitive power and European standards. On the contrary/ policies are now in place that directly frustrate the development of the SME sector. The ultimate effect of which is the continuous expansion of corruption and lowering of legitimate entrepreneurial goals.

### **1.2.2 OBJECTIVES**

The objective of this action line is to strengthen the SME sector by creating institutions and policies designed to provide direct support, unification, information and guidance currently unavailable for SMEs. In light of the present economic conditions, the needs of SMEs have become more pronounced and this has resulted in an urgent need to establish a competitive environment in agreement with European standards and regulations.

### **1.2.3 ACTIONS**

The actions foresee:

1. the development of a clear definition of SMEs, along the lines of those proposed by the European Union, through which a proper framework of support for the SME sector can be based (*SME DEFINITION*).
2. the building of an institutional infrastructure for encouraging and supporting SMEs (*INSTITUTIONAL INFRASTRUCTURE*).
3. the implementation of a consistent policy of support measures and relieves for SMEs (*SUPPORT SYSTEM*).
4. the development of a program for the financial assistance and relief for the SMEs according to the general economic conditions in the country (*FINANCIAL ASSISTANCE AND RELIEF*).
5. the development of a foreign economic policy for the attraction of government support for the SME sector (*FOREIGN ECONOMIC POLICY*).

## *SME DEFINITION*

### *Background*

Recent definition of SMEs under section 1.1 of the Law for the State Bank for Investment and Development is as follows: Small size enterprises is defined as those enterprises with no more than 50 employees and a balance value of its long-term material assets not exceeding 5,000 times the national average monthly salary. Medium size enterprise is defined as those enterprises with no more than 100 employees and a balance value of its long-term material assets not exceeding 10,000 times the national average monthly salary.

The definition adopted by the European Commission is as follows: SMEs are defined as enterprises which have fewer than 250 employees, and have either an annual turnover not exceeding ecu 40 million, or an annual balance-sheet total not exceeding ecu 27 million. When necessary to distinguish between small and medium sized enterprises, a small enterprise is defined as an enterprise which has fewer than 50 employees and has either an annual turnover not exceeding ecu 7 million or an annual balance sheet total net exceeding ecu 5 million. In addition, to be classified as an SME, an enterprise must also conform to the criterion for independence which states that independent enterprises are those which are not owned as to 25 per cent or more of the capital or the voting rights by one enterprise, or jointly by several enterprises, falling outside the definition of an SME or a small enterprise, whichever may apply.

### *Recommendation*

The development of a clear and appropriate Bulgarian legal definition of SMEs is needed through which a proper framework of support for the SME sector can be based. This definition needs to also incorporate to a large extent those definitions that have been adopted by international institutions. Such a definition is essential for two reasons. First, from a domestic standpoint, the country needs to clearly define its SME sector so that Bulgarian SME programs, policies and laws can be implemented with distinct constituents. Second, from an international standpoint, there has recently been significant international institutional recognition and interest in the promotion of the SME sector as a means to further development. Therefore, without a definition of SMEs that incorporates international definition, Bulgarian SMEs may be excluded from capital and assistance designated under international definitions for SME development.

In light of the European agreement for association and subsequent commitments, legislation must be harmonized with that of the EC. As such, it is necessary to include the independence criterion in the Bulgarian definition of an SME. The lack of this criterion creates a situation in which a Bulgarian holding company or other economic associations could be established and receive the benefits of a SME status.



## *INSTITUTIONAL INFRASTRUCTURE*

### *Background*

A Bulgarian institutional infrastructure to support and encourage the development of the SME sector is severely lacking. Few public institutions authorized to carry out economic functions have a special policy for SMEs. State and political powers are aimed at creating formal governmental unions; undermining the motivation to create independent unions. Lobbying is either highly fragmented or reduced to serving personal and narrow political interests.

### *Recommendation*

Currently, the most feasible action to create institutional infrastructure is one that demands minimal financial expense but gathers governmental-wide support. The solving of this problem is a question political will. The roles of both state and private institutions must be addressed in the overall formulation of a dependable institutional infrastructure.

A centralized structure requires the governmental addition of an agency or commission to address the needs of SMEs. The primary advantage of this approach is the consolidation of information and resources into one "address" for entrepreneurs and international investors to visit. However, the proliferation of Bulgarian agencies has significantly reduced the efficiency of specialized organizations. These problems are the result of competition between the agencies, a lack of synchronized effort and generally deficient agency regulation. It should be noted that while a government agency may have certain advantages, such as deep pockets, access to information, and hopefully, legislative support, such institutions are often subject to significant political pressures. Political concerns often hinder the free flow of information and resources to businesses in the form of lack of funding, restrictive policies, and government programs that support or discriminate against particular sectors of the economy.

As a result, it has become increasingly important to develop self-organized SME associations, institutions and unions that provide similar assistance that would be found at government agencies. Maintaining independence provides the ability to exercise pressure upon the state and allows them to run more efficiently. In creating such bodies, it will be necessary that clearly defined policies regarding state relations, forms of dialogue and use of their expertise are created. In addition, criteria for the legitimacy of business associations must be formulated and their independence guaranteed.

## *SUPPORT SYSTEM*

### *Background*

From the viewpoint of the process of integration of Bulgaria in the European economic marketplace, and of the weight SMEs have in developed democracies,

the formation of a competitive environment has to become a priority in the strategy of the state. This is an essential prerequisite for catching up with the European standards. However, hostility of the state towards private business has been displayed not only in its failure to create adequate, coordinated support systems for the Bulgarian SME sector, but also in its generally insulting political attitude and its lack of desire for dialogue.

However, when implemented, SME programs have proven successful. Two such programs are administered by the Ministry of Industry and funded by PHARE. The Ministry of Industry established regional development agencies in Burgas and Smolyan to provide seminars, training programs, consulting, information servicing and project funding, such as a tourism development project in Burgas. In addition, two business centers were created in Russe (transportation) and Plovdiv (food industry), to assist in the development of those economic sectors. Other Ministry of Industry programs include financial support of entrepreneurs in the participation of international business events and a company support program to provide expert assistance in the areas such as market research and business planning.

### *Recommendation*

Once a clear anti-crisis program and a concrete implementation of structural reform is underway, it will be necessary to outline the spheres in which SMEs will use certain privileges, advantages and concessions. This approach should be legally decreed in the Public Procurement Law.

A common system of concessions and encouragement measures for SMEs must be created which include the creation of "business incubators" to provide trade, financial and technological information servicing; relieved procedures of registration, licensing and administrative service; relieves for renting of offices . and working premises; training support; assistance in the creation of associations and the creation of "innovation poles" to transfer technologies and act as mediators between the research centers and SMEs. Appendix #1 lists alternative forms of government assistance and support structures implemented in different countries for the development of SMEs.

The basic idea of state assisted centers of business development and technological transfer is the exploitation of synergy effects through the horizontal and vertical co-operation between firms. The networking and clustering of firms can contribute to a reduction of costs for individual enterprises, both through the introduction of work-sharing processes and also, in the area of overheads, through the common usage of business-related infrastructure.

Further, support institutions should be linked with international support programs, such as the Firm Level Assistance Group ("FLAG"). FLAG is a consortium of seven organizations that provide volunteer experts, consultants, trainers and US study trips. Attention needs to be made to develop mutually beneficial relationships between Bulgarian support institutions and international

programs by providing linkages between those enterprises that need technical assistance and those organizations that are looking to supply it. Such efforts will increase the effectiveness and penetration of already successful programs, such as FLAG.

Access to new technologies and advanced know-how has become an essential component of economic competitiveness, particularly for SMEs. In this respect, the existence of an adequate information program or infrastructure for the dissemination of research and technological developments on a national and international level is of great importance. An example of such an infrastructure is the network of 52 innovation relay centers in the European Union Members States, which commenced operations in late 1995. These centers promote innovation by bringing research and technology closer to companies, especially SMEs, and by encouraging the participation of additional industry and research centers from the European RTD programs. In Bulgaria, such a center is now being established under the IN CO-COPERNICUS Program of the EU. The Fellow Member to the Community Innovation Relay Center ("FEMIRC") is an alliance between three government agencies, the Ministry of Industry, the Agency for Economic Coordination and Development and the Bulgarian Academy of Sciences and two NGOs, the Applied Research and Communications Fund and the Bulgarian Industrial Association. Through FERMIC's services, Bulgarian SMEs will receive information and advice on RTD programs, funding opportunities, and the use of RTD results; consultancy on the development of proposals for specific projects and direct assistance in partner searches; and technological assistance, including the identification of external technology suppliers and in the absorption of new technologies.

## *FINANCIAL ASSISTANCE AND RELIEF*

### *Background*

Although plans for the development of the Bulgarian financial and insurance sectors are in progress, they lack a consistent and coherent strategy for the support of the SME sector. Absent adequate sources of capital, credit guarantees, insurance, and other quintessential financial tools, the development of the SME sector will continue to fail miserably. Fundamental to this system is a viable banking industry, insurance and securities industry, and pension and mutual funds that are capable of supporting the financial and credit needs of SMEs.

### *Recommendation*

Concurrent with the aforementioned general procedures for financial stabilization under Action Line 1.1, a long-term agenda must be implemented for the financial relief of the starting and strengthening of SMEs in light of a clear program of structural reform.

In addition to the general restructuring of financial institutions in which must exist a strategy to meet the needs of SMEs, a special Fund should be created to provide, among other things, credit guarantees for the SMEs, export insurance and guarantees, partial financing of "business incubators," partial financing of the innovation centers for SMEs, direct and indirect financial support training and expansion.

In accordance with the already stated principles for guaranteeing the independence of SMEs, this could be a mixed fund with state and private participation. For example, the capital for the fund could be supplied from the government, while the administration of the fund could be sub-contracted to private enterprises. In addition, if private funds are solicited for the Fund, private pressures could help to alleviate governmental political pressure that undermines the effectiveness of the fund. In addition, an active foreign investment policy should focus in part on international development sources of capital which could be designated for the Fund. Concrete Fund policies, objectives and lending guidelines will aid in the attraction of much needed development capital.

The Fund should also be structured on a regional principle, with a certain regulated autonomy of regional structures. This will create a competitive environment at an inter-regional level, and provoke the municipality authorities into providing support for the SMEs. The local social and business structures will also be motivated to contribute for the fund-raising.

Other financial support systems for SMEs that need to be incorporated into the national policy for economic development as it emerges are special state assistance for SMEs operating in developing or poor regions; financial and tax concessions for the introduction of technologies, establishment of new working places, and improvement in the qualification of the employees; systems for encouraging and guaranteeing risk enterprises; normalization of the insurance system and the introduction of specialized insurance techniques for SMEs; systems for credit guarantees; and tax provisions that support large corporations that act as "accidental credit banks" for SMEs. Finally, it is extremely important to remove legislative burdens that prevent the formation of enterprise funds, foreign and domestic, to supply additional funding to SMEs.

## *FOREIGN ECONOMIC POLICY*

### *Background*

Another element of public policy which hinders the development of SMEs is the inadequate cooperation with the international financial institutions. For example, the EBRD has provided 90% of its support to the public sector and only 10% to the private sector even though the bank was created to support the two sectors proportionally 40% and 60%, respectively. With that in mind, the European Union has also been reviewing its policies for the support of developing

economies and has recognized the importance of allocating resources for the development of the SME sectors. The lack of such a policy is especially emphasized when regional cooperation is considered; SMEs could play an important role in international cooperation.

### *Recommendation*

The support for SMEs should be accented in the country's foreign economic policy. Specific areas of concern are as follows:

1. The attraction of aid for SMEs, both technical and financial, should develop on a bilateral and multilateral basis, and focus on international organizations and financial institutions;
2. Special attention needs to be paid to SMEs in the common system for the encouragement of exports (if such priorities exist in the state);
3. Informational provisions and promotion have to be developed such as the use of trade counselors at the diplomatic missions.
4. Special provisions must exist for the inclusion of SMEs in the schemes of international guarantees; and
5. The priority of SMEs in the development of regional and international partnership must be emphasized.

### **1.2.4 EXPECTED RESULTS**

The expected results of these recommendations will be the creation of a support network and the removal of obstacles, common to all private businesses, but particularly relevant to SMEs. By providing SMEs with adequate representation and acknowledgment through the creation of applicable government and private support structures, the implementation of other supporting strategies can commence. Common resource centers, either business incubators or innovation poles, will provide information servicing and coordination activities.

The final expectations of such projects are the creation of a network of support institutions, policies and programs that will make the Bulgarian SME sector competitive, both domestically and in the international market.

## **2. ACTION LINE 2: IMPROVING THE INSTITUTIONAL AND LEGAL ENVIRONMENT FOR SMALL AND MEDIUM SIZE ENTERPRISES**

### **2.1 ACTION LINE 2.1: IMPROVING THE INSTITUTIONAL FRAMEWORK FOR SMALL AND MEDIUM SIZE ENTERPRISES**

#### **2.1.1 BACKGROUND**

Bulgaria has completed, by and large, building the institutional framework to implement laws affecting small and medium size enterprises (SMEs). Many government institutions were in place before 1989. Others, such as the Constitutional Court, the Supreme Judicial Council and the Committee on Protection of Competition, have been created in the last several years and are now functioning. Still, there still remain many gaps which directly affect SMEs.

#### **2.1.2 OBJECTIVES**

The objective of this action line is to facilitate the process of institution building and operation so that a better institutional framework for SMEs can be put in place as quickly as possible. Lack of institutions, such as a fully developed court system, a functioning notary public system and a nationwide commercial registry system, has a great negative impact on the functioning of SMEs.

#### **2.1.3 ACTIONS**

The actions foresee:

1. the completion of the structuring of the court system (*COURT SYSTEM*);
2. the creation of a private notary system (*NOTARY SYSTEM*);
3. the creation of a nationwide commercial registry system (*COMMERCIAL REGISTRY SYSTEM*);
4. improvement of the Committee on protection of Competition efficiency (*COMMITTEE ON PROTECTION OF COMPETITION POWERS*).

#### *COURT SYSTEM*

##### *Background*

The Law on the Structure of the Judicial System was passed in 1994. Pursuant to this law, Bulgaria must establish a four-tier system of courts to implement a three-instance procedure (that is, four different courts that guarantee a trial and two appellate reviews). The Bulgarian Constitution required the courts to be established by July 1992.

### *Recommendation*

Politicians are responsible for implementing existing court structure legislation. Creation of the Courts of Appeal should take place as soon as possible. SMEs suffer greater consequences relative to large corporations from the inoperable court system. Implementation of the courts should be preceded, however, by the development of procedural rules (administrative, civil and criminal) tailored to meet the requirements of the new system. Experts from academia, the SME sector, NGOs, and practicing judges and lawyers could assist court administrators in the development of procedural rules.

## *NOTARY SYSTEM*

### *Background*

As in most countries, Bulgarian legislation requires that real estate and automobile transactions, mortgage executions and other transactions to be witnessed by a notary public. In many cases, the law requires signatures to be notarized, dates or contents of documents to be verified, or copies of documents to be certified. Absent the notary's seal when required, transactions are usually invalid.

Although standard international practice operates under privatized notary systems, Bulgaria currently relies on a very limited number of notaries who function as state officials. It is not uncommon to wait weeks to execute a mortgage or buy real estate, and the otherwise simple signature notarization process usually takes over an hour. The inoperable and uncertain notary system has a stifling effect on SMEs because of its time and monetary costs.

To remedy this situation, Parliament recently passed a Law on Notaries. The law follows the model of Austria, Germany and other European countries and provides for the development of a private notary system.

### *Recommendation*

The private notary system will reduce transaction costs, further develop the private administration system, and free the government from the burdensome notary responsibility. Now that the law has been passed, the government should work with experts from academia, the SME sector, NGOs, and practicing notaries and lawyers to expedite the implementation of the law and educate notaries about working under a private notary system.

## COMMERCIAL REGISTRY SYSTEM

### *Background*

Property registries are created to provide a publicly available record of the ownership of property, its type, size or shape, and whether or not it is encumbered. As in most countries, Bulgarian legislation requires that properties and information about them be registered. While registries exist in Bulgaria, there is no central system.

Information on real estate, for example, can be found in any of over 100 registries located throughout Bulgaria. To locate the property of a bankrupt debtor or the property owned and encumbered by a prospective borrower, creditors must check each registry by physically visiting each location.

There are also 29 commercial registries located throughout the country. To conduct due diligence on the legal standing of a prospective partner or purchase, one might be required to visit a registry in Varna, Blagoevgrad, Russe, or almost anywhere else. Such inconvenience is not necessary in a country the size of Bulgaria and in a modern era of computer technology.

Recently, Parliament passed the Law on Registered Pledges which provides for a central pledges registry with the Ministry of Justice. Creating the registry institution is critical for putting the new law in operation. Through the central registry both debtors and creditors will be able to make security interests public, secure priority of security interests and safeguard against relying on property already encumbered by third party security interests.

In general, registry information is difficult to obtain. Officials do not have proper understanding of the concepts of freedom of information and often create (voluntarily, or not) obstacles to free access to information. Such obstacles seriously encumber SMEs who often lack the resources to hire lawyers and consultants and have to fight the bureaucratic impediments themselves.

### *Recommendation*

Ultimately, a system of computerized central registries needs to be created, Focus should be placed first on creating a computerized central pledges registry with a central database and numerous terminals, and operating under a simplified administrative procedure. The experience from creating and operating this registry should be studied carefully and carried over to other existing or future registries.

One action that can be taken in the short term, however, is to create uniform formats for national computer databases. When such formats are developed, they can be made available to local registries that can begin recording information according to the standardized national form. When a national



computer system is developed, the locally produced information should be easily transferred to the national system.

In general, free access to information should be adequately provided for by law, so that looking for and finding publicly available information is an efficient process. The EU First Council Directive of 9 March, 1968, regarding public availability of commercial registry information needs to be observed.

## *COMMITTEE ON PROTECTION OF COMPETITION POWERS*

### *Background*

The Committee on protection of Competition has been in existence for over five years. Unfortunately, the powers provided to it by law are insufficient to tackle problems such as the counterfeiting of goods, monopoly positions and intellectual property rights infringements.

### *Recommendation*

The Committee on Protection of Competition must be provided with clear-cut powers which would allow it to take direct action against agents of unfair competition practices. The current approach, where the Committee is only authorized to take court action against violators, must be abandoned and substituted with direct administrative powers. Thus, SMEs will be better protected against strong monopolies remaining from the communist economic period and against the producers and importers of counterfeited goods.

## **2.1.4 EXPECTED RESULTS**

Implementing institutional reform will have a boosting effect on the development of SMEs. The cost of running a business will be significantly decreased by reducing the time and effort necessary to resolve legal disputes or to perform routine operations, such as notarizations and due diligence on registry information.

## **2.2 ACTION LINE 2.2: IMPLEMENTING EXISTING LAWS AFFECTING SMALL AND MEDIUM SIZE ENTERPRISES**

### **2.2.1 BACKGROUND**

Bulgarian Parliament has passed a number of laws relevant to the activity of SMEs that have not been effectively implemented. Failure to implement the laws has been due to a lack of relevant experience among implementing officials and representatives of SMEs (e.g., bankruptcy); the lack of an institutional framework to support the laws, (e.g., registered pledges); and legally fixed implementation

procedures that slow down the process (e.g., privatization). In all such cases, SMEs suffer due to the inability of institutions and the private sector to implement or act under, laws that are the result of already existing political consensus in society. Such laws are national capital that is being wasted by failure to use, resulting in loss of thousands of opportunities for SME development.

### **2.2.2 OBJECTIVES**

Appropriate actions should be taken towards implementing existing and non-implemented legislation. Each sector, private and public, must do their part to become educated about how new laws function in order to obtain the desired results. Joint work needs to be done if interaction among SMEs and public institutions is to appear and bring to life new social mechanisms and functions.

### **2.2.3 ACTIONS**

The actions foresee:

1. the implementation of bankruptcy legislation (*BANKRUPTCY LEGISLATION*);
2. the implementation of registered pledges legislation [*REGISTERED PLEDGES LEGISLATION*];
3. the implementation of privatization legislation (*PRIVATIZATION LEGISLATION*);
4. the implementation of intellectual properties rights legislation (*IPRs LEGISLATION*);
5. the implementation of securities regulation legislation (*SECURITIES REGULATION LEGISLATION*).

#### *BANKRUPTCY LEGISLATION*

##### *Background*

Liquidation and reorganization procedures are common features of developed market economies and are viewed as essential to the functioning of an efficient economy. Such procedures can also be used as methods of privatization. In August 1994, the law on bankruptcy came into force. The law allows for the restructuring or liquidating of insolvent companies. Later, because of the severe banking crisis, bankruptcy-of-banks and conservatorship legislation was passed.

Although Bulgarian courts and practitioners are generally experienced in insolvency law, they lack a full understanding of reorganization and bankruptcy, and conservatorship of banks. Few reorganization bankruptcy-of-banks cases have been filed under the new laws (and were not provided for under the old) and courts, practitioners, creditors and debtors will likely suffer because of initial inexperience.

Implementation of the law is often hindered by judicial and practitioner inexperience and government attempts to save large companies whose liquidation or even reorganization would boost social discontent and unemployment.

#### *Recommendation*

Bankruptcy courts and practitioners need to be trained in the intricacies of reorganization and bankruptcy-of-banks law. This training could be accomplished by traditional seminars and the "hands-on" experience of participating in test cases. An appropriate company or bank could be identified and taken through the process with training teams of appropriate judges, lawyers, trustees, conservators, creditors and debtors.

A large number of expected bankruptcies will most likely inundate Bulgaria's fledgling bankruptcy court system. To prevent the overwhelming of the system, and accompanying delays, steps should be taken now to develop court technology including databases to inform courts, practitioners and the public of the status of pending bankruptcies. If such information is readily available, courts and practitioners will be able to better perform their jobs and public resistance to bankruptcy may decrease as some of its benefits become apparent.

### *REGISTERED PLEDGES LEGISLATION*

#### *Background*

In early November, Parliament passed a new Law on Registered Pledges. Undoubtedly, this Law will greatly enhance the development of bank financing and other credit which will, in turn, positively affect SMEs. The implementation of this Law, however, requires hard and extensive preparatory work: designing of a registry institution; designing of a fully computerized, paperless registry system; implementing a reliable telecommunications system connecting the central database with local terminals; training registry officials into the implementation of a registry system run by administrators, not by judges. In this effort, the government will have to rely on private businesses in the fields of telecommunications, computers, information technologies, personnel management and others. The successful implementation of the central pledges registry will not only enable the implementation of the Law on Registered Pledges, but it will also serve as a pattern in designing future registries and

reforming existing registries. The central pledges registry might become the core institution of a future merged registry for registering real estate transactions, commercial companies and other elements of a healthy SME legal environment.

#### *Recommendation*

The Government, under the Ministry of Justice, should invite proposals from relevant experts from business and academia, in order for it to design a modern and workable registry which could also serve as a model in reforming the registry system of Bulgaria. Legal experts drafting the secondary legislation that will govern the registry institution and procedures must work closely with technical experts. Once the technical facilities and the proper legal framework are in place, future registry officials and staff must be trained into running the registry. SMEs, banks and other private entities possibly to be affected by the new system should be educated, as well. The efforts of the Government, the SME sector and NGOs need to be coordinated to achieve a maximum effect of training.

### *PRIVATIZATION LEGISLATION*

#### *Background*

Bulgarian officials adopted a system of mass privatization in June 1994, which supplemented a market privatization scheme adopted in April 1992. However, Bulgaria has become known internationally for its slow and insufficient progress towards privatizing its industry. Obviously, an efficient privatization system will increase opportunities for SME creation and development. The undergoing first round of mass privatization demonstrated what a potential there is in converting existing state owned medium and small businesses into private SMEs. Market privatization holds the same potential. Successful implementation of privatization legislation will result in a big step towards creating a strong and significant SME sector in Bulgaria.

#### *Recommendation*

As stated in Action Line 1.1, Bulgarian authorities must pursue all privatization options including mass privatization, market privatization, combinations of the two and other methods such as bankruptcy liquidation. In addition, special attention needs to be paid to implementing secondary legislation which has often stalled the privatization process. Special rules need to be designed for shortening the duration of privatization transactions development and completion. An open public dialogue needs to be initiated where SMEs, lawyers and economists from the private sector can discuss expedient techniques with the government.

## *INTELLECTUAL PROPERTY RIGHTS ("IPRs") LEGISLATION*

### *Background*

Bulgaria had become known for its lack of support and protection of IPRs. However, the government took quick and adequate action and currently Bulgaria is among the countries with most modern and complete legal framework for the protection of IPRs. Despite new legislation, the rate of IPRs violation still continues to be high.

### *Recommendations*

IPRs legislation needs proper enforcement. Officials in IPRs enforcement agencies need to be trained to act in a more efficient manner against violators. Owners of IPRs need to be educated in the field of applying protection measures against violators. Better protection of IPRs will help the SME sector in two ways: SME owners of IPRs will receive strengthened protection creating greater incentives to pursue innovation and the unfavorable image of the Bulgaria's SME sector as a generator of IPR violation will radically improve.

## *SECURITIES REGULATION LEGISLATION*

### *Background*

New securities regulation legislation has been passed. Its first year of implementation demonstrates that the greatest hardships were derived from the lack of proper capital market infrastructure.

### *Recommendation*

As stated in Action Line 1.1, Bulgarian authorities must work to create a proper capital market infrastructure. Of critical importance is the creation and proper provision for a central depository for securities to serve as a single central locus for all securities transactions record keeping. The SME sector will benefit significantly from a developed capital market which includes well working securities exchanges.

### **2.2.4 EXPECTED RESULTS**

A lot of time, public energy and capital has been invested in creating new modern legislation. This investment continues to stay dormant while the Bulgarian SME sector suffers from lack of appropriate legal framework. This results in a multiplication of the loss to society as a whole. Bringing to life newly passed legislation as soon as possible will utilize a lot of investment that has been made by Bulgarian society and will sharply improve the legal conditions for SMEs and will increase the size and vitality of the emerging SME sector.

## **2.3 ACTION LINE 2.3: DRAFTING ADDITIONAL LAWS AFFECTING SMALL AND MEDIUM SIZE ENTERPRISES**

### **2.3.1 BACKGROUND**

Many steps have been taken towards creating an enabling environment for SMEs, many of which have been completed and some of which still need to be finalized. However, there are still a number of laws that need to be drafted in the near future. In drafting such laws, special attention should be paid to two factors. First, stability of the legal system should be preserved as much as possible in this process which implies change and motion. An unstable system of laws means a lack of a legal system. Second, special attention should be paid to prevent the passage of retroactive legislation which represents the worst form of legal instability. Failure to observe these two principles will compromise the entire reform effort: harming SMEs instead of promoting them.

New legislation should take into consideration that Bulgaria has entered into an Association Agreement with the European Union and filed a request for full membership in the European Union in December, 1995. As a consequence, Bulgaria has adopted a policy towards approximation of its internal legislation with EU law. Therefore, all steps must be taken to ensure that new legislation follows an appropriate direction, in terms of approximation with EU law.

### **2.3.2 OBJECTIVES**

This paper is not intended to propose an exhaustive list of laws that need to be drafted in order for the legal framework for SMEs to be completed. However, it suggests certain important pieces of legislation which are necessary for the development of the SME sector.

### **2.3.3 ACTIONS**

The actions foresee:

1. drafting modern foreclosure legislation (*FORECLOSURE LAW*);
2. drafting amendments to leasing law (*LEASING LAW*);
3. drafting consumer protection laws (*CONSUMER PROTECTION LAW*);
4. drafting electronic commerce legislation (*ELECTRONIC COMMERCE LEGISLATION*);
5. drafting modern currency exchange legislation (*CURRENCY EXCHANGE LEGISLATION*);

6. drafting modern trade mark legislation (*TRADE MARK LEGISLATION*);
7. drafting government procurement legislation (*GOVERNMENT PROCUREMENT LEGISLATION*);
8. passing specialized legislation on SMEs (*SME LEGISLATION*)

## *FORECLOSURE LAW*

### *Background*

Foreclosure is a difficult process in Bulgaria. Confidence in the legal mechanism for enforcing rights is low and private "enforcement" and racketeering groups flourish. The result of the difficult foreclosure process is that commercial turnover remains slow. Businesses attempt to avoid situations where money would be owed to them for fear that commitments will not be honored and enforced.

The existing foreclosure law does not recognize or allow for non-judicial methods of foreclosure (with the exception of the newly passed Law on Registered Pledges which, when it takes effect, will only allow out-of-court foreclosure on pledged movable property). Every creditor who has procured a writ of execution, regardless of whether it is a secured creditor, must go through a lengthy judicial process. Sale of a debtor's assets must be effected at a court appointed auction. The initial auction price must be determined by a court appointed expert. If a creditor must foreclose on a combination of real estate and chattel, this must happen in two different procedures which do not necessarily run parallel in time. Debtors are not allowed to bid and creditor's rights to bid are limited. Foreclosure on bank accounts is practically unworkable. Steps need to be taken so that the law will enable creditors to easily obtain information about the existence and location of bank accounts.

Current foreclosure legislation favors the debtor. Debtors have numerous opportunities to prolong the procedure. Fines for violation of procedural rules are outdated and low and do not deter procedural violations. Even when, after a lengthy process, the court has scheduled an auction, a debtor whose assets may exceed the value of the creditor's claim, may delay the process by another two years. If prior to the auction, the debtor pays 20 percent of the claim and commits to pay ten percent every quarter, foreclosure is stopped. The result can be that the creditor is forced to accept payments over a two-year period from the debtor.

While this law was written to service a 1952 command economy, it is currently unsuitable. Although SMEs comprise a significant number of the debtors in the economy and an efficient foreclosure procedure may not work to their immediate

advantage, SMEs will ultimately benefit from a more stringent legal framework applicable to them since it will enhance lending.

#### *Recommendation*

Organize a working group to draft and lobby for passage of a modern foreclosure law. The government will perform much better in providing a workable foreclosure legislation if it works closely with banks and other private businesses. By far, private businesses and banks are the ones who suffer most from the current foreclosure framework and could propose suitable solutions to most of the existing problems. In this way, it will be guaranteed that no problems will be left unresolved.

### *LEASING LAW*

#### *Background*

Leasing is used in western economies as an effective means of "pay as you go" financing. It is particularly attractive for SMEs. Bulgaria has a long tradition, over ten years, of leasing relative to its Central European neighbors.

Leasing transactions were recently provided for in a newly passed division of the Law on Commerce. Still, certain problems remain which inhibit the development of leasing as a financial method.

Under VAT, finance transactions are tax exempt. Finance leasing transactions (where, simply put, money is borrowed to finance the purchase of equipment), however, are not classified as finance transactions under Bulgaria's VAT law. The result is that a finance lease cannot compete with a finance loan.

Demand for financial leasing should be high in Bulgaria primarily because (1) the country faces a lack of financial resources for starting businesses, (2) suitable financing is difficult to obtain from Bulgarian banks and (3) the process for obtaining bank loans is usually long and arduous.

#### *Recommendation*

Consideration should be given to amending the VAT law to allow financial leasing to compete with other forms of financing. Also, work needs to be done in respect of protecting the lessor's interests where the lessee defaults on the lease payment. So far, Bulgarian law does not recognize lessor's right to repossession of leased goods. In this respect, the government would do better if new legislation is developed in dialogue with leasing companies and SMEs which are the most likely beneficiaries of financial leasing.



## *CONSUMER PROTECTION LAW*

### *Background*

Bulgaria has not passed consumer protection legislation Which seriously affects SME businesses since most of their clientele consists of consumers. Therefore, consumer protection laws will largely affect the volume of business of SMEs.

Consumer protection legislation will also have a disciplining effect on SMEs by allowing them to build better credibility with customers. Consumer credit in the form of vendor financing will be enhanced. In turn, this will increase the turnover of SMEs producing and trading in consumer goods.

### *Recommendation*

Consumer protection legislation needs to be drafted. It needs to cover both sale of consumer goods and consumer credit. Consumer organizations, NGOs and SMEs have critical role to play in the public dialogue which needs to precede drawing up of draft laws.

## *ELECTRONIC COMMERCE LEGISLATION*

### *Background*

Electronic commerce is about to start making its way into Bulgaria. Analog telephone lines are being progressively replaced with digital high quality lines. Electronic mail is quickly becoming more and more popular and the Internet network is growing. In addition, computerized registries are starting to emerge.

Despite significant improvements in Bulgaria's electronic business infrastructure, existing legislation still only addresses the concerns of business based on paper commerce. A contract made orally, over the telephone, or via fax or telex is often not enforceable, or if enforceable, it may be difficult or impossible to prove it in court. Paper filings into computerized registries increase the social cost of maintaining the registry.

### *Recommendation*

Legislation inserting reliability in electronic commerce needs to be drafted and . passed. While there are no obstacles under current law for transacting business via electronic means, it is almost impossible to utilize telecommunication technologies because there are no legal protections for such contracts. Therefore, new legislation must provide for security and encoding of electronic business information. A digital signature law is critical for enabling authentication of the signer's signature and guaranteeing the authenticity of information. A digital signature law will enable electronic filing in computer based registries. The law

of evidence needs to be changed in order for it to accommodate electronic documents which have not been provided for under current law.

## *CURRENCY EXCHANGE LEGISLATION*

### *Background*

Currency exchange legislation now in effect was created in 1966 to provide the currency framework of a socialist economy existing in isolation from the international markets under a state currency monopoly. The most defining characteristic of this framework is the amount of restrictions in place and the amount of discretion maintained by monetary authorities to grant currency permits. Since current currency law is unsuitable for a market economy, currency exchange matters are now largely being regulated through secondary legislation. This causes instability of the framework and has a general inhibiting effect on the business of SMEs. Since the Bulgarian economy is largely dependent on imports, exports and foreign investment, the stifling effect of old-fashioned legislation is becoming even stronger.

### *Recommendation*

New legislation on currency exchange needs to be drafted. In doing so, the government needs to study the experience of foreign investors and foreign and local trading partners. Studying the experience of banks both in Bulgaria and abroad is important, as well. The new laws should define clearly what is prohibited and what is freely allowed. Inserting clarity and stability in the legal framework will dramatically improve the climate for SMEs.

## *TRADE MARK LEGISLATION*

### *Background*

Current trademark legislation is clearly outdated and unworkable in the current market environment. The legislation providing for trademarks was created in 1967 and is suited to regulating the behavior of the agents of a centrally planned economy. Accession of Bulgaria to GATT places new requirements to trademark law, consistent with the modern international concepts.

### *Recommendation*

New trade mark legislation should be drafted reflecting the modern internationally accepted standards for trade mark protection. The efforts of the Patent Agency of Bulgaria to create a new law should be supported by NGOs, lawyers and SMEs, both at the drafting and at the passage stages. After the new law is passed, work should be done to train lawyers and trade mark specialists in

implementing the modern law. Enactment of this law will complete the process of reforming Bulgaria's IPRs legislation.

## *GOVERNMENT PROCUREMENT LEGISLATION*

### *Background*

Government procurement laws do not exist in Bulgaria. This leaves the fields of dispositions with government property and funds, as well as awarding government contracts, totally unregulated. SMEs are among the potential government contractors and need strict and clear procedures for awarding government contracts. Without such laws, SMEs will undoubtedly lose many government contracts to powerful and influential economic agents.

### *Recommendation*

Draft and pass government procurement laws. SMEs and NGOs should be part of the drafting and advocacy process. Only in this way government procurement rules will account for the legitimate interests of SMEs and will provide for a favorable legal framework for SMEs.

## *SME LEGISLATION*

### *Background*

SMEs are a part of the economic reality which, like all other parts, are governed by the laws and agencies which regulate the activity of all economic agents. A legal framework favorable to business in general would be sufficient for a healthy SME sector. However, in recent years, SMEs have attracted increasing attention from regulatory agencies on a national and international level. The European Union issued a Commission Recommendation of 3 April, 1996, Concerning the Definition of Small and Medium Sized Enterprises. This and other pieces of legislation reveal that, on an international scale, SMEs are attracting the special attention of legislators and institutions. Therefore, the emerging SME sector in Bulgaria deserves even stronger support and attention on behalf of authorities.

### *Recommendation*

Specialized legislation regarding SMEs needs to be passed. Whether in the form of a special law, or in the form of amendments to various laws, such legislation must provide for the following:

1. preferential tax treatment of SMEs in terms of direct taxation;

2. presenting SMEs with options to choose their accountancy and tax treatment (from among accountancy and tax treatment of individuals and general business entities);
3. preferential tax treatment of transfers of title to SMEs among close relatives, including by inheritance;
4. preferential customs treatment of imports and exports of SMEs (although the effects should be weighed since such treatment may run contrary to Bulgaria's international obligations as a member of the WTO as well as other bilateral international obligations);
5. preferential treatment of SMEs as employers and providers of social security;
6. simplified registration procedures;
7. creation of a SME Agency which shall be charged with monitoring the economic and legal climate for SMEs, maintaining relationships among SMEs and the Government, and formulating the Government policy towards SMEs.

### **2.3.4 EXPECTED RESULTS**

If the described new legislation is drafted, the legal framework for SMEs will be almost complete. Participation of SMEs in the law drafting procedures will educate them into the process *oi* maintaining a public dialogue on policy issues. SMEs will also get a chance to have a say in the process of creation of the legal framework governing their activities.

## **2.4 ACTION LINE 2.4: INSTITUTIONAL EFFICIENCY**

### **2.4.1 BACKGROUND**

Institutional efficiency is as important as the presence or absence of government institutions themselves. One way to foster institutional efficiency in Bulgaria is to develop uniform operating systems in all institutions.

### **2.4.2 OBJECTIVES**

In many cases, high quality legislation in Bulgaria fails to have a positive impact on the relationships governed by it. This is due primarily to inefficient and non-uniform implementation by implementing agencies. One of the purposes which the government must pursue is bringing uniformity and quality in the implementation of laws.

### **2.4.3 ACTIONS**

#### *Background*

Although Bulgaria is a small country, it sometimes experiences problems with a lack of uniformity and coherence in its legal system. For example, an investor

who has to deal with real estate, may be surprised to find that notaries in different parts of the country interpret the same law in any number of ways. The investor will also discover that the type and number of documents required at different locations for what is otherwise an identical transaction can vary enormously. A similar situation exists in Bulgaria's 29 district courts where the investor must go to register his or her company.

This, of course, results in inefficiency of the market and its agents. No entity can develop standard operating procedures for standard types of transactions. What should be a routine process, needs to be learned every time it is applied in new venues.

In a different situation, central government institutions must often perform administrative functions related to commerce. They grant import/export or trading licenses, give permission, provide information, and exercise other forms of control. These functions may be discretionary or non-discretionary. Regardless, the applicant must furnish such an agency with information and documents. The investor **will** sometimes be surprised that when approaching the same agency for identical reasons, but on different days, the requirements have changed. The change is not because policy has changed or government employees are malicious, but because there is no clear standard for some administrative requirements. The obvious result is multiplication of the applicant's efforts and resources spent on obtaining approvals from the central government.

#### *Recommendation*

A possible way of fighting internal and external institutional inefficiency is the creation of standardized operating procedures, including the creation of standardized forms. As a result, the inefficiency due to difference in practice of institutions performing identical functions in different venues will be dramatically reduced. Also, the practice of all institutions will become consistent and predictable. The overall result will be that agents on the market will be able to develop standard operating procedures equally workable at any point in time and at any location. The social cost to transacting business will be decreased.

The introduction of standardized forms and lists will also help institutions to increase their internal efficiency. It will take much less time for employees of a central government institution to process documents when they are familiar with standard forms. Standardization will also contribute to the simplification of internal procedures.

#### 2.4.4 EXPECTED RESULTS

The expected results are that the climate for doing business will improve. SMEs will be a major beneficiary of such an improvement. Increasing the efficiency of institutions will result in decrease of transaction costs.

### **3. ACTION LINE 3: MONITORING THE CHANGE IN POLICY AND LEGAL ENVIRONMENT FOR SMES IN BULGARIA**

#### **3.1 ACTION LINE 3.1: DEVELOPMENT, DESIGN AND IMPLEMENTATION OF A COMPREHENSIVE MONITORING SYSTEM**

##### **3.1.1 BACKGROUND**

In light of the proposed recommendations, a monitoring system is of principal importance for the success of the **IPC** project as it would perform at least two functions:

1. To monitor the direct impact of policy decisions and to assess the effectiveness of policy change efforts in the SME sector.
2. To provide relevant vehicles (based on analyses and relevant data) to decision makers that would both inform them of developments in the SME sector and provide support for policy change.

The importance and validity of different types of monitoring systems have increased significantly in recent years. Monitoring systems have also become widely used by businesses and governments in decision making. Such monitoring systems include, the Index of Economic Freedom developed by the Heritage Foundation, the International Corruption Ranking developed jointly by the University of Goettingen and Transparency International, and others developed by the Economist Intelligence Unit, the EBRD, etc. Effective monitoring systems include quality information and analysis and reporting and policy recommendations that have approved by the relevant policy and/or decision makers.

##### **3.1.2 OBJECTIVES**

The objective of this action line is to design and implement a comprehensive monitoring system to determine whether or not policy recommendations are being administered and enforced, and ultimately, if the desired level of success is has been achieved. The heart of this monitoring system will be the Center for the Study of Democracy ("CSD")- Since 1990, the CSD has gained considerable experience in monitoring public attitudes, privatisation and economic reform, and media and audience behavior as an independent public policy research institution.

### 3.1.3 ACTIONS

The actions foresee:

1. the design an implementation of the monitoring system (*DESIGN AND IMPLEMENTATION*).
2. the development of at least two levels of monitoring, one on the macro level and one specific IPC related activities (*LEVEL OF MONITORING*).
3. the acquisition of data regarding the implementation of programs and the development of basic instruments to be used to quantitatively and qualitatively analysis the data (*MONITORING METHODS AND DATA SOURCES*).

#### *DESIGN AND IMPLEMENTATION*

The main output of the monitoring system will be a Report to be produced every 6 months. The findings in this report will be reviewed periodically, e.g., in six month cycles, in both a *workshop discussion* and a *policy forum*. The objective of the workshop discussion will be to assess on an expert level the relevance and the objectivity of the report of findings. The report of findings (approved by experts) will provide the background for discussions in the policy forum. The main objective of the forum will be to give public approval to the Report and to discuss eventual future activities.

Both the discussion group and the policy forum will also provide guidance for the development and implementation of the monitoring system itself. Specifically, the precise format and level of the monitoring must be outlined, the exact information and analyses needs to be designed, and the main indicators of the monitoring system need to be agreed upon.

#### *LEVEL OF MONITORING*

At least two levels of monitoring must be included in the system: a macro level and a specific IPC related activities level.

On the macro monitoring level, the system would monitor macro-economic performance and developments in the country based on a comprehensive system of indicators. Ideally this could be done using the group of ten indicators of The Index of Economic Freedom (see B.T. Johnson, T.P. Sheeny, *THE INDEX OF ECONOMIC FREEDOM: The Heritage Foundation, 1995, p. 11-21*) and by using modified scales and interpretation. These indicators are:

1. Trade policy
2. Taxation policy
3. Government consumption of economic output

4. Monetary policy
5. Capital flows and foreign investment
6. Banking policy
7. Wage and price controls
8. Property rights
9. Regulation policy
10. Black market

With respect to specific IPC related activities, monitoring at this level is dependent on the specific design of the IPC project and the activities to be undertaken.

#### *MONITORING METHODS AND DATA SOURCES*

Part of the basic information covering the levels of monitoring outlined above could be obtained by the National Statistical Institute and by using the survey research database of CSD. The latter includes surveys on economic reforms, privatization, public attitudes, as well as registration information on companies in the state and the private sector.

The other part of the information will be obtained through a combination of survey research methods. The basic instruments to be used will be quantitative and qualitative surveys are:



Focus groups  
with experts

Focus groups could be used in the initial stage of the project to help specify the relevant system of indicators on which the monitoring system will be based. At later stages focus groups could be used to obtain qualitative assessments of the legal and economic environment of the SME sector.

Suggested number of groups: 2-4

Quantitative  
surveys of experts

This type of surveys could be used to obtain expert assessment of ongoing/projected changes in legislation, economic situation, etc.

Sample: non-representative sample of 70-100 experts.

Quantitative  
surveys of business  
leaders

This type of surveys could be used to obtain assessments of the impact of ongoing/projected changes over the SME sector.

Sample: sample composition would depend on the type of impact monitored. It could be constructed to monitor developments as a result of IPC, or developments of the economy in general.

Quantitative  
surveys of the public

Surveys of the public could be used to assess the overall acceptance of reform efforts, attitudes towards economic policies, etc.

Sample: surveys of that type should be based on a representative sample of the population 18+ of about 1000 respondents.

Each monitoring cycle research focus will include a combination of statistical information and surveys of the aforementioned four types. Including all four types of surveys would be necessary in order to adequately cover the different aspects and impacts of change. Depending on priorities, information needs of decision makers the composition of each cycle could be modified.

## Appendix # 1

# ALTERNATIVE FORMS OF GOVERNMENT ASSISTANCE AND SUPPORT

Azerbaijan: Profits reinvested in machinery, technology and training are tax free. A tax holiday for the first two years of activity is available for SMEs in most productive sectors (three years for small firms). Duty exemptions are available for small joint ventures importing foodstuff from abroad.

Belarus: Tax-free period of three years for start-up firms and 50 percent of profits untaxed reinvested. A state co-founded Business Support Services and Financial Fund for Entrepreneurs provides support services.

Croatia: a department of Ministry of Economic Affairs oversees the promotion of the handicraft and small business sector, coordinating its activity with that of other ministries. Financial support for small businesses (less than 100 employees) is channeled through the commercial banking sector and supported by the Croatian Guarantee Agency for Private SMEs. Local assistance programs are also available through municipalities

Czech Republic: Support for SME, financed by the Czech National Council Act 28 April 1992, is available in the areas of training, credit subsidies, consultancy and applied research, with priority given to the capital goods sector and depressed areas. 1994, new measures were taken to support SMEs, including price supported guarantees, contribution to interest payments for bank credits and interest free loans for projects involving technology transfer (financial support is provided jointly by Phare and the Czech government).

Estonia: Governmental institutions supporting SMEs are the SME Office of the Ministry of Economy and the Department of Local Government and Regional Development at the Ministry of Internal Affairs. Non-governmental bodies include the Estonian Small Business Association, the Chamber of Commerce and Industry, and the Phare-established Business Advisory Center. Financial support is channeled through a number of public funds with a new SME Fund established in January 1995.

Hungary: A large number of specialized state funds addresses the financial needs of enterprises with fewer than 150 employees over a very broad range of activities. Subsidized credit is available both from national and international sources (both bilateral and multilateral), often mediated by local ad hoc foundations. Credit guarantees and export insurance schemes for small enterprises are also available. Technical assistance for small enterprises is available from a number of national private foundations, often financed by the state and Phare. Other programs exist.

Latvia: SMEs have the possibility of not registering for VAT if their turnover is below LAT 10,000. Profit tax relief (80% discount on profit tax) and simplified auditing and accounting standards are also offered to SMEs.

Subsidized loans (4.5% interest per month) and training programs have been set up by donors including Phare.

Lithuania: The SME Development Program, approved on 9 March 1995, provides a wide range of services. Six Phare co-founded Business Advisory Service Centers provide counseling and training to start up SMEs.

Moldovia: State policies for SMEs are framed within the Law on Support and Protection of Small Business adopted on 20 May 1994. A program to support private SMEs for the 1994-1997 period was approved in 1994. A Small Business Support Fund was created in October 1993 and allocated Lei 128,500 in 1994. Many tax incentives

Poland: A policy document, "Small and Medium Enterprises in the National Economy/" was adopted in 1995. The document envisages amendments and changes to legislation favorable to SMEs. A network of credit guarantee funds is available. The Polish Foundation for the Promotion and Development of Small and Medium Enterprises is in the process of being established.

Romania: The Romanian Agency for Development with the support of non-governmental institutions and often with international assistance has prepared specific measures to assist SMEs, including a simplified computation of profit tax base, VAT exemption, deduction of investment costs, SME credit lines 50% below market interest rates and technical assistance through SME development centers.

Slovenia: The Small Business Development Center (Ministry of Economy) is the governmental agency that supports SMEs and coordinates international assistance. The implementation of policy measures to support SMEs is in the hands of the Small Business Development Network (co-founded by the Ministry of Economy, Labor and Technology and independent Chamber of Commerce and Craft).

## Appendix #2

# ECONOMIC POLICY ASPECTS OF THE GROWTH OF THE SME SECTOR IN BULGARIA

**P**

## INTRODUCTION

During the last two decades, considerable attention has been given to the contribution of the SME sector to economic structure and to the creation of new job opportunities in developing countries. At the same time the creation and development of SMEs has been seen as an indicator of the existence and development of entrepreneurship in our society.

Studies show that SMEs are better suited to meet free market requirements than are other types of enterprises. Specifically, they are more flexible and able to meet changes in dynamic environments, and more inventive and resourceful in maintaining their ability to meet the requirements of the customers. As such, they are instrumental in the formation of a competitive environment in our society. They play a leading role in such areas as research and development, where they constantly expand their territory.

However, they need sources of information, support, and advice that they cannot get themselves. These needs are more pronounced in the dynamic business environment created under the influence of the processes of international market expansion.

In response to these needs, the EC established a special action program in 1987 and created a special working group to work on the problems of SMEs. Today this program is part of the greater business support program of the EC, and the working group, which has been integrated in DG XIII, is now responsible for policy in this field.

The definition of SME varies in the different EC member countries. Some use only one criterion, the number of employees, and others include turnover or assets value. Regardless, the leading standard remains number of employees, according to which the following classification has been made:

- micro enterprises - (1-9);
- small enterprises - (10-99);
- medium enterprises - (100-499)

Two methods have been used to determine which economic field SMEs should be classified in: relative share of employment in the sector and relative share in the formation of sector surplus value.

In the United States, SMEs dominate. Sectors in which enterprises hiring less than 500 employees constitute 60% of the sector's total employment. Expert estimates claim that 98% of all companies in the United States are SMEs. They account for 40% of the GDP and 53% of the overall employment.

Nevertheless, whichever method is used to measure the importance of SMEs in national economies, it can be concluded that this type of enterprises has

a significant share of the output in sectors like metal processing, trade, transport, and communications. They also dominate the so called "other industries," as well as the construction and services sectors.

The importance of SMEs is best described by OESD's statement (Fifth Planetary Meeting OESD Advisory Group on Investment): SMEs are a key element in economic development and a synonym for transition.

Having appreciated the huge role SMEs have played in transition economies, since the beginning of the reforms in Eastern Europe, the EC developed its own programs for development and support of that sector. The program has been updated for the 1994-1997 period. According to this program SMEs are enterprises which employ not more than 500 people, have assets valued at less than 75 million ECU, and no more than a third of its assets are owned by an enterprise which is not an SME.

There are numerous ways to support SMEs. The main projects dealing with SME support are EUROPARTNERIAT, BC-NET, EUROPEAN COMMUNITY INVESTMENT PARTNERS (ECIP), EURO-INFO-CENTERS (EIC) etc. Programs like PHARE, TACIS, JOPP, and TEMPUS contribute significantly to the cooperation between the East and the West through technical help, consulting services, investment support, and joint ventures. Special attention is paid to SMEs in the programs for support of developing countries participating in G-24, OESD, and UNDP.

Financial assistance for the private sector in Bulgaria, including SMEs, was as follows: July 1993, 30 million ECU from the European Investment Bank; August 1994, 3.2 million ECU from EBRD, which was absorbed by the activities of Caresbac-Bulgaria LTD; PHARE program aid 1991, 20 million ECU; 1992, 22.5 million ECU; 1993, 6 million ECU, a total of 48.5 million ECU (source: Background Dokuments & Working Dokuments, G-24 Nigh Level Meeting, March 10, 1995.)

The following research was aimed at defining the current status of SMEs in Bulgaria and at producing a system of recommendations for the necessary economic measures and support for SMEs in our country.

## **I. THE STATUS OF BULGARIAN SMEs**

### **I.I. Emerging of private SMEs — general conditions**

The National Statistics Institute's data appears to indicate that the greatest number of enterprises in Bulgaria are SMEs. Following the criteria and classifications used by the EC, the majority of the registered private firms fall into this category. According to research conducted by UPEE, 99% of the firms which were analyzed are SMEs: 75% small, 24% medium, and only 1% large. This situation is not a result of special attention given to the SMEs, however. It simply depicts the conditions in which private entrepreneurship is being conceived in the country.

As opposed to the situation in other former socialist countries of Central and Eastern Europe, through the end of 1989, the level of private entrepreneurship in Bulgaria was incredibly low. Moreover, following the establishment of socialism in our country, the level of expropriation encompassed all economic activity. The expropriation of the land was not legally arranged in practice, but its scale exceeded those undertaken in the other European countries of the so called "socialist camp." In addition, the cooperation movement was brought to an end. Almost all of the property of cooperations was nationalized and they became state organizations.

With the beginning of reformation in Bulgarian, laws were created and enacted, which gradually shaped the frame of the legal environment, in which private business was to grow. At the same time the main private business development factor, accumulated capital, was missing. Considering this situation, the restitution and the restoration of land and private property to entrepreneurs are the main factors for changing the economy's micro and macro frameworks. The initial actions following the start of the reforms were closely related to the creation of a suitable environment and conditions for the emerging of private business. SME entrepreneurs were also forced to develop and establish themselves in this environment. Statistics show that 60% of the SMEs were begun with entrepreneurs' own savings and only 30% with bank credit.

Despite the lack of special attention, the enterprising nature of Bulgarians proved praiseworthy since the political and economic reforms were undertaken in Bulgaria. In just a couple of years, 300 thousand private firms were registered, almost all of which fell into the category of SME. This new-to-our-country sector is gradually expanding and defending its share in the formation of GDP and the creation of new employment opportunities. Despite this fact, however, society remains cautious in trusting the private sector. State institutions and political groups contribute to this behavior. The existence of words like "restitutes" in the vocabulary Bulgarian politicians shows they are not loyal to private owners. There have even been comments regarding the revision of constitutionally guaranteed immunity of private property. Each economic policy failure is blamed on the SME entrepreneurs, undeservedly labeled profiteers.

SMEs have not been given the necessary attention since the start of the reforms. Bulgarian small and medium entrepreneurs are not stimulated or supported. On the contrary, they are constantly hindered by bureaucratic, organizational, financial, and other barriers. The poor appreciation of the role and significance of SMEs is one of the many elements contributing to the worsening of the disastrous economic crisis in the country.

## **1.2. Influence of the general economic situation on SMEs**

In 1995, the opportunity for converting the production increase from the previous year, brought about by the so called "push from the bottom" effect, into a permanent tradition remained unused.



There was economic excitement in some sectors as early as 1993. And there was economic growth as early as 1994. For example, during the first half of 1994, manufacturing industry growth was 4.6% higher compared with previous year results. The private sector has made up for the decline in state production in food, wine, and tobacco, and the textile industries, which account for 40% of the production of the private sector. The private sector's production has grown 40% as a whole. Highest growth has been registered in the trade and construction industries, 60% and 41%, respectively.

Unfortunately, the development of the private sector was not encouraged despite these favorable conditions. The flexibility and the dynamic nature of SMEs were not used appropriately, but instead, they were oppressed. Following the end of 1995, the economic crisis became increasingly difficult for the country. This fact was officially admitted only in the end of the first trimester of 1996. The critical situation of the period 1995-1996 for the economic reform in the country can easily be deduced from the data exhibited in Table 1. Notice that during the initial years of reform, Bulgaria was not drastically behind the other countries in transition. The decline of the GDP in the initial years was objectively described by the destruction of the old framework. However, the lack of decisive measures for carrying out the reform prolonged the inertness of the Bulgarian economy. The ruining practice of subsidizing the public sector is still dominant. Any delay of the beginning of the reforms will be fatal. The country is falling into a situation of international isolation because of its inconsistent relationship with international financial organizations, the lack of strategy in attracting foreign investments, and the chaotic implementation of privatization. Whatever existing potential has dissipated and numerous chances were missed.

Table 1

*GDP growth rate (percent) and Gross Domestic Investment (GDI)*  
*(source: World Development report 1996)*

Country	1981-89	1990	1991	1992	1993	1994	1995	GDI% 1990	of GDP 1994
Poland	2.6	-11.6	-7.0	2.6	<b>3.8</b>	<b>5.5</b>	<b>7.0</b>	25.6	15.9
Slovenia	~	—	-9.3	-5.7	1.0	4.0	5.0	16.9	20.8
Hungary	1.8	<b>-2.5</b>	<b>-7.7</b>	<b>-4.3</b>	<b>-2.3</b>	2.5	2.0	25.4	21.5
Macedonia	~	—	-9.8	<b>-12.4</b>	-12.0	-5.7	-4.0	32.0	18.0
Czech rep.	1.8	<b>-1.2</b>	-14.2	<b>-6.4</b>	<b>-0.5</b>	2.6	5.0	28.6	20.4
Slovakia	2.7	<b>-2.5</b>	-14.6	<b>-6.2</b>	<b>-4.1</b>	4.8	7.0	33.5	17.1
Estonia	0.2	<b>-7.1</b>	-22.1	<b>-21.6</b>	-6.6	<b>6.0</b>	4.0	30.2	—
Latvia	3.7	<b>-1.2</b>	-8.1	-35.0	-14.9	0.0	1.0	40.1	—
Bulgaria	4.9	<b>-9.1</b>	-11.7	<b>-6.0</b>	<b>-4.2</b>	0.0	3.0	25.6	20.8
Lithuania	1.8	<b>-3.3</b>	-13.1	-39.3	-16.2	2.0	3.0	34.3	—
Albania	<b>1.7</b>	-10.0	-27.7	<b>-9.7</b>	11.0	7.4	6.0	28.9	13.5
Romania	1.0	<b>-5.6</b>	-12.9	-13.8	1.3	2.4	7.0	30.2	26.9

the deepening of the crisis does great damage to the private sector as a whole, but SMEs are especially hard hit.

### 1.3. The lack of state strategy for economic development

Since the end of 1989, there has been no strategy for development of economic priorities. Even today when phrases like "structural reform" have turned into a terrible curse, the government still cannot point out the sectors it plans to prioritize. All this deprives the private sector, and SMEs in particular, of the ability to work out their own strategy, relevant to national economic policy. In addition, the dialogue between the authorized state institutions and private businesses has been disrupted, which deprives entrepreneurs of the ability to influence the national economy priorities.

In this situation, private businesses, and especially the SMEs, are forced to adapt to and follow the chaotic economic policy of the state authorities. The end result is the extinction of SMEs and the creation of an additional source of unemployment to the main one, the state enterprises which are going out of business.

The poor rate of privatization and the lack of strategy, and the deliberated practical activities for attraction of foreign investments, exert a bad influence upon the environment in which SMEs are to emerge and develop.

Table 2 contains data about the level of privatization in some other countries in transition.

*Table 2.*

*Privatization level of the other countries in Central and Eastern Europe*

	Czech republic	Poland	Russia	Hungary	Estonia
State property	40%	54%	34%	42%	15%
Foreign investors	5%	2%		40%	60%
Manager privatization		30%	55%	2%	12%
Voucher privatization	50%	6%	11%		3%
Restitution	2%			4%	10%
Other	3%	8%		12%	

While data regarding the level of privatization in Bulgaria, experts estimate that the percentage of state property is still well above 90 per cent. In Bulgaria, state authorities prefer measuring the contribution of the private sector to the GDP and the level of employment of the work force. These data are shown in Tables 3 and 4, respectively.

*Table 3*

*The private sector's share of the GDP*

*(source: 1994 annual report of BNB)*

Sector	1991	1992	1993	1994	1995
The private sector as a whole	12.0	18.4	25.0	27.5	
Agriculture and forestry	5.4	6.7	7.2	8.9	
Industry	0.7	4.3	6.3	6.0	
Services	3.9	7.4	11.5	12.6	

*Table*

*Sector employment structure percentage*

*(source: National Employment Agency, 1996 annual report)*

Sectors	1989	1990	1991	1992	1993	1994	1995
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
State	94.5	94.1	89.9	82.3	71.7	64.0	59.3
Private	5.5	5.9	10.1	17.7	28.3	36.0	40.7

These data show the steadfastness and the drive for existence of the private sector despite its incredibly small share in the property structure.

Foreign investment is critical not only to the private sector and SMEs, but to the overall economic development of the country as well. The opening of our country to foreign investment is instrumental in the creation of a normal competitive environment, the utilization of new technologies, and Bulgaria's integration into the world's economic-trade process. The investment excitement expands the range of the private entrepreneur's activity. Unfortunately, practical results in this area have been disappointing. According to data provided by BNB, foreign investment for the first half of this year amount to 49 million USD,

which is 27.6 million USD less than the first half of 1995. Thus, it appears that a stable and continual tendency of economic isolation of our country has been established. At the same time the Foreign Investment Agency produced more optimistic data.

*Table 5*

*direct annual foreign investments (up until June 30, 1996)*

YEAR	AMOUNT IN USD
1991	14,129,927
1992	64,858,766
1993	191,981,829
1994	412,408,795
1995	517,405,983
<i>first half of 1996</i>	<b>610,049,510</b>

For comparison Table 6 shows data from other countries in transition.

*Table 6*

*Cumulative foreign direct investment inflows - 1994*

*(Source: World Bank)*

Country	in millions USD	% of GDP
Poland	6459	7.0
Slovenia	438	2.6
Hungary	10634	30.0
Macedonia	36	2.4
Czech republic	3996	12.5
Slovakia	483	<b>4.0</b>
Estonia	646	14.5
Latvia	73	2.0
Bulgaria	397	4.0
Lithuania	323	5.5
Albania	186	12.0
Romania	1101	2.5

#### **1.4. Hostile attitude towards SMEs and the private sector**

The hostility of the state towards private business is displayed not only in its insulting attitude and its lack of desire for dialogue, but is also found in its economic policy. The desire to demonstrate production growth in 1995 caused a considerable amount of financial resources to be invested in state enterprises operating at a loss. The negative consequences of this dissipating practice are divided in two areas. On one hand, resources which could have been used for support of the private sector and SMEs in particular were misused. And on the other hand, the wasted resources invested in the state sector at a loss are being compensated for by appropriating them from the private entrepreneurs. To the larger private enterprises this means diminishing their ability to reinvest, but for SMEs, this means draining vital resources.

Private business, and especially SMEs, have been antagonized during the last couple of years. One of the latest and most conspicuous examples in this respect is the policy accepted towards private flour mills and private bakeries. Regional governors put in charge of grain distribution satisfied mainly state structures without hiding their animosity towards the private enterprises. In this environment lacking provision of resources by the administration, there are numerous occasions reported where local mayors stop by the private bakeries to maliciously ask, "Haven't you gone bankrupt yet?" The approach in distributing the fodder to private and state livestock companies, the buying up of milk products, and other similar situations, are all analogous to the one described.

This thesis is supported by the following passage taken from the Declaration of the MB of the UPEE "Against the genocide attempts on Bulgarian private business" from July 28, 1995.

"The MB of the UPEE brings social attention to actions of the government like creating new state monopolies in the industry and other branches of the economy, the pouring of billions of Leva into state enterprises and banks operating at loss, etc. which are fatal to free enterprise. The end result of these actions is Bulgaria's economic collapse and international isolation. In their essence these actions constitute a crime against the nation and its people. If the executive and legislative powers do not alter their attitudes towards private businesses and the Bulgarian entrepreneur considerably, our country is bound for a catastrophe."

This year marked the first time private sector activity has declined since 1990. The manufacturing production in non-agricultural branches in August was down 1% compared with 1995. The data for the month of September showed that the level of production declined more than 5% compared with 1995.

This fact indirectly suggests the numerous bankruptcies and closings of SME firms. In addition to this analysis we can use the headlong decline of the trust line. This trust line is an arithmetic mean of the balances of the estimates for production expectation, the number of requests, and the negative of the level of stockpiles of produced goods. In the private sector, this line has gone down by 15 points since the beginning of 1996 in the "industry" branch and 20 points in the "construction" branch (*data provided by the National Statistics Institute*) revealing a considerable decline for the first time during the last three years.

Other SME condition in 1996 include the growing number of unemployed, released from the sphere of the private sector, which amount to 89.2 thousand of the total number of 488.7 thousand for the first months of 1996, as well as 160,000 private firms missing in the latest company registration, despite the provisional nature of the comparison (*data provided by the National Statistics Institute*).

## **1.5. The lack of governmental strategy for support of SMEs**

The state administration has no strategy for the creation of the appropriate environment which should promote attainment of competitive power and European standards. The administrators and the relevant institutions are conducting a policy of racketeering of private owners, rather than creating an environment of loyal competition, the end result of which is supposed to be the attainment of European standards and regulations. The end negative effect of this behavior branches in two ways. On one hand corruption expands, and on the other the entrepreneurs lower their goals. They waste the opportunity for developing into economic entities, capable of challenging international competitive powers.

A marked example of this primitive approach is the way foreign economic relations with Russia are viewed. The complaint about losing Bulgarian position on the Russian markets is not a complaint about the markets themselves as much as it is about the illusion that these markets are still as undemanding as they were during the time of centrally planned economies. The reality is quite different now. Russia has gotten ahead of Bulgaria in economic reform and the requirements of the Russian market are no different than those of the international ones. That is why political speculations on the "Russian markets topic" can have only one consequence: depriving the Bulgarian entrepreneur of the opportunity to develop his potential so that he could become an equal partner in the international economic processes.

The creation of a normal competitive environment is integral to the process of European integration. Special attention has been given to this problem in the White Paper "Preparation of the Associated Countries of Central and Eastern Europe for Integration into the Internal Market of the Union" of the EU Commission, where it says:

"Politics in the area of competitive markets is a key element to the development of the domestic market. Without "the introduction of a system which creates competitiveness in the general market without any deformities (Article 3-G), the domestic market could not possibly start functioning."

## **1.6. Diminishing demand -- a hit on SMEs**

Policies that ignore diminishing demands also constitute significant obstacles for the development of SMEs. For example, in 1995 the level of production was constantly increasing, demand was constantly diminishing, and at the same time inflation was increasing at rates which were slower than in previous years. This inadequate economic policy influenced SMEs greater than other firms because they are equally dependent on the end consumer as well as the consumer expenditures of the big firms. The demand for servicing large firms diminished, as well as production lines.

## 1.7. Inadequate taxation policy

The recession, which is objectively linked to the transformation, led to income shrinkage in the budget. While tax increases are the easiest policy, they are an unproductive approach to overcoming the budget gap. Tax increases are a short term approach and do not lead to a stable solution. Raising the tax level and the expansion of the tax base pushes the economy the wrong way. The solution to the problem should be sought in improving the job done by the tax administration and in cutting public expenses.

The most characteristic feature of the widely accepted practice of carrying out state collections (taxes, excises, tariffs, customs duties, and other duties) is its chaotic nature. The inconsistent state policy in this sphere and the actions of the administration bring about tax nihilism, rather than the required tax culture and discipline. The obstacles that SMEs face because of the tax policy include:

- The regulation of the annual taxation results (taxable and nontaxable expenses) is decreed by an act of the Council of Ministers, which allows its easy and perpetual revision;

- The range of expenses which reduce the annual amount to be taxed constantly diminishes;

- The use of negative results from previous years is no longer used in the formation of the positive financial result for the current year;

- A practice of accepting limitations introduced with old dates is being widely accepted;

- Only 10% of education expenses are accepted as nontaxable expenditure, which is a serious drawback for SMEs, where education is crucial to their survival and stabilization;

- Expenses common to SMEs, such as the reconstruction and office, machine, and other improvements are not being reduced;

- The process of advanced payment of taxes must be developed and stabilized;

- There is an incredibly slow procedure of recovering VAT credit with no interest accumulation for blocked funds;

An additional burden for SME activity is the ineffective and inconsistent work of the tax authorities. In this respect the following problems must be addressed:

- Arbitrary interpretation of the laws and other normative regulations by public officers;

- Lack of control mechanisms for the structure of the tax administration to be used by the MF in supporting the interests of the economic entities;

- In many cases, tax inspectors are hostile and aggressive. Errors are sought deliberately, and a percentage reward is given for every "erred amount."

Similar remarks can be made about the actions of the customs administration.

## **1.8. Lack of institutional infrastructure**

SME development is also hindered by the lack of institutional infrastructure to support and encourage entrepreneurial spirit. All Central and Eastern European countries have at least two of three necessary organizational structures of SMEs, namely: a clear national policy and a precise program for the realization of this policy; organizational infrastructure inside the state institutions; and a law for support and encouragement of the SMEs. Not one of these requirements have been met in Bulgaria. As long as the institutional and organizational infrastructures are concerned, the following obstacles hinder the work of SMEs:

The public institutions authorized to carry out economic functions have no special policy for the SMEs. Bureaucracy and apathy void the activities of the few existing structures which do have any policy. For instance the appropriate fund at the Ministry of Industry has 60 million Leva at its disposal and has supported only 13 projects so far;

The state and the political powers aim at creating formal governmental, rather than independent, unions. This undermines the motivation for creations of such unions. There is practically no support for SMEs from their own unions. For example, until 1993, the Bulgarian Chamber of Commerce and Industry supported micro-projects with preferential credit up to 50 thousand Leva. This kind of activity has already been transferred to the International Bank for Investment and Development, which provided a new approach to the mechanisms of this type of crediting. The Bulgarian Industrial Association extremely limited access to the national resource of revolving credit. By a government decree of 1991, these resources were frozen in "Mineralbank." As a result, many companies that were extended credit did not meet their debts;

The state has not regulated its relationship with business organizations, does not communicate with them, and does not use their expertise. The participation of some organizations in the tri-lateral commission is to regulate social problems rather than to support private business and SMEs in particular;

Lobbying is highly distorted and is reduced to serving personal and narrow political interests.

## **1.9. Lack of support for SMEs in international economic policy**

Inadequate cooperation with the international financial institutions hinders the development of SMEs. No actions have been undertaken to support private business, and especially SMEs. For example, the European Bank of Reconstruction and Development has provided 90% of its support to the public sector, with the remaining 10% going to the private sector. This is an exact opposite of the major working principle of the bank. The bank was created to support the two sectors in relation 60% for the private and 40% for the public sector. Another aspect of the poor job done in providing resources for the SMEs is the deliberate hindering, twisting, and creating of bureaucracy within the already developed mechanisms for distribution of help provided. For example



First Private Bank was authorized to control the resources provided by the EC for private agriculture development. These resources were not utilized to their best because the agriculture producers did not have direct access to the bank. They were forced to use mediator satellite firms which served mainly the governmental agricultural cooperations.

In its international economic policy, the country does nothing to attract resources for SMEs, or to create an international legal framework to ease their activities. The lack of such a policy is especially emphasized when regional cooperation is considered, where SMEs could play an important role in international cooperation.

### **1.10. Shadow economic and criminal activities**

During the last years the crime factor has begun to exert considerable influence upon Bulgarian economy. This tendency is displayed in the following directions:

- ) The inadequate tax policy pushes SMEs in shadow economics;  
The strengthening of the position of shadow economics brings about the domination of dishonest competition. Shadow economics fosters pseudo market economy. This, in turn, strengthens the position of those who are against reforms. The drive for survival becomes a drive for chaos; Entrepreneurial spirit is being destroyed by the pseudo market conditions, brought about by the expanding shadow economy, and by the policy of administrative intervention in business. The motivation for work is lost as a whole;  
Two directional racketeering on entrepreneurs also has a very negative influence. SMEs are being squeezed between the so called "power organizations" and high level corruption and sluggish bureaucracy.

These factors are also extremely harmful to the activity of foreign investors. For example, United States Federal Racketeering Laws prevent American businesses and persons from engaging in activities such as bribery outside the United States. Therefore if local business practices include such activities as part of the modus operandi, American businesses are effectively excluded from the market.

### **1.11. Final remarks**

The obstacles SMEs face are common to all private businesses. These obstacles include: the lack of free market for agricultural land; the restrictions foreign natural and legal persons face when buying land; the fact that execution of the institutional reforms is carried out slowly and ineffectively. The Privatization Law does not provide for the necessary variety of privatization techniques. No special approach has been provided for the so called small privatization, which is supposed to contribute to the successful development of SMEs.

Unfortunately, these obstacles were not removed during the seven years of reform in Bulgaria. The private businesses and the SMEs in particular face a lot of difficulties. The share and the position of SMEs in the national economy are far from meeting the world standards. The data shown in Table 7 support this conclusion.

*Table 7*

*Private sector output as a percent share of GDP  
(source; EBRD, IMP, WB, official data)*

Country	1990	1995
Poland	27.5	58.0
Slovenia	10.8	36.0
Hungary	19.5	59.8
Macedonia	14.0	39.8
Czech Republic	5.0	69.2
Slovakia	6.0	58.0
Estonia	10.0	60.0
Latvia	11.0	55.0
Bulgaria	9.8	35.0
Lithuania	10.0	56.0
Albania	5.0	59.8
Romania	16.0	38.0

The delay in the formation of conducive economic conditions for the private businesses and SMEs is one of the main reasons for the deep and comprehensive crisis which has seized the country.

## II. ANALYSIS OF THE BILLS FOR ENCOURAGING AND SUPPORT FOR SMEs IN BULGARIA AND SUGGESTIONS FOR THE PROVISION OF INSTITUTIONAL STRUCTURE FOR THEIR APPLICATION

Following a long and fatal delay in the legislative solution to the problems of encouraging and support for SMEs in Bulgaria, three bills, dedicated to this matter are currently being drafted. The first was made by two parliament members of the Bulgarian Business Block, Yasho Minkov and Borislav Borisov, the second by an independent member of the parliament, Kristiyan Krastev (KK), and the third by a group of members from the democratic left wing (DL). The normative vacuum and the parry affiliation of the authors of the first project suggest a peculiar normative maximalism, with which its authors are trying to solve all the problems of SMEs on one hand, and to create a comprehensive base for their future free realization on the other.

This approach was used in KK's bill, in which the private type of property is absolutized as an object of preferential treatment by governmental institutions.

Conversely, the DL bill treats the matter "officially" to a greater extent as a denunciation of a procedural and political necessity, rather than as an effort for an actual and acting legal and economic regulation and stimulation of SMEs.

Hence the palliative nature of the future law, which the National Assembly will pass when DL deems necessary, as well as the future parameters of the economic resources approach, will be the result of the legislator's will.

A short analysis of the three bills will contribute to the examination and future recommendations. It will not be carried out from a formal point of view, but from the position of the actual resources of the Bulgarian economy at the moment.

The bill proposed by the BBB seems to be least realistic and desirable at this time. However, it suggests numerous solutions and it discusses the matter thoroughly: from economic preferences of an institutional development of a legal initiative. Following the creation of an agency for SMEs and the corresponding to its goals "Fund for the promotion of small and medium businesses," the incentives for SME development will fall into the following categories:

1. With the creation of the firms: improvement of registration procedures, renting buildings and office space for production activity, utilization of electric power, communications, etc.
2. With the actual economic activity: credits and subsidies, tax concessions, accelerated amortization.

In this document the tax concessions for SMEs are heavily emphasized. These include: five year gratis period for the small and two year for the medium enterprises, with the condition that it would be treated as tax credit and it is to be repaid eventually. This stimulus is for companies which are "meant for manufacturing" or occupied in "prioritized area activities," whereas in non-prioritized areas the tax gratis period is three years for the small and one year for the medium businesses.

The following actions are also considered: customs and customs sums preferential treatment for imported raw materials and technologies, release from import and export duty preferential treatment for raw and other materials involved in the production, 30% discount on the tariffs for railroad and automobile transportation.

3. Quota: with the placing of the production of and winning market share by the SMEs, in which the goods and services of SMEs should be preferentially ordered and utilized through the system of state orders.

The logical structure of the bill and its financial security are to be provided by an Agency for the SMEs, which is to carry out public policy in this area as a public entity financed by the state budget. The Agency is to gain economic materialization primarily through sources of the state budget, but also through outside credits, international agreements, aid from international financial institutions, sponsors, etc.

In KK's bill only the small enterprises are supported. He considers all companies equal in property; and takes the top limit for the definition of a small firm to be 20 million Leva annual turnover and 20 employees registered under the Labor Code.

As opposed to BBB's bill, KK's project stresses credit preferences rather than tax concessions. It suggests crediting at an interest rate no higher than 50% of the basic interest rate of the BNB, and the guarantees for these credits for the Small Private Enterprises (SPE) by the government. Second most important action is a 50% deduction for tax on revenue or the income tax from the amount of taxes due /Article 4, paragraph 2/ for all SPEs, regardless of their sphere of activity or nature of production and their services.

The priority of credit preferences is also displayed in the project for creation of a Bank for SPEs: "a joint-stock company with 100% state owned stocks." The sources of the assets of the bank should be provided by the state budget in the first place, but also through the bank's own activity, international aid and sponsoring; their utilization is described basically in the bill.

Since the most important factors are the regulation-simulation methods and techniques for SME promotion, their poor definition and imperatively wishful nature in the discussed document can not be overlooked. For instance, chapter one, which describes the responsibilities of the government towards private business, has eight paragraphs on stimulation and support of business, and only two of them address the matter specifically. The rest are of general nature: Paragraph 3 states "the state points SPEs in prioritized areas of the economy, for which purpose additional support is to be provided" /?/; Paragraph 4 states that the "state orders by the SPEs are to be satisfied with priority" /how, using what regulations, in what amount?/; Paragraph 7 states that the state "stimulates the export of SPEs output and the import of technical equipment" /using what mechanisms and sanctions, and why only the SPEs?/.

Evidently, the author relies mostly on a mythical state, the future Agency for SPEs, and the SPE Bank, more than they could possibly help. This bill is also unrealistic and impractical in most of its points, especially regarding the creation of a public bank and the preferential credit policy which are impossible in today's environment and the economic policy functioning in Bulgaria.

DL's bill has the following characteristics:

1. It does not provide for any tax concessions for the firms, with the only exception being the possibility for accelerated amortization of durable assets.
2. It provides for crediting equal to two-thirds *of* the common interest rate, with the difference to be made up for by a "Small and Medium Enterprises" Fund.
3. Maybe the most important feature is that the state budget is the last source of support for the "SME" Fund, and "priority is given to international

financial organization assistance, international agreements, grants, etc." This feature suggests a realistic approach which is relevant to the financial-credit catastrophe in Bulgaria and based on the balance relationship "resources-demand."

To recapitulate the ideas and mechanisms for stimulation and support of SMEs in all three bills we can conclude **that:**

- They are dominated by the desire to fulfill a common party order, rather than the desire to solve the problems of SMEs using realistic economic measures. This makes them inadequate for the actual economic situation in the country. Let us assume the National Assembly passes a synthesis bill of the three proposed ones. Then 99% of private firms will not be paying revenue taxes for three years, and 75% for six years. The same number of firms should receive credit at 66% of the basic interest rate, not pay customs duties for imported raw materials and technologies, have the right to accelerated amortization of their durable assets, not pay import and export dues, use 30% lower tariffs for transportation services, etc. This practically means burdening the state budget in two directions: on one hand the number of revenue sources shrinks, and on the other, a huge amount of expenditure appears in order for the desired preferences to be provided. It is plainly evident that this kind of approach will be impractical for the next few years.
- The projects are quite abstract and general which deems them non-operational. This is especially valid for the projects of BBB and KK, which plan part of the preferences for the SMEs to be provided through state orders. Meanwhile, the Law for placing state and regional orders which was accepted at first reading does not even touch on this matter.
- The centralized and bureaucratic essence is treated at length. Despite the envisioned division of the Agency for SMEs and the existence of regional programs, all they happen to be parts of a single center (Agency, Fund, Bank.) This will impede the operation of the suggested institution and the accumulation of assets through international sponsors and organizations, most of which prefer to provide resources for specific goals to specific subjects, and not to bureaucratic formations under the guardianship of the government.

On the other hand, the proportion of the powers in the parliament, and the latest string of events, related to the acceptance of the Monetary Board as the only possible solution alternative for the salvation of the financial-credit system and the survival of Bulgarian economy, determine even further the conservative and the palliative nature of the future law for the SMEs.

These events can push it even further behind in the legislative program of the National Assembly. That is why we suggest an approach in which the problems SMEs face should be viewed as a function of several parameters:

1. Acceleration and expansion of economic reforms, especially those concerned with the stimulation of private business.

2. The opening of the country to foreign investors and partners.
3. Anti-crisis regulation and stimulation, in which priority should be given to those firms and activities which could strengthen the exports of our country and refresh production and investment.

As a result, apart from the mechanisms and levers of SME stimulation discussed in the proposed bills, actions should be undertaken in the above three directions for development. These actions should provide the future legal-constitutional framework for the development of SMEs. We endorse this idea, keeping in mind the specific functioning of the division of powers in Bulgaria, the political instability, and the budgetary-credit collapse of the economy. In these restricting circumstances, to claim and expect that all problems would be solved with the help of a single law is not realistic. The Law for the land can be given for comparison. It has been active for five years, and still the actual returning of the land to its legal owners is only half way through.

### III. RECOMMENDATIONS FOR OVERCOMING THE PROBLEMS

#### III.1. Improving of the business climate in the country

In today's situation of deep and all-embracing crisis in Bulgaria, the basic, crucial factor for SMEs is the improving and stabilization of the overall economic conditions in the country. All the common measures stated below<sup>T</sup>, even though not directly aimed at SMEs, have considerable import upon their existence and stable functioning, as regards their contribution to the entire economic development of the country.

##### III.1.1 Anti-crisis program

In recent months, structural reform in Bulgaria is spoken of widely. However, structural reform is only one component of what the country needs: an anti-crisis program.

The anti-crisis program should be a medium for giving preferences to the SMEs

The development of the SMEs results not only from the overall structural reform and the opening of the Bulgarian economy, but it also depends upon the carrying out of a comprehensive and efficient anti-crisis program. Our opinion is that, with the grave consequences of the catastrophe, and the elements of a future consensus upon the indisputable acceptance of the conditions of the IMF, this is the most realistic initiative as an institutional and regulative stimulation of the SMEs. There are several arguments that ground such an optimism:

the dynamic, vital and adaptive nature of SMEs;

their increasing share in the gross domestic product;

the dominant presence of SMEs in the sphere of foreign trade, which has critical importance for the economic growth and restructuring of economy;

the hidden economic potential of private business, with favourable circumstances and legal guarantees from the state given, will reveal itself and assist for the attraction of a considerable volume of foreign capital to Bulgaria.

For these reasons, a future anti-crisis program would inevitably give chance for a new, and maybe real impact in the development of SMEs which, thanks to their experience, entrepreneur spirit and potential, will find their proper place in the economic and public structure of society.

In general, we may say that the anti-crisis program should be based on several key components: the lowering of interest rates and taxes (particularly of the profit tax); the selective approach to sectors and firms which would contribute most for the softening of the economic collapse and the future increase of economic activity; the encouragement and insurance of exports and foreign investments in Bulgaria. These basic elements of an anti-crisis program are determinative as well in the formulating of the concrete recommendations for building of an effective policy for stimulating the development of small and medium enterprises in Bulgaria.

#### 111.1.2. Speeding up of the structural reform

In the framework of common measures, the effecting of a real and expedient structural reform is of critical importance. In order to finally realize this reform, which for all these years remained in the sphere of promises and political speculation, what is needed is a clear, practical and transparent program for its carrying out. Only in the environment of transparency and constant application of steady measures will SMEs be able to work out and employ their own strategy in accordance with the state priorities.

As has already been stated, the structural reform program could solve only a part of the problems, the prerequisites for overcoming the crisis. In order to have a perspective, long-term strategy for the development of the SMEs, we need an anti-crisis program, and common political will for its bringing to life. Only such a program could motivate the entrepreneur spirit and allow the domestic economy to make use of its potential.

#### 111.1.3. Attraction of foreign investments

The foreign investment is essential for the overall economic rise. The entering of large foreign investors will serve as a generator and provocateur for the entrepreneur spirit. The function of huge industrial companies in accordance to the world standards will increase consumption both in general aspect, and as

regards supporting supplies. This will broaden the field for performance of SMEs, with high requirements to the quality of their work guaranteed.

As practice shows, the re-investing process on the part of large investors not only affects their own enterprises, but it also supports as well. This inevitably turns round the wheel of formation or consumers and, respectively, of manufacturers who could satisfy the increasing demand.

#### **III.1.4. General financial and tax policy**

\* Relief of the tax burden by means of ensuring the budget revenue not through constant increase of taxes, but through their ineluctable payment;

\* Expedient and decisive measures for tightening the financial discipline, particularly in improving the work of tax administration and the other financial control authorities;

\* Prompt and resolute cut of the losses in the public sector, which drain the resources of the private sector.

Despite all aspirations of private business, small, medium and large, the priority in policy change should be not so much the reducing of taxes, but rather the creating of a steady and predictable tax environment. It is imperative to finally abolish the practice of imposing taxes with back date, or changing the tax policy several times a year.

The specified, however trivial, measures will ensure the narrowing of the shadow economy perimeter, and accordingly improve the setting of competition. The more adaptive, responding to the international criteria enterprises, will strengthen their positions.

### **III.2. Encouragement and support of the SMEs**

#### **III.2.1. Financial concessions for the SMEs**

It is not logical in the conditions of a severe financial crisis to expect the appliance of particular financial concessions especially for the SMEs. Nevertheless, concurrently with the above mentioned general procedures for financial stabilization, some more long-term decisions could be taken for financial relief of the starting and strengthening of SMEs. What is more, the future implication of such measures could be responsibly declared in a clear program for conducting of the structural reform. These measures could involve:

Tax concessions for introducing of high technologies;

Financial concessions for opening of new working places;



Financial and tax concessions for improving the qualification of the employees;

Introducing of a system for encouraging and guaranteeing of risk enterprises;

Normalizing of the insurance system and introducing of specialized insurance techniques for SMEs;

Building of a system for credit guarantees.

In addition, large corporations, which often act as "accidental credit banks" for SMEs, should receive tax credit for having such a role. Further, the direct financial assistance from the state should be concentrated upon SMEs, whose sphere of activity is subject to sterner state regulation (physicians, drug-stores, etc.) Special state assistance is also necessary for SMEs operating in developing or poor regions.

### **III.2.2. General strategy for supporting of SMEs**

Upon the implementation of an anti-crisis program that stabilizes the economy, an outline the spheres in which SMEs will use certain privileges, advantages and concessions, is necessary. For example, they can be preferably assigned a quota of the public procurement, within which to compete only between themselves. This approach can be legally decreed in the Public Procurement Law.

From the viewpoint of the process of integration of Bulgaria in the European economic space, and of the weight SMEs have in developed democracies, the formation of a competitive environment (laws and a system to guarantee their enforcement, administrative procedures, etc.) has to be a priority in the strategy of the state. This is an essential prerequisite for catching up with the European standards.

It is necessary to work out a common system of concessions and encouragement measures for SMEs. These could include:

Relieved procedures of registration, licensing and administrative service;

Relieves for renting of offices and working premises

The creation of the so-called "business incubator" for SMEs.

Purposeful information servicing - trade, technical and technological;

The creation of "innovation poles" to transfer technology and act as mediators between research centres (universities, the Bulgarian Academy of Science, laboratories, research facilities of large companies, etc.) and SMEs. SMEs need to training of their technical staff, technical expertise,

technological information assistance, and a variety of services concerning their innovation policy.

The support in the training of specialists for work with SMEs in the state structures, for work in SMEs, and for work in entrepreneurial associations.

### **III.2.3. Building of institutional infrastructure**

Currently, the most feasible action to create institutional infrastructure is one that demands minimal financial expense but gathers governmental-wide support. The solving of this problem is a question political will. The roles of both state and private institutions must be addressed in the overall formulation of a dependable institutional infrastructure.

A centralized structure requires the governmental addition of an agency or commission to address the needs of SMEs. The primary advantage of this approach is the consolidation of information and resources into one "address" for entrepreneurs and international investors to visit. However, the proliferation of Bulgarian agencies has significantly reduced the efficiency of specialized organizations. These problems are the result of competition between the agencies, a lack of synchronized effort and generally deficient agency regulation.

Equally important is the development of self-organized SME associations, institutions and unions. Maintaining independence provides the ability to exercise pressure upon the state and allows them to run more efficiently. In creating such bodies, it will be necessary that clearly defined policies regarding state relations, forms of dialogue and use of their expertise are created. In addition, criteria for the legitimacy of business associations must be formulated and their independence guaranteed.

Indispensable from the two above aspects of institutional infrastructure, is the forming of a **special Fund** for encouraging and support of SMEs. In accordance with the already stated principles for guaranteeing the independence of SMEs, this should be a mixed fund with state and private participation. The state part will guarantee the control and adherence to the state strategy for priorities in the economic development. At the same time, it will be an indicator for the degree of state support for SMEs. The private part will be constituted from the privately collected resources (fees from the SMEs, support from other private funds, or attracted foreign aid). This participation will not only guarantee the independence of SMEs, but will also advocate the engagement of the separate entrepreneurs to the sector.

Fund should be structured on a regional principle, with a certain regulated autonomy of the regional structures. This will create a competitive environment at an inter-regional level, and provoke the municipality authorities into providing support for the SMEs. The local social and business structures will be also motivated to contribute for the fund-raising.

The tasks of the Fund could be:

- Revolving crediting for the SMEs;
- Credit guarantees for the SMEs;
- Export insurance and guarantee, which is of significant importance for the export orientation of the SMEs;
- Partial financing of the "business incubator" for SMEs;
- Partial financing of the innovation centres for SMEs;
- Direct and indirect financial support for the specialists training.

Appendix A of the main report lists various support structures used by other Central and Eastern European countries.

#### **III.2.4 The support of SMEs - an accent in foreign economic policy**

The support for SMEs should find its place in the foreign economic policy as well. Specifically, foreign economic policy needs to be created that addresses:

Attracting of aid for SMEs - technical and financial. The activities here should develop on both bilateral and multilateral basis: international organizations and financial institutions;

Special attention to SMEs in the common system for encouraging *oi* export (if such exists in the state);

Informational provision and promotion, using for this purpose the resource of the trade counselors at the diplomatic missions.

Including of SMEs in the schemes of international guarantees;

Priority of the SMEs in the development of regional and international partnership.

#### **III.3. Concluding notes**

We close the section of recommendations for overcoming the lack of whatever strategy for support and encouraging of the SMEs and overcoming the obstacles for their development, in clear realization that each of the suggested ideas may be an object of separate elaboration and further discussion. But before we undertake any concretizing researches, or programs for their application, it is essential to reach agreement as concerns the contents and structure of the whole pack of measures. This is conditioned by the interdependence of these measures.

## ECONOMIC POLICY RECOMMENDATIONS - SUMMARY

### 1. ECONOMIC STABILIZATION AND IMPROVING OF THE BUSINESS CLIMATE

Developing of an anti-crisis program in which the place and role of small and medium enterprises will be clearly and responsibly stated.

Developing of a national strategy for attracting of foreign investments, including decisive measures for improving the general business climate in the country.

Developing of a strategy for speeded, full-scale privatization, with maximum broadening of the applied privatization techniques.

Conducting of decisive measures (legislative and organizationally-administrative) for establishing of a steady tax policy and practice.

Conducting of a complex of measures for narrowing the perimeter of activity and influence of the shadow economy and creating of a competitive environment without distortions.

### 2. POLICY FOR ENCOURAGING AND SUPPORT OF THE SMALL AND MEDIUM ENTERPRISES

Developing of a program for financial support and relief for the SMEs, according to the general economic conditions in the country. Guarantees for conducting of a constant policy for implementation of the program.

Carrying out of a steady policy for introducing a guaranteed system of encouragement measures and relieves for the SMEs.

- \* Relieved procedures of registration, licensing and administrative service;

- \* Relieves at renting of offices and working premises;

- \* Creation of the so-called "business incubator" for SMEs.

- \* Purposeful information servicing - trade, technical and technological;

- \* Creation of "innovation poles". Their aim is the transfer of technologies and they act as mediators between the research centres (universities, the Bulgarian Academy of Science, laboratories, research facilities of large companies, etc.) and SMEs. Here the SMEs are offered training of their technical staff, technical expertise, technological information assistance, and a variety of services concerning their innovation policy.

\* Support in the training of specialists - for work with SMEs in the state structures, for work in SMEs (technical and management staff), and for work in the entrepreneurs' associations.

Building of an institutional infrastructure for encouraging and support of the SMEs.

\* A specialized, centralized or decentralized state structure :

\* Regulation of the conditions for founding and activity of the associations of small and medium business:

\* Establishing of a special Fund for SMEs with guaranteed independence and regional autonomy.

Including the support and promotion of Bulgarian small and medium enterprises as an indispensable accent in the foreign economic policy of the state.

\* Attracting of foreign aid (financial, technical, training), on bilateral and multilateral basis;

\* Engagement of the Bulgarian commercial representations abroad;

\* Priority of SMEs in the regional and international partnership.

## Appendix #3

# THE CONSTRAINTS FACING FOREIGN INVESTORS IN BULGARIAN SMEs

The purpose of this appendix is to identify those constraints facing foreign investors that encumber their ability to make Foreign Direct Investments ("FDI") in the SME sector in Bulgaria, and to make recommendation regarding the easing of these burdens

### The Importance of FDI in the Development of the SME Sector

Since developmental aid and government initiated capital formation have become difficult to acquire, equity capital for SME development must come from the private sector, both indigenous and from foreign investors. As many developing economies have little or no domestic risk capital available, they need to attract capital from abroad. And therefore, foreign capital must be actively solicited. The Bulgarian banking system can not currently support the development of the SME market and other sources of funds, such as the Ministry of Industry's Small Business Fund, established in 1991, remain underutilized.<sup>1</sup> FDI in which effective managerial control is established also serves to bring badly needed technologies and managerial techniques to SMEs.

However, relative to other Central and Eastern European Countries ("CEECs"), Bulgaria has had little success in acquiring FDI in general and even less in acquiring it for the SME sector. The Bulgarian Foreign Investment Agency reported FDI of \$517 million at the 1995, which represents approximately 2% of the total amount of FDI invested in CEECs. Unfortunately, this figure includes investments in so-called "immigration accounts" set up to circumvent Bulgarian foreign employment and immigration laws by establishing deposit accounts of BGL 50,000 (approximately \$200 as of the beginning of November). This has led to a very low average investment per deal. 65% of FDI deals have been for less than \$1,000 and 87% for less than 510,000. The average investment has been \$151,000 (compared with 5550,000 for the Czech Republic).<sup>2</sup>

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it may be interesting to note here that SMEs also provide an alternative form for savings for relatives and friends that have a knowledge of the abilities of the entrepreneur. Such savings are essential to the economy as the lack of faith in the current banking system has forced most individuals to hold cash balances. The attractiveness of an SME "investment" is increased as international partners provide capital and business acumen.

<sup>2</sup> *East West Investment News*, UN/ECE No 3 and 4, 1994

Other problems include the formation of Joint Ventures. In the middle of 1988, Bulgaria had 35 joint ventures, the combined Czech and Slovak Republics had 50, and Romania had 7. By the middle of 1994, Bulgaria had 2,185 joint ventures, the Czech Republic had 6,100, the Slovak Republic had 4,600, and Romania had a staggering 30,441.<sup>3</sup>

### Understanding FIEs and FDI

Unfortunately, there appears to be a misunderstanding with respect to the needs of FIEs, the reasons they invest, and the role that FDI can and should play in the development of the economy within the policies of the country.

First and foremost, Bulgaria lacks a cohesive strategic national economic development plan. Without such a plan, the country's potential for economic growth is severely decreased. Foreign investors are more concerned with the development of the domestic market in terms of creating opportunity than they are with the difficulties that they may face when investing.<sup>4</sup>

Yet, it appears that Bulgarian policy makers have placed a higher priority on the attraction of foreign capital than they have on the development of a national economic plan. Absent a comprehensive national economic policy supported by a stable legal structure, a strategic policy for FDI, which the Foreign Investment Agency has created annually, may be counterproductive.<sup>3</sup> Market potential and economic and political climates are all factored into the FIE decisions *to* invest. Governments that ignore the needs of investors and undermine their confidence risk losing local SME attractiveness as opportunities for investment. Below is a description of the factors that FIEs include in their analysis of business opportunities when looking to invest in a country.

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<sup>1</sup> *East West Join! Ventures*, UN/ECE, No. 3, 1989. *East West Investment News*, UN/ECE No 3 and 4, 1994

<sup>4</sup> An OECD study conducted in 1994 of 50 companies ranked the problems which foreign companies in Bulgaria. The top five, in order of importance, were Economic Stability, Red Tape, Legal Constraints, Slow Privatization. Few Investment Incentives.

<sup>3</sup> Such was the case of early Argentinean privatization. During the mid-80s, FDI was targeted as a priority for the privatization process. Two serious efforts were made to sell two of the major state owned enterprises, ENTEL and Aerolineas Argentinas. Their sales were celebrated to attract additional foreign capital. The Minister of Public Works and Service Rodolfo Terragno reached agreements with Telefonica from Spain and the Swiss airline company SAS. The project failed amid high publicity because of opposition from congress.



## The Market and Demographics

Before investors determine the constraints to investing, they first look for opportunities. Most potential investors are not concerned with a lack of investment opportunities in CEEC. They are more concerned with the political and economic stability of the country.<sup>6</sup>

## Macro Economic and Political Considerations

FIEs are interested in countries that have strong and stable economic indicators, the prospect for economic growth, moderate to low inflation, positive real interest rates, stable wages, and a stable exchange policy, Investors want well developed capital markets, including a stable banking system in which commercial banks are capable of assessing risks and providing capital. In addition, the availability of other forms of financing, quality information, liquidity, hedging vehicles and an overall degree of stability add to the attractiveness of a market. Investors are also attracted to markets in which fiscal and monetary policies favor stability and policy makers have good governmental relationships with international donor organizations and banks.

Stable economic indicators are also a sign of a stable government and governmental policies. Investors want to know that governments are committed to the well-being of the nation as a whole. Good legislation alone does not make good governments. Fears of expropriation, changing regulations, and lack of support for private business increase as the stability of the government decreases, regardless of what is written in the laws. Signs such as frequent changes in Ministers responsible for the decisions regarding foreign investment in SMEs will cause FIEs to reconsider the opportunities available for them in Bulgaria. Finally, FIEs are concerned with a domestic legal structure that supports the development of business and protects the rights of foreign investors.

## Commitment to Privatization

Governmental commitment to privatization is essential for attracting FDI. The continued slow privatization process in Bulgaria has significantly deterred

foreign investors. In general, it has provided fewer opportunities to form joint ventures or to buy local companies, and it created a lack of suppliers, distributors, and industrial consumers within the market.

With respect to SMEs, the slow privatization process has not only created fewer opportunities for FIEs because there were less companies to deal with, but it has also caused them to reconsider the attractiveness of forming their own SMEs in a market still dominated by large SOEs. While SMEs are often created out of market necessity for the servicing of large corporations, large SOEs tend to crowd out both SMEs in their own industry as well as hinder the success of other SMEs because of non-competitive business practices, providing less opportunity in the SME sector.

### Need for Reliable Information

Information is really the fuel that drives decisions. The more accurate the information, the less the risk. FIEs receive massive amounts of information that must be processed and acted upon such as the state of the economy, projected cash flows, supply networks, laws, customs regulations, and import/export restrictions. To reduce risks, FIEs need information that is easy to locate, arrives before decisions are to be made and is relevant to their questions.

### Markets Free from Criminality and Racketeering

The need for "good connections" creates serious legal and ethical questions in the West. For example, United States Federal racketeering laws prevent American businesses and persons from engaging in activities such as bribery outside the United States. Therefore, if local business practices include such activities as part of the modus operandi, American businesses are effectively excluded from the market.

### Incentives

While much focus is centered on FIE incentives, they are actually fairly low on the list of priorities of the companies looking to invest. In fact, they are only considered after the all of the other factors are taken into account or at best, incorporated into them. This is because incentives are not *reasons* to invest. In

some cases, incentives may actually be necessary to level out the playing field between FIEs and local companies. For example, if local companies are avoiding corporate taxes, it would be difficult for FIEs to compete in the market if they expected to meet all government requirements.

### Constraints and Recommendations

Most foreign investor concerns were addressed in the main body of this report. Recommendations have been proposed to stabilize the economy, accelerate privatisation, structure the financial system, and deter criminality. Below are a list of constraints that, although not unique to foreign investor, require special attention because the recommendations proposed in the body of the report do not address the specific needs of foreign investors.

#### Constraint: Lack of Reliable Information and Support Networks

The lack of reliable information is probably the main constraint facing FIEs. Many problems and constraints regarding bureaucracy, legislation, and tax codes can be lessened, or even eliminated, with adequate information resources. However, there is no current, single reliable source of information regarding investing in SMEs. The lack of correct information, or the supply of incorrect, information increases the risks of investing significantly and therefore may deter investors in SMEs.

In addition, time and money spent visiting or calling numerous sources to obtain incorrect information is very expensive. If a foreign company is gathering information on an SME, this could greatly increase the cost of the investment and force the FIE to reconsider the investment. Considering that the size of most SME investments is less than \$10,000, all incremental costs for FDI are expensive.

#### Recommendation

Greater emphasis must be applied to the development of service centers that provide basic information services specifically focused on SMEs for foreign investors. These information centers should also be capable of providing pre-project assistance and contacts brokering, project assistance and management, legal and tax advice, assistance with feasibility studies and information

regarding financial assistance, special financing incentives, and investment guarantees.

#### Constraint: Bureaucracy, Decision Making and Authorities

Foreign investors state that they must overcome tremendous bureaucratic hurdles in order to complete deals. They have to negotiate with several authorities that often do not seek the same goals or have the same information. Frequent changes in authorities also frustrates the problem. In addition, the people responsible for completing the deal are reluctant to make decisions and to bear responsibility. There is often a significant inconsistency between decision makers and policy statements. And the lengthy and complex permit and approval procedures are "still carrying the red tape style of the central planned system."<sup>7</sup> Similar to information gathering, this adds to the cost of a project. Companies investing in SMEs can spend a significant amount of money trying to find their way through bureaucratic mazes. Moreover, they often face more difficult obstacles to overcome because they have a harder time making "the right connections" and they are not viewed as important as large scale investments,

#### Recommendation

Its always simple to say that governmental procedures need to be streamlined. However, this is often difficult to implement and sometimes completely unrealistic. If changes do occur, they usually take months or years to complete. A more realistic short term approach is to increase the ability of institutions responsible for assisting FIEs with such procedures. More information needs to be gathered and organized for investors to be able to understand, no matter how complex, the process of FDI in Bulgarian SMEs.

#### Constraint: Tax Law, Enforcement and Credits

The taxation of foreign corporations and persons with a site of economic activity in Bulgaria is the same as that for domestic corporations and persons. The Corporate Tax Act passed July 1996 provides for a corporate tax rate for the state budget of 36% for profits in excess of BGL 2 million and 26% for profits less than BGL 2 million. However, inflation and a devalued currency

have combined to effectively push SMEs into the higher tax brackets. This higher tax rate, combined with a 15% tax on dividends, a 15% tax on foreign persons income, and a 5% tax to the professional qualification and unemployment fund 5%, makes FDI in SMEs extremely expensive.

Effectively taxing SMEs as large corporations disadvantages SME competitiveness against many already subsidized companies. This significantly decreases their attractiveness as targets for FDI. There is currently no significant tax relief for SMEs, not including direct incentives for participation in privatization.<sup>8</sup> Furthermore, tax authorities are currently poorly trained and inexperienced, and agencies are not coordinated. Tax collectors are unwilling to give clarifications for penalties and are concerned with finding faults to receive a 5% discovery reward.<sup>9</sup> Since SMEs may be without adequate resources to hire proper tax preparers, they are more likely to be burdened by the tax system and staff which causes disincentive to invest.

#### Recommendation

Providing tax incentives to FIEs that invest in SMEs will increase investment and may also serve to increase tax collection.<sup>10</sup> Most developing economies provide tax incentives to FIEs investing in SMEs. A structured tax incentive program should be implemented to steer FDI into strategic SME industries for development, such as manufacturing, transportation and tourism. However, the overall issue of effectively taxing SMEs as large corporations needs to be addressed through amendments to the tax code. Further, as previously stated, proper information resource services will also help SMEs to reduce the difficulties of understanding and preparing tax returns for the state.

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<sup>8</sup> Amendments exempting non-monetary contributions in excess of \$100,000 not exceeding 30% of total capital from VAT and duties are being reviewed.

<sup>9</sup> Ibid.

Whether or not tax revenue will increase with a reduction of taxes is based on the Laffer Curve and Bulgaria's current position on it. However, it can be argued that lowering high taxes in developing economies with little or no enforcement of tax codes can serve to increase revenues since the burden to overcome tax payments and possible penalties outweighs the desire to circumvent such codes. In addition, foreign investors tend to be more likely to follow tax codes and therefore increasing their presence would increase revenues.

## Constraint: Changing Immigration Regulations

As previously stated, much of the FDI invested in SMEs has been investments in so-called "immigration accounts" set up to circumvent Bulgarian foreign employment and immigration laws.

Previously, the combination of three laws, and articles thereunder, the Law on Foreigners' Stay in the Republic of Bulgaria, Article 8(4), the Law on Business Activity of Foreign Persons and on the Protection of Foreign Investment, Articles 3(1) and 9(1), and the Law on Commerce, Article 117(1), provided the legal framework for foreigners to establish a limited liability corporation with a minimum deposit account of BGL 50,000 (approximately US\$ 200 at the beginning of November) and receive a stay permit for a term of one year. Unfortunately, the spirit of these laws had been exploited by individuals wishing to establish residence within Bulgaria.

Measures were recently taken to reduce the number of FDI immigration accounts. Specifically, Parliament enacted amendments to the Law on Business Activity of Foreign Persons and on the Protection of Foreign Investment which raised the threshold for a foreign investment undertaking to USD 50,000. It is estimated that this new law affects approximately 6,800 small-sized joint ventures, representing approximately 10 percent of the total investment in Bulgaria. The Foreign Investment Agency estimates the total number of foreign investors in Bulgaria at approximately 7,100. Those investors that fall below the USD threshold will continue to carry on business in Bulgaria under the Commercial Code, but will not be entitled to repatriate their profits or their portion of the residual distribution of assets in the event of liquidation. These new provisions are a direct threat to Bulgarian SMEs trying to raise capital through foreign sources and a threat to SME investment by foreign investors in general.

### Recommendation

■ Policy makers must review the recent policy changes and determine whether or not the benefits of changing the laws to plug abusive immigration outweigh the costs to the Bulgarian economy by making it virtually impenetrable for foreign investors. At very least, special repatriation relieves

must be offered to foreign investors that can demonstrate legitimate and ongoing business in Bulgaria.

An alternative to the recent changes that has minimal costs for the government and legitimate businesses are spot checks. Highly publicized statistics from random spot checks of businesses established with capital at or around the minimum BGL 50,000 may not only find bogus companies, but it will also deter the future establishment of such companies.

#### Constraint: Unfair Treatment

Although guarantees and protection provided under the Bulgarian Constitution and other applicable laws provide for the fair and equal treatment of the business activities of foreign investors to the full extent provided to those of Bulgarian legal persons and individuals, favoritism for locals and in some cases, outright discrimination against foreign investors are not uncommon. Interviews with foreign investors revealed that they have, in some cases, received severely unfair treatment from federal and local governments and their agencies, commissions and institutions. Foreign investors have been crowded out in pre-privatization bidding procedures, given false or misleading information not supplied to insiders, treated unfairly in post-auction procedures, signaled out by local policing authorities for otherwise wide spread infractions and badgered in tax collection procedures.

#### Recommendation

While in many cases, support for domestic investors needs to be made a priority for the development of the local market, unclear and unwritten policies against foreign investors serve to dissuade future foreign investment. Policies must be established, disseminated and adhered to regarding the treatment of foreign investors in areas including, but not limited to, the privatization process, investment and mutual fund activities, import, export and distribution activities, and the telecommunications industry.

## Constraint: Domestic View of Foreign Investment

A study by the Center for the Study of Democracy conducted in 1993 revealed that among employees of SOEs, 34.7% would like that the state ownership of their company to remain in the future and 23.2% said that it doesn't matter. FDI is often viewed as "selling the country" by citizens. The public also often has fears that foreign investors concerned only with cutting costs will significantly reduce the workforce of the companies that they invest in. " This is not only apparent in the general attitude towards FDI, but it surfaces in the types of FDI that are favored. Bulgarian companies prefer forms of ownership that limit control by FIEs, such as joint ventures and co-operation projects.<sup>12</sup>

### Recommendation

The current situation facing Bulgarian SMEs is a misunderstanding of FDI and how it affects their companies. Quite often, Bulgarian SME expectations of foreign partners is significantly different than the latter's reciprocal expectations. By establishing networks of communication and in many cases providing direct assistance, associations and organizations build trust between domestic and foreign investors. They also provide for the transfer resources, including information regarding financial and professional resources as well as fostering distribution links.

### Concluding remarks

To attract investment in SMEs from abroad, Bulgarian policy makers must make Bulgaria an attractive investment for international investors. This success relies heavily on the creation of a national economic plan and anti crisis measures that stabilizes the economy and the political system, privatizes existing SOEs, reduces inflation, and basically builds a better economic climate for investing. Recent political and economic events had diverted foreign investors attention to other CEECs and foreign markets.

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<sup>11</sup> This is not a problem that is unique to Bulgaria. Margaret Thatcher's government had to overcome substantial public objection to "giving away" valuable national properties, "mainly to the rich," and abandoning the countries thirty year social contract to provide forms of full employment guarantees through SOEs. Smith, Roy, and Ingo Walter, *Global Banking and Capital Markets* Vol. II, Simon & Schuster, 1994

<sup>12</sup> Within the frame of Peco Copemiuc research project, CIPA CT 93-0258, 1995



Late privatization and development of the SME market may provide Bulgaria with an opportunity to examine the experience of those countries that took the lead in state reform. The failures and successes of early cases will give Bulgaria knowledge and information in the most appropriate ways to develop the SME market and to attract FDI. However, in the midst of heavy competition from other developing economies for FDI, the availability of capital for aiding the SME sector from abroad may be more difficult to attract in large quantities.

End notes

