

**BARRIERS TO SMEs FINANCE AND GROWTH – FROM THEORY TO  
PRACTICE  
Statistics in Transition**

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## **INTRODUCTION**

In 2000 the European Commission has decided to open accession negotiations also with the countries from the so-called “second wave” - Slovakia, Latvia, Lithuania, Bulgaria and Romania. The prospective member countries have completely different starting points in terms of the convergence process. The negotiations with them have started with the evaluation of different number of topics, which are 6 for Bulgaria. One of them is Small and Medium Sized Enterprises (SMEs) sector. In this context special attention should be paid to summarizing the relevant experience of the EU member state countries and those that belong to the first wave of negotiations started in 1998 (Poland, Hungary, Slovenia, the Czech Republic and Estonia). It is also important to discuss the manner in which preparation for membership can trigger further changes in the SME sector and the effect of those changes on the transformation process before and after full membership.

The main aim of the paper is to investigate the current state of Bulgarian economy and especially of the sector of SMEs and the main barriers to SMEs finance and growth in Bulgaria. As in most of the transition countries the main need for developing SME sector in Bulgaria is to establish the necessary institutional, legal and business framework to support and facilitate the development of entrepreneurship. It includes basic reforms such as changing registration and reporting procedures, reforming banking and tax system, as well as steps to eliminate corruption and bureaucracy, which still impede entrepreneurship in our country. To reach this objective we are going to research the existing institutional and legal environment, business support infrastructure and hampered access for SMEs to financial sources.

### **I. BULGARIAN ECONOMY DURING THE PERIOD 1996-1999**

One of the main issues of the unique and specific transition in Bulgaria from centrally planned to a market economy is the building up of a strong small business sector. This is extremely important for our country due to the fact that the non-privatised enterprises still dominate the Bulgarian economy. That is why the entrepreneurs and the owners of small firms should be aware of the pros and cons of the current economic environment and business conditions.

The period 1996 – 1998 was extremely difficult for the Bulgarian economy. After the relatively low economic growth in 1994, 1995 and the first half of 1996 the financial sector entered into a deep crisis, which reflected on the whole economy of the country. As a result in 1996 and 1997 a sharp decrease of the Gross Added Value (GAV) was observed, as well as an increase in the inflation rate and even reaching hyperinflation levels in the first two months of 1997. As a consequence a sharp fall in the real income of the population was registered.

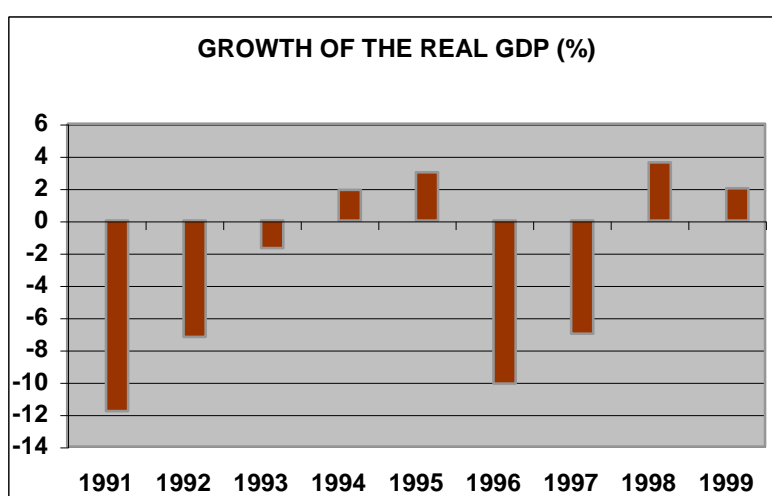
In 1996 the Gross Domestic Product (GDP) decreased compared to the preceding year by 10.1 %<sup>1</sup>, which is the biggest decrease of this indicator since 1991. In 1997 a new fall was registered by another 7 % but this was due completely to the sharp crises of the economy in the first half of the year. The fall of the GDP in the first quarter of 1997 was 22.7 % and during the second quarter - 13.3 % compared to the same periods in 1996. This was due to the sharply decreased internal demand of the population as a result of the fast fall of the real

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<sup>1</sup> The Report for SMEs in Bulgaria 1996-1999, Agency for SMEs, 2000, p. 13

income in the country, as well as of the extremely low investment activity of both the companies and the population. The low investment activity was determined by the extremely unstable economic situation in the country, which narrowed the horizons for planning of companies' activities, as well as by the high price of the investment products.

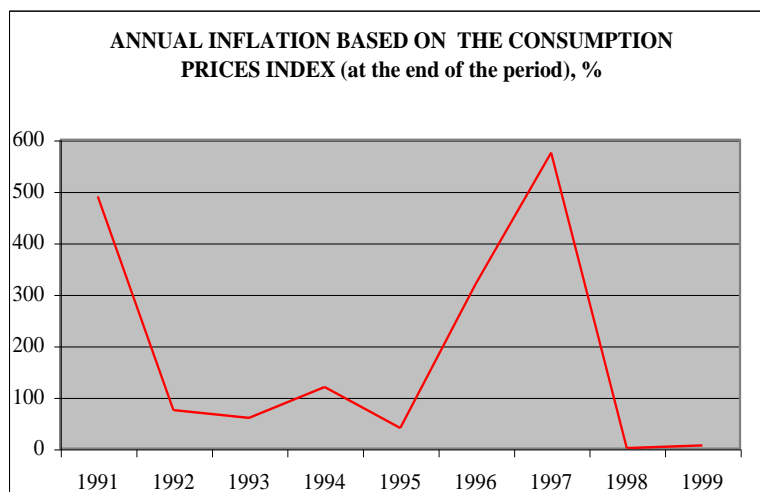
During the second half of 1997, immediately after the start of the economic policy of the new government, the main element of which was to introduce a Currency Board in the country, a period of stabilization of the Bulgarian economy commenced. During the last two quarters of 1997 growth has been registered by 2 % and 3 % respectively. The period of economic growth continued during the next two years. Thus in 1998 the GDP increased by 3.5 % and for the first nine months of 1999 the data of the National Statistics Institute shows 2 % growth (see Fig.1). In 1999 the pace of economic growth slowed down. To the negative impact of the two external shocks of 1998 – the Asian and Russian crises, the crisis in Kosovo was added. In spite of this the GDP growth for the whole year reached 2.5 %<sup>2</sup>.



**Figure 1**

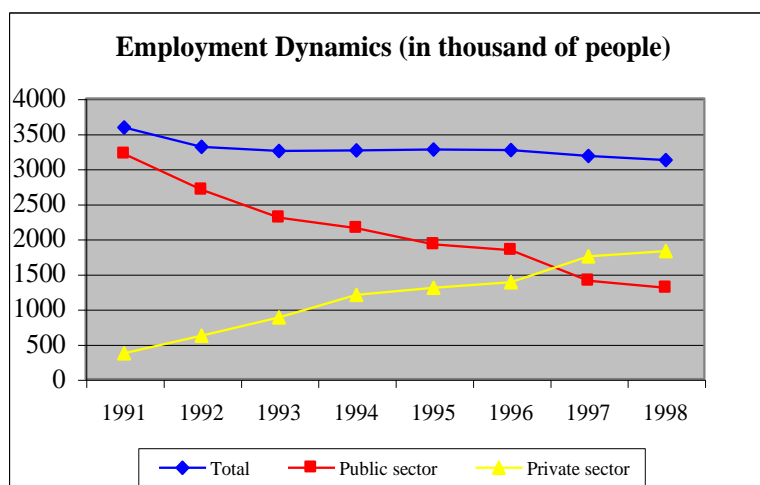
During the period 1996 – 1999 the Bulgarian economy has undergone several periods with different dynamics of price levels. In 1996 the inflation rate sharply increased. In the beginning of the year prices increased by 1 % – 2 % on the average per month, but in May and from then on the same indicator varied between 15 % and 25 %. At the end of the year when the economic crisis sharpened, Bulgaria faced a hyperinflation cycle. In January 1997 the consumption prices increased by 43.5 % and in February 1997, by another 242.7 %. The entrance of an interim government, which started implementing a new economic policy, continued by the government elected by the new National Assembly, as well as the introducing of Currency Board in the middle of 1997 were amongst the main factors which stabilized the price dynamics. During the second half of the year the monthly inflation levels fell down to 1 %. Stabilization of inflation continued over the next two years, as the values of this indicator for 1998 were 1 % (December 1998 compared to December 1997) and for 1999 – 6.2 % (December 1999 compared to December 1998) – see Fig.2.

<sup>2</sup> The Report for SMEs in Bulgaria 1996-1999, Agency for SMEs, 2000, p. 15



**Figure 2**

Fixing the exchange rate when introducing the Currency board in the country played a stabilizing role for the dynamics of the prices in two aspects. On the one hand, that increased the predictability of the environment for the producers who used import raw materials, as well as for the importers of end-user goods. The trust of the economic entities in the stability of the economic policy, implemented by the government, has increased. On the other hand, the export prices of the goods appeared to serve as a restrictive factor for the increase of the internal prices of the local producers.

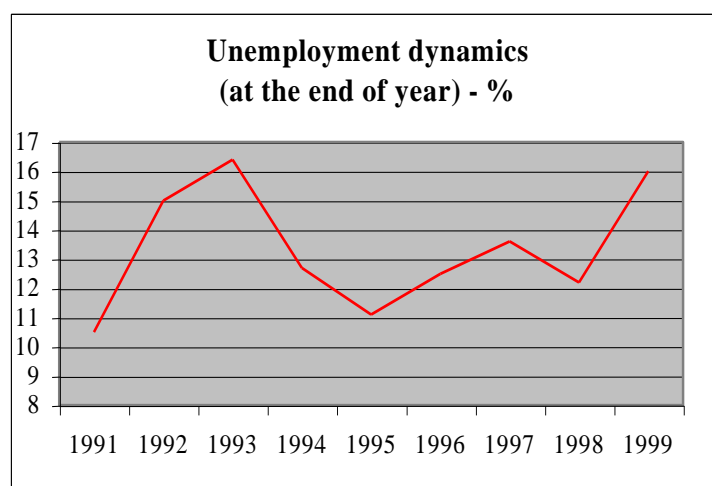


**Figure 3**

A typical trend for the transition period in Bulgaria to a market economy is the decrease of the number of employed people. The period 1990 – 1993 is characterised by fast reduction of employment and forming a group of unemployed people, who for the most part were unqualified and with low education level, thus with minimum chances for finding a job. In the period 1994 – 1996 the number of employed people has stabilised and even has recorded a small increase, at the same time when a growth of the GDP has been registered. In 1996 together with the sharpening of the crisis of the Bulgarian economy a gradual decrease in the number of employed people commenced. This was mainly due to the acceleration of structural reform in the country of which the privatization or liquidation of former state-owned enterprises was the basic element. It can be considered that in 1996 – 1997 the

Bulgarian economy was functioning with a bigger number of employed people than the optimum number necessary for generating the income during this period. For the period 1996 – 1998 the number of employed people decreased by 5 %<sup>3</sup>. In 1997 the number of employed in the private sector exceeded that in the public sector. This trend continued in 1998 when the percentage of the employed people in the private sector reached 58.6 % (see Fig.3).

As a result of speeding up the structural reform in the country and the still low demand for labour the number of unemployed has increased, as at the end of 1999 it equalled 17 % of the workforce in Bulgaria and their number has increased by 45 000 people or by 8 % compared to the end of 1997 (see Fig. 4). The workforce decreased by 150 000 people (4,2 %) at the end of 1999 compared to the end of 1997 and the coefficient of economic activity (ratio: workforce/population below 15 years old or retired people) decreased from 51.6 % at the end of 1997 to 49.2 % at the end of 1999<sup>4</sup>. This level of the economic activity is low both compared to the preceding years and to the other countries of Central and Eastern Europe<sup>1</sup>. According to the data of the observations made by the National Statistics Institute on the workforce about 50 % of the unemployed people in Bulgaria are long terms unemployed, i.e. with a period of unemployment longer than 12 months.



**Figure 4**

After introducing the Currency Board in Bulgaria and the reduction of the inflation rate to less than 10 % annually, a period of gradual increase of actual salaries in the country commenced (see Fig.5). A new legislative mechanism for regulating the increase of the salaries in the public sector has been adopted, which connected their dynamics with the financial state of the companies and the level of servicing their liabilities to different groups of creditors. This was aimed at improving the financial discipline of state companies. The dynamics of the salaries in the private sector affirms that private entrepreneurs have maintained strict income policy in their companies and probably they have bound the dynamics of the resources, paid as salaries, with the dynamics of the efficiency of labour. The aim of the government is that the same principle be applied in the change of incomes of salaries in the state companies. According to data of the Ministry of Labour and Social Policy for 1999 these companies in their major part observe the legislation in this sphere and their behavior comes closer to that of the private employers.

<sup>3</sup> The Report for SMEs in Bulgaria 1996-1999, Agency for SMEs, 2000, p. 18.

<sup>4</sup> The Report for SMEs in Bulgaria 1996-1999, Agency for SMEs, 2000, p. 19.

<sup>1</sup> The Regular Report of the European Commission on Bulgaria's progress toward accession, October 1999.



**Figure 5**

In 1996 and 1997, unlike the preceding years, the Bulgarian economy realised a positive balance on its current account of the payment balance. For 1996 it equalled 0.8 % of the GDP and reached 4.1 % of the GDP for 1997. To a great extent it was due to the positive trade balance during this period. For 1996 it was USD 187 million and in 1997 it increased up to USD 368.9 million. In 1997 exports increased only by 0.7 % compared to 1996, while imports decreased by 3.1 % compared to the same period<sup>2</sup>. In 1999 the Bulgarian currency devaluated significantly compared to the USD as a result of the devaluation of the EURO, to which the BGN is bound with on the international markets. This, however, has not influenced much the dynamics of Bulgarian exports, which has proved once again that more significant impact on this indicator is due to other factors, such as the low compatibility of the Bulgarian producers, still shrinking external demand and low international prices of key Bulgarian exports.

In 1999 the import of investment products increased quickly (by about 25 %), which is an indicator for the increased investment activity in Bulgarian economy. As a result of the increased real income of the population, the export of goods has also increased. This fact is a little bit disturbing and poses the question to what extent the Bulgarian producer is compatible and possesses the potential to meet the increased demand in the country. For 1999, according to data of the Bulgarian National Bank (BNB), the deficit of the trade balance reached USD 836 million and of the current account of the payment balance – USD 479.3 million.

## **II. BULGARIAN ECONOMY IN THE FIRST HALF OF 2000**

### ***Real sector***

According to data quoted by the National Statistics Institute, the Gross Domestic Product (GDP) has increased by 4.8 % during the first three months of the year 2000 as compared to the same period for the previous year<sup>3</sup>. As per current year prices the value of the produced GDP can be calculated as BGL 5,188 billion and as per last-year prices it is BGL 5,001 billion. Thus GDP per capita is BGN 632 or USD 319. The Gross Added Value (GAV) has

<sup>2</sup> The Report for SMEs in Bulgaria 1996-1999, Agency for SMEs, 2000, p. 20.

<sup>3</sup> The National Statistics Institute Bulletin for January-March, 2000.

increased by 4.9 % and now equals 85.1 % of the GDP. Fifty-eight per cent of it has been produced in the services sector, 32.7 % in industry, and 9.3 % in agriculture. From January to March the private sector has produced a GAV of BGN 2,739 billion which is 62 % of the added value in the entire economy. The share of the private sector has increased by 12 % as compared to the same period for the year 1999 (the National Statistics Institute claims that this is due mainly to the privatisation of Neftochim Ltd.). The government forecast, as agreed with the International Monetary Fund (IMF), indicates an increase of 4 % for the year 2000 and 5 % for the year 2001.

Unemployment is 18.19 % for the month of June, dropping by 0.67 points compared to the month of May. The fact that the number of unemployed people has remained relatively stable and the trend has only slightly changed may be accounted for by the factors of seasonal work, newly created vacancies and careful staff reduction. At the end of June the number of unemployed people was 696,551. At the same time the percentage of unemployment has increased as compared to the same period for the previous year when it was 12.75 %.

### ***Foreign sector***

The current account deficit has increased up to USD 374.1 million during the first four months of the year. For the same period in 1999 the current account deficit was USD 341.4 million. According to data quoted by the BNB<sup>4</sup>, at the end of April the trade deficit has increased up to 370.3 USD million as compared to the USD 324 million for last April. This increase in the deficit is due to the higher international prices of petroleum. In April exports increased by 12.8 % as compared to last April thus reaching USD 335.5 million, while imports dropped by 2 % and reflect a total value of USD 393 million. The improved foreign environment, including the continuing restoration of the European economies, the increased key prices for Bulgarian exports and their relatively low base in April 1999, has determined this considerable increase in exports. For the period of January-April imports amounted to USD 1.810 billion and increased by 21.1 % compared to the same period in 1999. Exports were USD 1.440 billion and increased by 23.1 % compared to the same period for the previous year.

### ***Fiscal sector***

The Ministry of Finance estimates that by the end of the year 2000 the revenues in the consolidated budget will reach BGN 10.128 billion or 43.2 % of the GDP. This is a conservative estimation and it envisages that revenues will exceed 8-10 % including tax payments receipts of between 4-6 %. The revised expectations for the expenditures in the consolidated budget are of BGN 10.484 billion or 44.7 % of the GDP with fixed non-interest payments of 89 % of the total expenditures or 39.7 % of the GDP. Thus it can be expected that the budget deficit for the year 2000 will be around 1 % of the GDP where the primary surplus will amount to 3.5 % of the GDP. The official budget deficit for the year 2000 is estimated at 1.5 % of the GDP.

### ***Financial sector***

According to data quoted by the National Statistics Institute<sup>5</sup>, the consumer prices index for the month of June is 100.13. The inflation for the same month is 0.13 % and with the accumulation from the beginning of the year it reaches 2.61 %.

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<sup>4</sup> The Bulgarian National Bank Report for January – June 2000.

<sup>5</sup> The National Statistics Institute Bulletin for April - June 2000.

At the end of June the EUR/USD exchange rate was 0.95560 and the USD/BGN exchange rate was 2.04670. In the middle of July the USD/BGN exchange rate continued to change in accordance with the EUR/USD exchange rate on the global market. The inter-bank trade was focused on servicing the sales of US Dollars by companies, which have accumulated Bulgarian currency to cover their tax payments. At the end of each month local companies make their routine payments to the budget, including VAT and other corporate taxes.

According to data provided by the BNB<sup>6</sup>, since May the monthly amount of new loans in BGN in the banking system has increased from BGN 122.4 million to BGN 156.09 million (+27.48 %). Short-term loans have increased from BGN 75.71 million to BGN 97.72 million (+29.07 %). The monthly increase of long-term loans is (+24.88 %) and their total amount in the banking system has increased from BGN 46.74 million to BGN 58.37 million. In June the number of loans granted in foreign currencies in the banking system continued to drop, and namely for loans in USD by (-31.7 %) and for loans in EUR by (-2.9 %). The total amount of short and long-term loans in USD is 8.23 million and in EUR 16.22 million.

In June the amount of deposits in BGN in the banking system dropped from BGN 2405.9 million to BGN 2397.0 million. In comparison to the month of May the reported decrease for the banking system is (-0.37 %). Deposits on demand show a slight increase (+0.6 %). Fixed-term deposits in the banking system have dropped by (-1.83 %). Apart from the business activity typical for the season, the deposit base of the system has also been affected by the tax payments of companies to the budget at the end of the first six months. The BGN equivalence of deposits in foreign currencies in the banking system has dropped from BGN 3067.1 million to BGN 2954.4 million. If calculated in US Dollars, this amount is USD 1443.5 million at the end of June or by USD 15.3 million less than the amount in May. The deposit base in foreign currencies has been affected by the lower exchange rate at the end of this period and the decrease of fixed-term deposits typical for the season.

An comparative analysis<sup>7</sup> of the key macroeconomic indicators for the period 1996 – 2000 is given in Table 1.

**Table 1**

**KEY INDICATORS**

<b>INDICATORS</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>
<b>ACTIVITY</b>					
GDP (real % change)	-10.9	-6.9	3.5	2.4	5
GDP (Euro bn)	7.8	9	10.9	11.3	12.7
GDP per capita (EURO bn)	939	1086	1324	1371	1544
GDP per capita (USD m, % change)	-28.4	15.7	21.9	3.6	12.6
<b>Components of GDP (%)</b>					
Production	30.6	25.3	25.5	23.4	
Agriculture	12.4	23.8	18.7	15.1	
Services	51.5	40.5	44.7	48.8	
<b>Structure of the employed (%)</b>					
Agriculture	24.4	25.3	25.7		
Services	27.5	32	30.8		

<sup>6</sup> The Bulgarian National Bank Report for January-June 2000.

<sup>7</sup> Source of data: The Report of the Institute for Market Economy: "Conditions for Conducting of Business: 1999 – 2000", The Bulgarian National Bank Reports and the National Statistics Institute Bulletins for 1996 – 1999.



<b>Real investments</b>	11.4	12.8	15.1	17.1	19.6
<b>Real investments growth (%)</b>	-22	-22.1	16.4	20	19.22
Foreign direct investments (USD m)	256	636	220	755	1000
Share of the economy in private proprietors (%)	45	50	63	75	75
<b>TRADE</b>					
Trade with EU (%)	37.6	41	46.5	52	53
EXPORT to EU (%)	39.1	43.3	49.7	55	56
IMPORT to EU (%)	35.1	37.3	45	50	51
Current account (% of GDP)	0.9	4.3	-0.5	-5.7	-5.4
<b>Fiscal balances (% of GDP)</b>					
Budget balance	-11	-3.1	1.1	-1.3	-1
State debt	124.6	106.8	86.7	71	68.4
Prices	-	-	-	-	-
CPI inflation (%)	123	1082	22.3	1.8	6.6

### III. BARRIERS TO SME FINANCE AND GROWTH

The analysis of the existing barriers to Small and Medium-Sized Enterprises (SMEs) is based on three separate studies:

1. A study requested by the *Center for Economic Development* and implemented by the research team of Vitosha Research Co., and based on group discussions with participation of:

- Representatives of branch associations of SMEs in Bulgaria
- Representatives of small and medium-sized companies
- Representatives of financial institutions in Bulgaria
- Representatives of institutions responsible for state policy in the sector of SMEs

The main objectives of the research conducted are as follows:

- a) To identify the main problems that SMEs in Bulgaria have to cope with in the period of transition to a market economy;
- b) To compare different points of view of representatives of different interested parties, as regards the problems of SMEs;
- c) To formulate concrete proposals for solving major problems before SMEs in Bulgaria in the period of accession.

2. A study of the Institute for Market Economy in the framework of the project “Rules, Regulations and Transaction Costs in Transition Bulgaria”, financed by the *Individual Research Support Scheme* of the Open Society Institute, Budapest.

The main objective of this research is to make an attempt of identifying and roughly measuring of transaction costs incurred by SMEs from the private sector in Bulgaria. That will provide an opportunity to take them away or simply to reduce them at a later stage, which will stimulate production and will increase the competitiveness of SMEs. The research is based on a sample that includes 120 micro- and small enterprises operating on the territory of 21 regional centers in Bulgaria in the sphere of production, trade and services. The methodology applied is based on a questionnaire, which concerns 4 types of costs:

- Costs of entering the business;
- Operating costs of the enterprise;

- Costs of contracting and implementing the contracts;
- Costs of transforming or abandonment of business.

3. A study requested by the *UK Know How Fund* and implemented by Bannock Consulting Ltd. in the framework of the project “Bulgaria Reform of Administrative Barriers to SME Development”, with an active participation of the Institute for Market Economy.

The main objective of the research is to determine the existing administrative barriers before SMEs, namely the so-called “compliance costs”. Individual interviews with representatives of 20 enterprises, 12 of them – micro, 7 –small and 1 – medium-sized firms, have been conducted. The research includes interviews with representatives of the Agency for SME, of governmental departments and agencies, donors, financial institutions, other consultants and institutes working in this field as well. Expected results of the research include reformed regulations and administrative procedures in selected areas, and a Government commitment to development of effective mechanisms and an agenda for continued deregulation. Based on the analysis of the results of these three studies we may identify the main barriers to SMEs in Bulgaria. They can be classified as follows:

### ***1. Barriers arising from existing legislative framework***

The existing legislative framework for development of SMEs in Bulgaria consists of a great number of legislative acts, norms and orders, regulating different aspects of SME activities, as well as different sectors of economic activities in the country. One of them is the Act for SMEs, adopted in September 1999. Within the period of 1998 – 1999 the Bulgarian Parliament has voted 314 Acts, 107 of which (according to a research of the Institute for Market Economy) have direct or indirect impact on the private sector growth. A review of the existing legislation shows<sup>8</sup> that as whole the legislative framework, which concerns with the sector of SMEs, is characterised by inconsistency, instability and contradiction; the procedures are time consuming and intricate; there are too many license and permit regimes and too many loopholes as well; concrete mechanisms for encouraging SMEs are also missing; there is a lack of tax alleviation and financing schemes outside the banking legislation. Thus the existing legislative framework does not sufficiently stimulate the development of SMEs and their sustainability, and the lack of a special unified legislation for SMEs strongly impedes their operations. That’s why, for 56 % of respondents the effect the legislation has on SMEs is dubious and contradictory.

The efforts should be devoted to overcoming the existing disadvantages of the legislation and achieving of much better harmonization between different legislative norms (very often one and the same matter has been treated simultaneously in several acts, which hampers in principal its right application). The main difficulty here is connected with the SMEs heterogeneity. No matter if it is just a family business aimed at providing a certain service or it is a new entrepreneurship targeted to fill a given niche in the market space and connected with a concrete production, it is much difficult to define certain activities as strictly typical for SMEs. Despite of their wide diversification the following potential advantages and disadvantages of SMEs may be determined:

1. A main advantage of SME is its flexible structural organization and its endurance to outside shocks. The SME flexibility that has to do with making effective fast changes in production aspects and their abilities to undertake simultaneously several activities are

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<sup>8</sup> The Report for SMEs in Bulgaria 1996 – 1999, The Agency for SMEs, 2000; The Report of the Center for Economic Development: “SMEs and Competitiveness”, 2000 and the Report of the Institute for Market Economy: “Legal and Legislative Reform – an Impact On the Private sector”, Newsletter of IME, March-July 2000.

traditionally connected with small and medium business and have been important factor for its competitiveness.

2. SMEs are characterized by relatively high costs of observing the tax legislation and other forms of government regulation, especially if they operate internationally. Enterprises in Bulgaria and especially those from the sector of small and medium businesses are confronted with more and more complex legislative, tax and administrative environments, in which they have to start and successfully run their business.

To overcome these barriers a wide spectrum of different schemes and activities has been designed in many West European countries to stimulate the process of start-up and development of SMEs. They provide a support to the process of registration of a new enterprise (so-called “one stop shop” approach) and concern specific measures for improving technological and economic environment, removing the existing financial and administrative barriers, and protection of entrepreneurs interests from unfair competition.

## ***2. Financial and related barriers***

Financing SME activities in Bulgaria is one of the main preconditions for future development of Bulgarian economy, as well as for achieving an economic growth. To set this in motion it is necessary for the commercial banks to provide a special lending policy to the sector of SMEs. Recently the commercial banks apply a very restrictive policy when granting loans to SMEs. The reason is that the prevailing part of the banks prefer to minimise risk and possess low return assets, and at the same time granting of loans to SMEs is non-attractive for them because of few objective reasons, such as high costs incurred when lending small credits, impossibility for SMEs to provide the required collateral etc. Taken into account the specificity of SME financing a number of financial instruments, especially designed to SMEs, have been developed as follows:

- Micro-lending schemes;
- Risk capital financing;
- Credit guarantee schemes etc.

The policy of international financial institutions such as IMF, WB, EBRD etc. is aimed either at providing specific forms of financing, directly intended to SMEs or encouraging the bank system in order to ensure a much easier access to bank loans for SMEs. The most frequently used forms are<sup>9</sup>:

- Participation in risk capital funds;
- Joint venture with local banks with aim to increase their capital base and improve bank's corporate management;
- Providing bank to bank loans;
- Co-financing of local projects with participation of local and foreign banks;
- Providing direct credit lines with a state guarantee

### ***A) Problems of bank lending in Bulgaria***

According to the current legislation in Bulgaria the bank lending process is subject to a permit regime and strict control. The bank is “a joint stock company, which deals with public attracting of deposits and uses the attracted cash resources for granting credits and for investments on its own account and on its own risk”<sup>10</sup>. The Regulation Order # 9 of the Bulgarian National Bank (BNB) determines the criteria for assessment of risk expositions of

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<sup>9</sup> Mateev, M. and M. Kilova, “Schemes and Forms of Micro-financing of Small and Medium-Sized Business in Bulgaria”, *Economy*, issues 11 and 12, 2000.

<sup>10</sup> The Act for Banks adopted on 1<sup>st</sup> of July 1997.

the banks and forming provisions that are necessary to cover the risk of losses<sup>11</sup>. In practice banks evaluate SMEs as highly risky and require collateral of more than 125 % in order to guarantee themselves at eventual provision. The size of collateral depends on the terms of the credit – the longer the term is the higher the guarantees requested by the bank are. Banks look more often for collateral with quick liquidity (such as gold, blocked deposits in BGN or in foreign currency, state securities or half of the value of the first order mortgage). They are also restricted in regard to the type of property, which the bank may accept as collateral, in case of a mortgage. Even mortgages on real estate are not highly valued as the properties (estates) are with low liquidity and their real estimation is a problem.

According to the data provided in the Report of the Agency for SMEs during the year 1999 the average interest rate on granted long-term loans in BGN was 15% for the private sector. For short-term loans in BGN the average interest rate for private enterprises was 14 % respectively. Interest rates on new credits in USD are on average 10% for short-term financing and 14% for long-term financing. Interest rates on new loans in EURO are on average 9 % for short-term and 11 % for long-term loans<sup>12</sup>.

What is the current policy of the commercial banks when granting loans to SMEs? After the Currency Board was introduced, the BNB supervision regime over the commercial banks in Bulgaria strengthened and banks became too cautious when granting new loans, especially to the sector of SMEs. Till now that policy has not been changed too much. Banks grant mostly short-term loans for working capital when a guaranteed collateral is made available (between 120 % and 180 % of the total amount of the requested loan) and preferably to clients with good reputation. Despite the permanent tendency of diminishing the basic interest rate, the interest rates on bank loans preserve their relatively high levels.

According to various research works<sup>13</sup> on SME development that have been conducted in the last few years more than half of the firms interviewed pointed out the financial barriers (lack of initial capital, lack of financing for working capital и shortage of resources for investment activities) among the three major difficulties that hamper SMEs when starting-up their activities. At the same time only 20-30 % of SMEs have applied for loans. The reasons for that could be seen mainly in the conditions under which the credit resource is being supplied and the impossibility of SMEs to comply with them. Researches show that during the last 2-3 years the majority of the requested loans have been used for working capital and their size was up to \$ 10 000. According to the Report of the Agency for SMEs the decision of a bank whether to approve a certain request for loan or to reject it depends, to a certain extent, on the collateral provided against the requested loan and on a second place – on the size of the firm and its financial state.

It is obvious that at present the process of bank lending in Bulgaria is strongly limited. According to the data provided by BNB at 30.06.2000 only around 31.5 % of all profitable assets in the bank system are in the form of outstanding loans. In principal banks avoid investing their free resources in loans, despite of the stable macroeconomic environment and other positive tendencies that have occurred after the Currency board is introduced. It could be affirmed that a real well developed lending market is missing. In practice it is impossible

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<sup>11</sup> According to the Order # 9 banks may apply more detailed and rigorous inside classification of the risk expositions following the criteria established by the internal bank rules for lending activities.

<sup>12</sup> The Report for SMEs in Bulgaria 1996 – 1999, The Agency for SMEs, 2000, p. 25.

<sup>13</sup> The Bulletin of the Foundation for Entrepreneurship Development: “*The State of Small Business in Bulgaria in 1998*” (a research of 650 SMEs in Bulgaria conducted by Sova-5 and published by the FED), The Research of the Center for Economic Development: “*SMEs and Competitiveness*”, 2000 etc.

for a small enterprise to receive a standard loan. Taken into account the fact that SME sector creates around 30 % of GDP we may conclude that 1/3 of the Bulgarian economy is devoid of granting loans. The problem is much more serious when one takes into consideration another fact – SMEs are the main source of employment in the economy and the hampered access to financial resources increases strongly the risk of higher unemployment.

#### *B) Problems for SMEs when apply for bank loans*

The specificity of the problems connected with financing and granting loans to SMEs in the transition period to a market economy is mostly determined by the character of and the extent to which the economic, legislative and socio-cultural conditions under which the SMEs operate in Bulgaria are developed. The research conducted show that SMEs come into collision with a great number of difficulties when applying for and receiving a bank loan. According to the Respondents among the most considerable impediments for SME's access to bank loans are the conditions of obtaining the loans. There are a few main barriers here:

- **Level of interest rate**

The average interest rate demanded for bank loans is between 14 % and 18 % and the representatives of SMEs consider it too high. According to 29 % of respondents this rate of interest is unbearable for the larger part of SMEs, which operate with an average profit of 10-15 %. That is also applicable to the loans granted by the Incentive Bank that was established to support the development of SMEs in Bulgaria. From the viewpoint of the financial institutions, however, this rate of interest is based on the market situation and is considered to be normal for the Bulgarian circumstances. Moreover the international financial institutions classify our country as a very risky market (and the required risk premium is higher, respectively) and set explicit conditions for granting loans at market interest levels.

- **Size and type of required collateral**

Very often SMEs are not in position to provide collateral that complies with the bank requirements for granting medium- and long-term loans. The size of required collateral varies from 120 % to 200 % of the amount of granted loan thus making it unattainable and even economically unprofitable for the enterprise (for 66% of respondents). Banks prefer as collateral a real estate mortgage in compliance with the regulations of the Order # 9 of the BNB. From the viewpoint of the financial institutions, there are several basic reasons for demanding such high collateral:

- First, the low liquidity of the collateral resulting mainly from the limited and undeveloped markets in the country;

- Second, the conservative central bank regulations in regard to the requirements for capital adequacy of the commercial banks, assessment of their risk expositions and forming provisions for covering the risk of losses;

- Third, the existence of certain legal regulations according to which granting of unduly secured loans can be subject to a legal persecution.

- **Criteria for assessment of the economic state of loan applicants**

The financial state of the enterprise and its credit history are among the basic criteria for granting loans. In practice, these conditions happen to be an invincible obstacle for starting SMEs, which cannot meet such criteria. Besides, a great part of the loan applicants - the small and medium-sized enterprises – conceal part of their profits and, for that reason, they cannot provide reliable information about their activities. It is a very frequent phenomenon that the small enterprises have no business plan and accounting documents to verify the turnover of their activities.

- **Impossibility of SMEs to make long-term financial forecast and guarantee revenues**

This “barrier” is directly related to the previous one. The absence of a long-term firm strategy and hence of any financial planning is, above all, a result of the unstable economic environment as well as of the fact that the entrepreneurs very often underestimate the necessity for scientific management of their business.

- **Expenses and clumsy procedure related to granting loans and a long period for decision-making that creates uncertainty and additional expenses for SMEs**

Granting a loan also incurs expenses for SMEs, which they cannot always afford. These expenses mainly refer to the preparation of a business plan, the fees for overall loan servicing, etc. According to 77% of respondents hiring business consultants is usually unaffordable for small enterprises.

- **Requirements for participation of SMEs with their own funds in the business project**

In many cases, the participation funds which the entrepreneur is required to have at the moment of granting a loan are excessively high. For many entrepreneurs the availability of such an amount of free resources would make seeking loans pointless. When applying for credit SMEs have minimum or zero funds of their own and it means that they expect almost 100 % funding by the bank.

- **Requirements for minimum turnover or high minimum loan size**

In practical point of view, there is no significant difference for the banks in the expenses on granting and servicing large and small loans. From this perspective and especially in such situations when the demand exceeds the supply, it is more favorable for the bank to attract a small number of big clients rather than many small loan applicants.

- **Additional requirements set by the banks**

A typical example of this is the requirement that an account should be opened at the same bank from which the loan is requested. When receiving loans from several financial institutions the respective number of accounts should be opened incurring expenses for their servicing.

- **Unwillingness of the commercial banks to grant investment loans to SMEs**

Seeking such loans is related to the overall technological and economic state of SMEs in the country. The needs of financial resources for starting SMEs, renewal of the outdated equipment in the privatized companies, increasing the production quality and the competitiveness of SMEs – all these factors determine the priority significance of the investment loans. According to the representatives of bank institutions the lack of credit resources is not an obstacle for development of the process of granting investment loans.

- **Other circumstances hampering the access of SMEs to bank loans**

Here it should be mentioned the excessive emphasis that the banks put on the collateral rather than on the future financial result when taking decision on granting a loan. Such circumstances can also be a low economic and legal culture of the loan applicants. To overcome this barrier the representatives of SMEs have proposed the following measures:

- First, organizing a special business training in which a leading role is assigned to the branch associations and non-governmental organisations;
- Second, establishing with the help of the branch associations a network for counseling services, which can support the entrepreneurs in preparation of business plans;
- Third, establishing special credit lines at relieved conditions as in some cases no presentation of a business plan is required and in other cases - they are prepared free of charge with the active support of the funding institution.

C) *Problems of commercial banks when granting loans to SMEs.* These problems can be grouped in the following directions:

- **Problems related to the legislative environment, including:**

- a) Requirements for bank capital adequacy, assessment of risk expositions and forming provisions for covering the risk of losses;
- b) Impossibility for appealing against some of the actions and decisions of the BNB in the court and unnecessary requirements for formal authorization by the National bank for a number of operations typical for bank business;
- c) Penalty responsibility for bank officers who have granted unsecured and unrepaid loans;
- d) Lack of alignment of the National accounting standards with International accounting standards in regard to granting loans;
- e) Frequent changes in the tax legislation and customs (tariff) regime;
- f) Extremely difficult collection of creditors' receivables;
- g) Prohibition for the privatized enterprise to sell or lodge assets for the period of up to 10 years after its privatization for deals that concern payments by installments, repayment of debts of the privatized enterprise, implementation of the investment program.

- **Problems related to the business environment, including:**

- a) Unstable and dynamic business environment in which enterprises cannot make long-term forecast for their activities. High corporate and other taxes hamper the investment activities of SMEs in Bulgaria;
- b) Limited and undeveloped markets in the country that leads to low liquidity of the required collateral. The most of SMEs possess assets (plant and equipment) that are, to a great extent, obsolete and cannot be used as collateral against an investment loan before the bank.

- **Subjective problems such as:**

- a) Banks often do not possess debt capital with an appropriate term structure that limits granting of long-term investment loans;
- b) Lack of sufficient training and motivation of the bank officers when granting and servicing loans to SMEs – qualification and skills of the bank staff need to be further improved.

### ***3. Barriers arising from trade policy in light of Bulgaria's EU accession***

When assessing the role of SMEs in economic development of each country one should also take into consideration the impact of recently applied trade policy, as a part of the external process of European integration and globalization, on the competitiveness of SMEs. The role and place of SMEs in Bulgarian foreign trade (imports and exports) have been considered in the Report of the Agency for SMEs for the period 1996 – 1999<sup>14</sup>. Although the share of SMEs in export activities is relatively small – around 1/5 of the entire exports of the country, we have to consider the fact that in some sectors like agriculture, construction, trade, hotels, hostels and catering services, transport and tourism, this share considerably exceeds 50 %. Considering imports the picture is much different – here the share of SMEs is around 1/3 of the total import. SMEs play an important role in the import of goods to meet the internal demand of end-user products, mainly in agriculture, trade, construction, hotels and catering services. In many cases these are specialized foreign trade firms rather than direct producers.

All these figures are an indicator of the unrealised potential of SMEs for expansion of foreign trade exchange in the country, as well as of the underestimated role of this sector by the government institutions responsible for development and implementation of the trade policy of the country. Globalisation as a character of the external transition of the country to market economy leads to a considerable increase of the requirements on the competitiveness of all firms, including SMEs, which is an essential problem for small countries with open

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<sup>14</sup> The Report for SMEs in Bulgaria 1996 – 1999, The Agency for SMEs, 2000, p. 59-60.

economies like Bulgaria. An increase of the competitiveness of SMEs could be pursued in two directions:

- First, ensuring free access of imports executed by SMEs to the internal market and thus creating a competitive environment for local production;
- Second, improving the access of export production of these enterprises to external markets through target oriented export policy and concrete measures for stimulation of export activities.

An indisputable achievement of Bulgaria's transition to a market economy is the liberalisation of the trade and currency regimes<sup>15</sup>. At the current stage the state regulation in regard to the internal market is aimed at stimulating competition and defining clear (transparency) rules for trade activities (through the Act for Defending Competition and the Act for Defending Consumers). As regards the foreign trade policy the main instruments for an overall reconstruction of the economy are the new Foreign trade regime and the Customs tariff<sup>16</sup>. They create a favorable business climate for SMEs to function in Bulgaria. The bilateral trade agreements with many countries also create new opportunities for expanding the role of SMEs in exports and thus developing a better environment for their export activities, without stimulating them directly. The most important agreement among them is the membership of Bulgaria in the World Trade Organisation (WTO), which helps expand the opportunities for Bulgarian SMEs to take advantage of the processes of liberalization of world trade and globalisation of production for achieving concrete economic goals. At the same time it is a guarantee for observing the multilaterally set rules for executing the international trade and implementing a reasonable and transparent trade policy. That is of extreme importance for those SMEs that do not possess enough tools to fight against unfair competition in international markets.

Which are the main problems and barriers for SMEs arising from the existing foreign trade policy in the country? The results of research regarding SME development in Bulgaria distinguish the following barriers:

1. Lack of sufficient protection of Bulgarian producers from unfair foreign competition. 69 per cent of respondents have pointed out that one of the serious threats for Bulgarian SMEs is the competition of subsidized imports from the European Union (EU). Moreover subsidizing exports of the West European countries makes the Bulgarian goods noncompetitive not only in internal market, but also in third country markets. That is why according to the representatives of the branch associations that have been interviewed the government has to provide a reasonable protection of the Bulgarian producers within the existing tendency of liberalization of the foreign trade. Such protection is necessary as to enable Bulgarian SMEs to adapt themselves to increased global competition.

A necessary but not sufficient step in this direction is the opportunity for Bulgarian government to negotiate with the European Commission that the production imported from the EU with "zero duties" is not subsidised (but even in this case the state stimulation for agricultural producers from the member states of EU will continue to exist although not as a direct subsidiary to exports). Another important step is to provide SMEs with easily accessible information for the requirements of the integrated European market (the single market). The adaptation of Bulgarian producers and exporters to these requirements could not be achieved without an active intervention of the state aimed at:

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<sup>15</sup> The EBRD Transition Report 1999, p. 202

<sup>16</sup> A new Customs Tariff was introduced in January 1998 based on the International Harmonized Commodity Description and the Coding system. A new Act for Customs has been adopted in January 1999 as well.



- Simplifying the administrative and legislative framework necessary for SMEs development;
- Improving the financial environment and increasing the access of SMEs to financial resources;
- Facilitating the access of SMEs to new markets, organizing training on marketing and quality management and fast introduction of the corresponding European standards (e.g. ISO 9000).

2. Lack of appropriate conditions for stimulating exports. The research conducted by the *UK Department for International Development (DFID)* and the *Foreign Investment Advisory Service (FIAS)*<sup>17</sup> show that the government does not run a target oriented policy that may create the necessary preconditions for stimulating Bulgarian exports. There is a lack of sufficient interest in society in the necessity of development of a national strategy for stimulating exports and for significant improvement of the effectiveness of different government structures assigned with similar tasks (e.g. the Center for stimulating exports, the Agency for export insurance, etc.). The 1999 Report of the EC on Bulgaria's progress towards accession pointed out that "there is not a foreign trade strategy and an overall effective policy for opening Bulgarian economy"<sup>18</sup>. This fact is confirmed by an analysis of the volume, dynamic and structure of Bulgarian foreign trade during the last 10 years. During the period 1992-1999 the trade has increased by 12.5 % from \$ 8.4 billion to \$ 9,4 billion as for the same period exports has increased by only 1.2 % and amounts to \$ 4 billion, while imports has recorded an increase by 22.4 % and reached \$ 5.5 billion. In 1999 the country registered once again a negative trade balance that is the biggest one from the beginning of the period of 10 years and amounts to \$ 1.5 billion. By June 2000 r. the trade balance is again negative and amounts to \$ 819 billion<sup>19</sup>.

According to 87 % of respondents the exceptionally high quality requirements to producers are the main barrier for Bulgarian exports, especially to the EU countries. The certification of SMEs for adopted systems of quality control in correspondance with the ISO 9000 standard is the most often applied requirement. The process itself requires participation of consultants, certified organisations and laboratories (in Bulgaria there were not more than 250 certified labs by August 2000) and considerable financial costs. The existing opportunities for stimulating Bulgarian exporters according to respondents are the following:

- Lending the export against commodity collateral. Very often big foreign trade deals cannot be executed because of impossibility of SMEs to provide for such a loan.
- Negotiating fixed export quotas both with EU and other countries that are large importers (for the period 1992 – 1999 exports to the countries of EU have recorded the biggest increase – 80.9 % compared to Balkan countries – only 3.3 % and the biggest is the decrease of exports to Russia – 72.3 %).
- For some trade agreements (e.g. those with Russia for delivery of gas and nuclear fuel) a payment of the deliveries against Bulgarian goods might be included in the contract.
- Activating the role of Bulgarian trade foreign offices. In some important countries trade representative offices are not still opened, in others – they do not work effectively enough.

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<sup>17</sup> The Report of Foreign Investment Advisory Service (FIAS): "Bulgaria - Administrative Barriers to Investment", November 1999.

<sup>18</sup> The Regular Report of the European Commission on Bulgaria's progress towards accession, October 1999.

<sup>19</sup> The Report of the Institute for Market Economy: "SMEs and Competitiveness", 2000, p. 31

- Creating better conditions for participation of Bulgarian SMEs in fairs and trade exhibitions as exclusively important for establishing trade contacts and partnerships.
- Running broad advertising and information campaigns in mass media with the financial support of the state to popularise Bulgarian goods abroad.

3. Problems arising from forthcoming accession of Bulgaria to the EU. According to 36% of respondents the main problem here is the need for quick adoption of European norms and directives in this area and its solution depends entirely on state initiative. Major obstacle again is the lack of sufficient information in regard to both the directives themselves and the requirements for control and monitoring of the production processes.

#### ***4. Barriers arising from tax and insurance policy***

In regard to the financial and tax legislation, the frequent change of the legal framework has had an unfavorable effect on SMEs for several main reasons. Bulgarian legislation is, to some extent, a product of working out the separate laws “ad hoc” without harmonization of the terms and the concepts as well as of the established specific legislative order. The adoption of different laws is, to a great extent, due to the pressure of external factors (for example under the pressure for fast harmonization of Bulgarian legislative norms with European ones), instead of the conduction of an iterative legislative policy. Shaping the laws is not always a result of preliminary research of the relevant matter and the experience of the countries with developed market economies. Sometimes adoption of foreign legal arrangements and laws takes place without conforming them to the national peculiarities. General interpretation and application of the tax laws is not always ensured, which leads to adoption of huge number of sub-normative acts, decrees and interpretation letters that often has an opposite effect. Taxes have to be imposed in order to regulate the investing behavior of economic subjects and individuals instead of killing every entrepreneurial initiative.

In Bulgaria taxation of SMEs does not differ from common taxation in the country. Companies that are registered as sole proprietors, which does not always mean they are small or medium-sized enterprises according to the requirements of the Act for SMEs are to pay advance tax installments throughout the year according to the Act for Corporate Income Taxes. At the end of the year, they form taxable income under the requirements of the Act for Personal Income Taxes. Besides there exists an “Act for Patent taxes”, which as a mode of taxation is in contradiction with the Constitution of Bulgaria (article 60), as it is not conformed to personal incomes. There is a sole alleviation in the Act for corporate income taxes concerning the small enterprises according to which at a level of taxable income up to BGN 50 000 they pay 20 per cent income tax. This is the only existing tax preference for SMEs in Bulgaria.

Based on the research conducted the main problems arising from the existing tax-insurance system can be grouped as follows:

- *First, size of the taxes and the tax-insurance burden*  
85 per cent of respondents consider that total tax and insurance burdens are too high (all taxes that a company pays are above 40 % on average per year). According to the representatives of SMEs the size of the income tax should be decreased. The insurance payment is also too high and for that reason many SMEs do not pay fees on social securities, health insurances, professional qualification, and unemployment fund to their employees. This problem can be solved easily through the introduction of a system of tax stimulation and tax alleviation. A good example of that are France and Great Britain, where the tax alleviation system is best developed in comparison with the other countries of the EU. In

France there is a minimum tax rate and it is defined on the basis of enterprise turnover. It plays as a credit against the income tax owed for the present and the following two fiscal years. In Great Britain the alleviations are incorporated in the tax legislation of the country and the limits for the turnover are voted each year within the budget. All this has a positive effect on the relatively higher share of the small and medium sized enterprises in these two countries.

Two aspects may be considered when assessing the impact of indirect taxation, namely the VAT regime and its implication. On the one hand, Bulgarian system of VAT should be put in line with the requirements of the unified system of VAT of the single market that will create the necessary stable tax environment and will facilitate Bulgarian SMEs in their foreign trade activities. On the other hand, the current VAT system discriminates against SMEs in comparison to the “big” enterprises, because it treats them only as “bearers” of the tax burden, but not as tax liable entities. In order to become tax liable entities, the firms should be registered under the Act for VAT and its annual turnover should exceed 75.000 BGN for the last 12 months. This registration threshold is too high in comparison with similar requirements in the EU countries.

The rules according to which the tax credit can be reimbursed represent another important problem that has a negative impact on the economic activities of SMEs. The tax regulatory orders that treat this matter are changing each fiscal year with a tendency to become more and more restrictive in respect to the tax liable entities. These constant changes in the Act for VAT do not allow establishing clear tax legislation and take us away from those EU regulations that are aimed at simplification and improvement of the administrative and regulatory business environment. For example, there are different tax schemes for stimulating SME that operate in different member states of the EU – alleviated, simplified, deduction etc. regimes. The system of differentiated VAT rates that is already known in almost all EU countries can also be introduced, but according to the 3-year stand-by agreement with the IMF, Bulgaria took the obligation to maintain only one tax rate for VAT (20 %).

- *Second, effectiveness of the tax administration duties*

58 per cent of representatives of SMEs that have been interviewed reproach the process of administration of tax-insurance policy. SME activities are considerably hampered by a very complex bureaucracy system that has recently been applied to the tax and insurance policy. It takes too much time and increases the costs for SMEs. That concerns the conditions for reimbursement of the tax credit<sup>20</sup> as well. In many cases the existing administrative procedures have been unnecessarily complicated, additional requirements and new heavy rules have been unofficially added, and that on its own turn creates conditions for corruption. According to the National Insurance Institute the most serious problem in regard to the administration of the insurance relationships concerns the filling in the so-called “information register” for SMEs. Creation of a State Agency for Revenues that will alleviate the administrative procedures on collection of taxes and insurance payments and will create the necessary transparency in the tax-insurance relationships, is the first positive step in that direction.

- *Third, different treatment of taxable entities*

26 per cent of respondents consider as extremely heavy barrier before SMEs in Bulgaria the existing regime of non-equal treatment of different taxable entities. That conclusion mostly

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<sup>20</sup> According to the achieved agreements with the IMF the time period for recovering the tax credit to firms is reducing from 6 to 4 months from January 2001 onwards.

refers to the production enterprises and starting-up SMEs, which are not registered under the Act for VAT and gray economy” or are gradually pushed out of the market and go into bankruptcy. That is why as far as a decrease of the registration threshold is one possible direction for changing the existing Act for VAT<sup>21</sup> towards harmonisation of our legislation with the European norms, another one could be an adoption of models for alleviated regimes of VAT payments. An alternative direction for changing the tax regime is an introduction of equal base for taxation of all taxable entities, which will create conditions for legitimisation of SME turnovers and reporting them at the “legal” market.

- *Fourth, existing tax payment discipline and taxpayers culture*

57 per cent of representatives of SMEs consider that the tax discipline and culture among them is very low at present. Most of SMEs hide their profit and thus avoid tax payment or do not pay social and health insurances. According to the Respondents the main reason for such behavior is the unfavorable economic environment in the country that fails to ensure appropriate conditions for small business development. There certainly is a mutual dependence between the limited opportunities for financing and lending to SMEs and the tax payment evasion as the hidden profit is the only source for SME development and growth. They consider the economic motivation as one of the most important conditions for strengthening the financial discipline of taxpayers and increasing the tax collection efficiency. The administrative measures and stronger audit procedures that have been recently applied in the country (which are subject to continuous changes in the tax legislation) are not enough to motivate taxpayers. There have been some suggestions in this direction:

- 1) Creating opportunities for partial VAT reimbursement to the end-users of goods; this possibility will stimulate SMEs to disclose much bigger part of their actual turnover, which now remains in the “gray economy”.

- 2) Removing the obstacles before SMEs when a legal tax document for “small” payments and deals has to be received. This problem concerns the relationships with some governmental departments and agencies that provide different kind of payable services as well.

- 3) Creating opportunities for training SME managers that will result in improving the tax discipline and economic culture of Bulgarian taxpayers and entrepreneurs. The investments in business education and training are considered by them to be very important and much more useful than the advertising campaigns in mass media with a doubtful effect.

### ***5. Barriers arising from state policy concerning SMEs development***

We talk about a consecutive state policy aimed at stimulating and supporting SME development since 1997. Besides the laws and regulations concerning the SME sector that have already been discussed an institutional framework necessary to formulate and implement the state policy in regard to SMEs has been created during the last two years. A National strategy for SME development has also been adopted. Bulgaria has joined different programs of the EU for stimulating SME development; a process of harmonization with the EU legislation in this field has already begun. The institutional framework involves the following state institutions and organisations assigned with SME sector:

1. Agency for SMEs created in 1997 as a government body, which assists the state in developing and implementing the new government policy for stimulating SME activities. The Act for SMEs was adopted in September 1997 with the help of the Agency.

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<sup>21</sup> This change will concern unfavorably retailers, individuals dealing with craft activities and those that provide services using personal labor, because they are not registered under the Act for VAT. To overcome this barrier such change should be accompanied with an introduction of alleviation regime of payment of VAT for these entrepreneurs.

2. Consultative board for SMEs created under the Act for SMEs, which is a state-public consultative body for evaluation of the impact of legislation on SMEs, with participation of representatives of different ministries, chambers, unions and branch associations of small and medium businesses. An information strategy for registration of companies and a database for SMEs have also been developed.

3. Partnership network of state, governmental and non-governmental institutions and business organizations for achieving a synergy effect of the support policy for SMEs: business centers, technological parks, incubators and innovation centers. The Agency for SMEs is working in collaboration with the Bulgarian Industrial Chamber, the Bulgarian Trade-Industry Palace, the National Association of Municipalities, etc.

The national strategy for stimulating SME development and the work program for its accomplishment adopted in 1988 play a significant role in the process of creating well-developed sector of small and medium-sized enterprises. The strategy is aimed at establishing a favorable institutional, legal, administrative, financial and competitive environment that stimulates the development of SMEs in Bulgaria. Despite all initiatives, the question about the role of the state remains contradictory and in most cases a negative attitude towards it and its policy, concerning SMEs, is prevailing. The definite position of respondents is that the state has to build such favorable economic and legislative environment where it is possible for SMEs to run a normal business. According to the answers of representatives that have been interviewed the main problems concerning the relationships between the state and SMEs are:

a) Disturbed dialogue between the state and SMEs that reflects the way of responding of the state institutions towards their suggestions. The slow reaction towards the suggestions of the branch associations or the absence of such raises a serious skepticism to the intentions of the state to conduct a constructive dialogue with the representatives of small and medium businesses and to support effectively SMEs development. Reasons for such attitude are motivated, on the one hand, with the withdrawal of the state from the direct support to SMEs and, on the other hand, with the non-efficient management of the financial resources that it owns.

b) Overall negative attitude of the state to the private business. 24 per cent of respondents consider that the policy the state formulates and executes is based on the presumption that Bulgarian entrepreneur is a potential offender. That is why the philosophy of a big part of Bulgarian legislation and the way of arranging the administrative procedures are oriented towards preventing from different breaches that has certainly an opposite effect. A great number of the problems of SMEs are local and concern their relationships with the municipality administration.

c) Clumsy procedures for registration of newly established firm and starting-up a new business that takes lots of time and requires increasing costs<sup>22</sup>. Besides the big firms and especially the big foreign companies have a privileged status compared to Bulgarian SMEs. All the research has devoted special attention to the necessity of decreasing the number of permit/license regimes<sup>23</sup>. The representatives of SMEs make a direct connection between the existence of multiple permit regimes and clumsy administrative procedures on the one hand and the widespread corruption among the government clerks on the other hand. The respondents have also expressed distrust in the state institutions and doubts for corruption and privilege attitude towards some companies in regard to the distribution of funds coming from different international programs.

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<sup>22</sup> The Research of the Institute for Market Economy: "Rules, Regulations and Transaction Costs in Transition Bulgaria", 2000.

<sup>23</sup> This recommendation is also stated in the last Regular report of the EC on the Bulgaria's progress towards accession, November 2000.

It will be interesting to present here the results of the survey done by the Institute for Market Economy. It carried out a personal interview survey of 20 firms between the 1<sup>st</sup> and 16<sup>th</sup> of June 2000. The survey was designed to collect data on compliance costs<sup>24</sup> borne by the Respondents: 12 of them are SMEs in 0-10 employee size band, 7 in the 11-50 size band and one in 51-200 size band. Some 40 per cent of respondents were registered for VAT that is they have had a turnover in excess of BGN 75 000. Table 2 shows the average number of days per year per Respondent firm spent on various types of regulatory requirements. Building permissions (27.7 man-days) are the heaviest time burden even though the results show that 75 % of firms were not involved in this activity during the year of survey. Consumer protection burden that appears to relate to the activities of local authorities in enforcing standards seems very high. However, if social security, National Insurance Institute registration and other tax formality requirements are added together then these are among the single heaviest burdens (19.8 man-days). Health and safety (14.1) and employment requirements are prominent (12.4), as is licenses/permits (15.9). The total of 155 man-days per enterprise appears high but it needs to be remembered that it includes the man-days equivalent of paid out costs to bookkeepers, accountants, etc as well as the man-days equivalent of bribes.

**Table 2**

**Average costs of compliance and non-compliance per firm<sup>25</sup>**

	Average compliance costs per enterprise in man-days p.a.
1. Building permissions	27.7
2. Consumer protection, quality of products	20.5
3. Licenses/permits	15.9
4. Safety policy	14.1
5. Health, safety and working environment	12.4
6. Premises	10.5
7. Control and inspection	8.9
8. Social security and employee's income tax	7.7
9. Payment of profit tax, VAT etc.	7.1
10. Labour contracts, maternity leaves, etc	5.7
11. National Insurance Institute registration	5.0
12. Comments on legislation and policy	4.3
13. Sector specific: import/export, vehicles	3.6
14. Court registration	2.6
15. Fire prevention	2.4
16. Company reports	1.9
17. Qualification courses	1.6
18. BULSTAT registration	1.0
19. Provision of information	0.9

<sup>24</sup> Compliance costs are administrative costs for business of dealing with regulatory requirements and include the costs of owner and staff time and paid-out costs for bookkeepers, accountants and other professionals as well as fees paid for licenses and registration. Firms, which choose not to comply wholly or partly with the regulations, also may bear time and paid-out costs in terms of penalties, fines and corruption payments (bribes).

<sup>25</sup> Resource of data: Inception Report: "Bulgaria Reform of Administrative Barriers to SME Development", Bannock Consulting Ltd., 2000

20. Collective bargaining	0.8
21. Applying for donations and deductions	0.1
<b>TOTAL:</b>	<b>154.8</b>

d) Inefficient operation of the state institutions that are concerned with the support and stimulation of SME activities. For example, the most of respondents evaluate the activities of the Agency for SMEs as ineffective. The same is true for the activities of the Center for Export stimulation that has to supply information not only on forthcoming fairs and commercial exhibitions but also on the conditions for participation of Bulgarian producers and traders in them. The prevailing attitude towards the activities of so-called “business incubators”, which status is arranged in the Act for SMEs, is that they are very ineffective – practically they do not provide any support to the starting SMEs.

e) Insufficient role of the state towards an active assignment of public orders to Bulgarian SMEs. The Respondents point out here, for example, the production of food and the possibility for the budget organizations to announce tenders for supplying with food products made in Bulgaria.

f) Unclear status of the branch associations. In this respect new legislation on their legal status is necessary, as well as some opportunities for active participation of the branch associations in shaping the state policy towards SMEs should be available.

#### **IV. RECOMMENDATIONS AGAINST THE BARRIERS**

As a result of the conducted studies and analyses of the barriers to SMEs the following recommendations on improving financial and legislative framework and enhancing the competitiveness of SMEs in Bulgaria can be made:

1. Supporting the entrepreneurs at the stage of preparation of the required documents for applying for loan from a financial institution. The support can be in one of the following forms:
  - a) Organizing specific business education at the stage of preparation of economic background of the business plans for applying for a loan;
  - b) Providing consulting services from the branch associations as to help entrepreneurs in preparing business projects.
2. Alleviating the requirements for capital adequacy of the banks, evaluation of their risk expositions and forming provisions for covering the risk of losses – mainly by changes in the related orders of the BNB (Orders # 8, 9 and 11).
3. Sharing the existing risk. It can be distributed between different institutions and through different schemes, namely:
  - a) Establishing so-called guarantee funds with an active participation of the state, which recently is the most widespread form. A great significance for encouraging starting-up of SMEs, financing of research activities or feasibility studies is attributed to the specialized risk funds, because there is no financing towards such projects at the moment.
  - b) Opening up credit lines and creating schemes for financing from international donors, which share the risk with Bulgarian banks. Such credit lines provide long-term financing and a free of charges period for the principle. Usually the foreign donors provide non-paid consulting services, for example, for preparation of business plans etc.
  - c) Sharing the risk with the insurance companies. Such opportunities, that are used very rarely, have been offered by the Agency for Export Insurance (AEI). In this way through making an insurance contract with the Agency, the quality of collateral can

- be increased against some banks. The insurance bill (promissory note) of the AEI may be used as additional low risk collateral when short-term loans are granted.
- d) Creating opportunities for an easy access of SMEs to funds for working capital and investment loans. That can be reached through introduction of standardized procedures for granting and managing loans from the commercial banks. It may result in reducing the costs on credit activities and accelerating the lending process.
  - e) Using alternative recourses for financing SME activities, for example, through granting loans from non-financial institutions.
  - f) Using non-specific forms for bringing closer the interests of banks and branch associations for achieving more favorable conditions for granting loans to SMEs. An active exchange of information between banks and branch associations may support this process.
  - g) Strengthening the role of the state that will make the support to the process of granting loans to SMEs stronger. To achieve it specific rules for development of the incentive bank's activities should be established, which can make the process of lending easier, specific schemes for encouraging the starting-up entrepreneurs should be introduced as well.

Such recommendations for abolishing the existing barriers can be made towards the other sectors – tax and insurance policy, foreign trade and customs policy, etc. The goal is that favorable conditions for developing and encouraging the small and medium business in Bulgaria have to be created towards:

- Facilitating the access of SMEs to financial recourses including bank loans and financing schemes that provide capital for newly established enterprises.
- Decreasing the tax and insurance burdens and introducing preferences and stimuli especially designed for SMEs, enhancing the tax culture and discipline of entrepreneurs.
- Introducing measures for encouraging exports and defending Bulgarian SMEs from unfair competition at the conditions of strong liberalization of foreign trade.
- Strengthening the role of the state and alleviation of the heavy and clumsy administrative procedures and license regimes, decreasing corruption among the government officials.
- Enhancing entrepreneurial culture and organization of a tailored business education that helps SMEs to apply for a loan.

## **CONCLUSION**

At present SMEs have limited funding sources. The unclear legal framework restrains donors from providing significant funds for micro and small enterprise lending. Programs that disbursed loans through commercial banks have secured larger credit lines, but have also compromised some of their social objectives. In order to minimize operating expenses and improve efficiency levels, banks prefer to serve a small number of clients while loan sizes constantly increase. Although loans are given to small and medium-sized enterprises, the needs of micro-enterprises are not usually addressed.

The restrictive and unclear legal framework does not facilitate access to public and/or private capital either. Micro-finance institutions (MFIs) that exist do not have access to the capital markets, since they cannot issue equity that can be leveraged with borrowed funds. MFIs may not attract deposits as well. None of the existing supportive programs may access to voluntary savings of the general public for the purposes of leveraging the MFIs on-lending capacity. Relevant regulations and efficient supervisory mechanisms for MFIs



would attract private institutional investment as well as banks participation in providing debt capital and/or equity investment.

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