

# STABILITY PACT

**SOUTH EAST EUROPE COMPACT FOR REFORM,  
INVESTMENT, INTEGRITY AND GROWTH**



**BULGARIA ENTERPRISE POLICY  
PERFORMANCE ASSESSMENT**

**Prepared by**

**ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT  
AND EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT**

**DECEMBER 2002**



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## **BULGARIA ENTERPRISE POLICY PERFORMANCE ASSESSMENT**



**ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT**

**The Stability Pact for South Eastern Europe** is a political declaration and framework agreement adopted in June 1999 to encourage and strengthen co-operation among the countries of South East Europe (SEE) and to facilitate, co-ordinate and streamline efforts to ensure stability and economic growth in the region. (see [www.stabilitypact.org](http://www.stabilitypact.org))

**The South East Europe Compact for Reform, Investment, Integrity and Growth (“The Investment Compact”)** is a key component of the Stability Pact under Working Table II on Economic Reconstruction, Development and Co-operation. Private investment is essential to facilitate the transition to market economy structures and to underpin social and economic development. The Investment Compact promotes and supports policy reforms that aim to improve the investment climate in South East Europe and thereby encourage investment and the development of a strong private sector. The main objectives of the Investment Compact are to:

- Improve the climate for business and investment.
- Attract and encourage private investment.
- Ensure private sector involvement in the reform process.
- Instigate and monitor the implementation of reform.

The participating SEE countries in the Investment Compact are: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Former Yugoslav Republic of Macedonia, Moldova, Romania and Serbia and Montenegro<sup>1</sup>. Building on the core principle of the Investment Compact that “ownership” of reform rests within the region itself, the Investment Compact seeks to share the long experience of OECD countries. It provides region-wide peer review and capacity building through dialogue on successful policy development and ensures identification of practical steps to implement reform and transition.

The work of the Investment Compact is actively supported and financed by seventeen OECD member countries: Austria, Belgium, Czech Republic, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Japan, Norway, Sweden, Switzerland, Turkey, United Kingdom and United States.

(see [www.investmentcompact.org](http://www.investmentcompact.org))

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This report is an output of one of the Regional Flagship Initiatives of the Investment Compact for South East Europe, a key component of Working Table II of the Stability Pact. It has been jointly produced by the OECD and EBRD with the expert advice of local consultants (Center for Economic Development). The main authors of the report are Ricardo Pinto (OECD), Francesca Pissarides (EBRD) and Elisabetta Falcetti (EBRD). Background research and support was provided by Diana Christozova (formerly of CED, Bulgaria) and Magdalena Varshilova (CED, Bulgaria), who provided the first draft. The report was initiated and has benefited significantly from input and comments from Declan Murphy, Programme Director of the Investment Compact (OECD), Antonio Fanelli, Principal Administrator (OECD, Investment Compact). Jim Bourke (consultant, Ireland) has provided expert guidance on the report.

The assessments and views expressed in this report are those of the Investment Compact Team of the OECD secretariat and the EBRD Office of the Chief Economist and do not necessarily reflect the views of the institutions participating in this enterprise policy performance assessment or of OECD and EBRD Member countries.

## NOTE

1. On 4 February 2003, the Yugoslavian Parliament adopted a new constitution for a state union called Serbia and Montenegro.

## FOREWORD

Starting a business in today's environment brings opportunities and challenges. New lifestyles demand greater choice of products and services. New technologies and greater access to global markets have provided increased business opportunities. At the same time increased competition, insistence on quality and unremitting pressure for lower costs, just to mention some issues, represent major challenges for business. For Small and Medium-sized Enterprises (SMEs) the challenge is greater. They lack scale, resources and the capacity to handle complex business management. Typically, less than half survive more than five years and only a small proportion go on to become large companies. How to ensure the growth of the SME sector – a fundamental feature of all developed and growing economies – is a major policy challenge for all countries.

This Enterprise Policy Performance Assessment (EPPA) on Bulgaria seeks to help address that challenge. SMEs are a vital source of new jobs, exports and economic contribution to countries. The South East Europe (SEE) Compact for Reform, Investment, Integrity and Growth (Investment Compact), a key component of the Stability Pact, has consistently affirmed that the economic revitalisation of South East Europe is primarily dependent on private sector investment. Through the Investment Compact process, Stability Pact partners support and promote the structural policy reforms that will improve the climate for private enterprise and increase investment. Entrepreneurship and enterprise development are important elements in creating dynamic market economies. Progress has been achieved in various areas, but the report shows that the environment for creating and sustaining businesses remains underdeveloped in Bulgaria. Reforming and improving the environment for entrepreneurship is a priority.

The EPPA draws on the practical experience and views of Bulgarian SME representatives, expert advisors and the complementary experience and skills of the Organisation for Economic Co-operation and Development (OECD) and the Office of the Chief Economist of the European Bank for Reconstruction and Development (EBRD), two Stability Pact partner organisations that have been closely involved in the reform process in transition countries.

The analysis and assessments made in this report provide valuable insights into the key issues confronting SME owners and managers and the challenges to policy makers. The Stability Pact, through the Investment Compact for South East Europe, will continue to contribute to establishing this framework in Bulgaria and in the region as a whole through regular up-dates of the information contained in this report.



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## CONCLUSIONS AND RECOMMENDATIONS

### 1.1. Summary Conclusions

The Bulgarian government is increasing the support given to the SME sector, in recognition of the growing importance of SMEs to the national economy. An illustration of this support was the adoption of the second National SME Strategy and its associated work programme in 2002, preceded by the adoption of the 1999 SME Act and the establishment of the Agency for Small and Medium-sized Enterprises (ASME) in 1997 which constitute the main framework for SME policy in Bulgaria.

This Enterprise Policy Performance Assessment (EPPA) highlights a number of issues, grounded on insights from SME owners and managers. It identifies a number of actions needed in order to build further on the progress already made in improving the policy environment for SMEs.

In overall terms, the study finds that good progress has been made by the Government of Bulgaria in setting out and beginning implementation of new policies to support the growth and development of SMEs. A stronger outreach and partnership with SMEs is needed if the opportunities for growth of the sector are to be maximised. In line with experience in other countries at a similar stage of transition to a market-based economy, there are some issues emerging relating to policy implementation. It will take a persistent and determined effort to ensure that implementation is kept on track and momentum maintained. The best way to do this is with regular progress reviews to obtain feedback to identify areas requiring renewed focus.

The main issues identified in this assessment can be summarised as relating to the practicalities of:

- Communicating and consulting effectively with SMEs spread throughout the country.
- Co-ordinating the activities of the various bodies working to support SME development.
- Reducing complexity and ensuring coherency and consistency in policy, laws, regulations, procedures and support programmes, particularly between fiscal and developmental policies.
- Avoiding unnecessary changes in laws, regulations and programmes to facilitate planning of investments.

### 1.2. Performance Assessment Recommendations

#### *Institutional Framework*

#### *Institutional Changes*

- Define clearly the relationship between SME policy-making and implementation. The continuing uncertainty as to what will be the future institutional form of the above (a separate ministry, a government agency, a merged institution, etc.) creates uncertainty within the existing organisations and undermines confidence in the State policy towards the SME sector.
- Clarify and strengthen the model that has been pursued so far, namely the Ministry of Economy supported by an SME Agency (ASME), which unlike other countries in SEE is responsible for both policy-making and implementation (since it is a governmental agency).

- Both ASME's funds and the associated reporting should be with the same organisation, namely the Ministry of Economy, in order to secure effective transparency, accountability and synergy.
- Regular (monthly) meetings between the Ministry of Economy and ASME in order to ensure implementation of SME policy generally and the national SME strategy specifically.

### ***Financial Support for ASME and the National SME Strategy***

- Secure and stabilise the medium-term future of ASME and its regional branches through a mixture of national and international resources. Having invested in the policies, strategies and institutions at national and regional level, the Ministry of Economy should take the lead in ensuring financial stability for these institutions.
- Ensure the provision of adequate financial support for the effective implementation of the second National Strategy for the Encouragement of SME Development and the associated Working Programme (2002-2006). Having developed and received Government approval for the strategy, the Ministry of Economy should ensure implementation.

### ***Regional and Local Government***

- Review the multiplicity of institutions with an SME-related remit – over 300 organisations in 19 hierarchical levels. The capacity of regional and local administrations to support SMEs should be strengthened through provision of technical assistance and resources to enhance the capacity of staff.

### ***Communication with SME Stakeholders***

- Communicate and consult with SMEs on Government policies and strategies by developing more representative, regular and permanent mechanisms for dialogue between Government and the sector, such as through better representation (ASME and other bodies representing small enterprises) on the Council for Economic Growth. This would rebalance the perception that the Government is focused on improving the business environment for large enterprises, but neglecting small enterprises.
- Strengthen the Advisory Council for SMEs (ACSME) to enable it to become a regular forum for communication and consultation with a wider range of SME stakeholders than at present. Adequate resources need to be devoted to this mechanism in order for it to be seen as an effective SME stakeholder forum which develops and presents a more coherent view on issues relating to SME policy and strategy development.
- Make more effectively use of ASME's regional network to reach a wider range of enterprises, especially in the more remote regions of the country through the creation of Regional Advisory Council for SMEs.

### ***Regulatory Environment***

#### ***Registration, De-registration, Re-registration***

- Introduce a single code number for each enterprise, in order to save time and costs to entrepreneurs submitting the same basic information to different bodies.
- Evaluate the pilot "one-stop-shop" initiatives with a view to establishing such a system throughout the country, as in the case of other part of SEE such as Romania (see OECD, 2002).
- Publish, evaluate, simplify the regulatory regimes that affect the setting-up phase of businesses. The same applies to procedures for re-registering and terminating enterprises.
- Adjust the SME definition in line with the standards of the European Union.

#### ***Regulations***

- Implement the proposed reforms identified by the Inter Ministerial Working Group on Administrative and Regulatory Environment in close co-operation with ASME. The Working Group

requires sufficient resource and capacity to recommend further reforms and monitor progress with implementation.

- Take steps to ensure the implementation of a proactive approach to regulations by introducing the principle of “silent consent” as soon as possible (“silent consent” is where if the relevant public body fails to answer within a prescribed period, it will be deemed that consent has been given).
- Ensure that the adoption of new legislation or regulation of businesses is preceded by an assessment of their likely impact on SMEs in the form of a report to Ministers.
- Present a report to the cabinet by every six months, charting progress in implementing reforms to eliminate corruption and reporting notable successes in tackling corruption. The report should be published to publicise progress made.

## **Tax Policy for Small Businesses**

### ***Policy Principles***

The Ministry of Finance and the Ministry of Economy, in co-operation with ASME, should work together to ensure that:

- Greater simplicity, stability and clarity are achieved in tax policy.
- The fiscal administration is made much more sensitive to the needs of the SME sector.
- Tax laws and regulations are consistently and fairly enforced.
- The integration of the tax system is continued.
- Consultation with SMEs or their nominated representatives on tax issues is carried out regularly.
- SMEs are able to obtain regular, simple and up-to-date information explaining the tax system.

### **VAT**

- Design the VAT refund period to facilitate cash flow, using the international standard of one month.
- Permit SMEs with turnover of less than BGN 50.000 ( 26.000) to register for VAT at their own discretion.

### ***Grey Economy***

- Strengthen efforts to collect arrears, regardless of firm size.
- Improve administration and collection rates to widen the tax base.

### ***Consultation***

- Use regional forums and seminars to ensure that the SME sector is consulted on the implementation details of forthcoming taxation developments, and is well informed / trained in advance of new tax rules coming into effect.

## **Financial Instruments for Fostering New and Small Businesses**

### ***Debt Collection***

- Improve the legal framework regulating collection from bad debtors – speed-up foreclosure procedures for available security (mortgages and registered pledges), accelerate the execution by non-secured creditors, and rationalise and tighten bankruptcy procedures. This requires a co-ordinated effort in amending several laws, such as the Commercial Code, the Banking Act, the Civil Procedural Code, the Penal Code, etc. The rationalisation of the legal framework for collection of collateral will benefit financial institutions engaged in SME lending and consequently improve the availability of finance for the SMEs.

### ***Collateral***

- Amend the central bank's regulations on the definition of collateral as "liquid collateral" for the purpose of determining the net exposures of banks. In addition to the collateral types that currently qualify as liquid, some other traditional security types could be also defined as such – guarantees by prime banks, mortgages on industrial and commercial real estate, pledges of some types of machinery and equipment (e.g. transport vehicles, agricultural equipment, machinery located at the real estate, on which the same bank has issued a mortgage loan, etc). Appropriate discounts, such as the traditional 50% on real estate could be applicable to the additional types of collateral defined as liquid. Such changes would have the immediate effect of reducing the amount of collateral required from borrowers.

### ***Diversification of Finance***

- Facilitate the repossession of leased equipment and rationalise the VAT regime for leasing activities.
- Facilitate the setting-up and operation of venture capital and direct equity investments (e.g. in the Commercial Code and Law on the Contracts and Obligations Act).
- Extend financial supervision to the lending activities of credit unions.
- Introduce the legislative framework allowing securitisation of pools of receivables. This would allow banks and leasing companies to pool loans/leases for placement to institutional investors with long investment horizons, such as life insurance companies and pension funds. This would consequently extend the maturity of the sources of finance available to financial institutions, allowing them in turn to lend for longer terms to the SME sector.

### **Advisory Services Supplied to New and Small Businesses**

#### ***Long Term Development***

- Continue to prioritise the support to SMEs through national policy focusing on subsidised business support services, especially targeting start-ups. In the longer term, competitive private provision of business advisory services may reduce the need for government or donor-funded initiatives to address market failure.

#### ***Service Provision***

- Review the range of services provided with a view to deciding how they should be developed to provide best value to fee-paying SMEs and comply with donors' targets. The objective should be to provide business advice and information services based on the priority needs of SMEs and to secure the provision of a flexible variety of services, in all regions, that will help support the competitiveness of SMEs.

#### ***Quality Standards***

- Introduce a system of certification and accreditation of advisory bodies to set quality standards and improve confidence in the benefits of services. The certification and accreditation should be carried out by a credible representative body. Related to this, business advisory centres should be encouraged to develop and publish customer charters, setting out the range of services provided and the standards they promise to adhere to. Entrepreneurs need to be informed of the potential gains from receiving professional advice before they become more willing to pay for them.

### **The Implementation of Business Incubators**

#### ***National Policy***

- Define national policy for the development of business incubators in Bulgaria.

- Allocate responsibility for the implementation of business incubators and the co-ordination of national and international funding for the creation of business incubators.
- Promote business incubators and disseminate information to Bulgarian entrepreneurs.
- Evaluate the possibility of using business incubators to support the emerging technological sector.



## INTRODUCTION

Private investment by Small and Medium-sized Enterprises (SMEs)<sup>1</sup> is a key generator of economic growth and social change in OECD member country economies. In most countries, over 90% of all enterprises are SMEs. It is now widely accepted that the contribution of SMEs to new jobs, exports, innovation and regional development is vital to national development. How to benefit from and maximise this contribution is a continuous challenge for all countries. This Enterprise Policy Performance Assessment seeks to help address that question for Bulgaria and highlight issues that require attention and priority action.

The State has a fundamental role to play in providing a favourable framework and environment for private sector development in OECD member countries. In the transition economies of South East Europe (SEE), where private investment levels lag behind those of developed countries, the necessity to create an enabling environment for SMEs and private investment is more urgent. Reform of the business and investment environment leading to the creation of a dynamic entrepreneurial culture is crucial to drive the process of change in industrial structures and the transition to market economy structures.

The OECD and the EBRD have undertaken a series of Enterprise Policy Performance Assessments (EPPAs) in all SEE countries in order to monitor the development of policies and infrastructures to support the SME sector. Substantial emphasis has been placed in eliciting the views of private SMEs on their past experience and perception of the key barriers to business and new investment, and their assessment of progress in implementing policies to encourage the development of SMEs.

Previous OECD research has identified six broad dimensions of the framework and environment supporting SME growth and development, which are particularly important for governments to get right:

- Institutional framework for SME policy.
- Rule of law and the regulatory environment.
- Tax policy for small businesses.
- Financial instruments for fostering small businesses.
- Advisory services supplied to new and small businesses.
- Implementation of business incubators.

Bulgaria has gone through a decade of democratic, economic and social transition. The Investment Compact, endorsed by the countries of SEE including Bulgaria, explicitly acknowledges that the revitalisation of the SEE region must rely primarily on private sector development and investment (Investment Compact Charter, 2001). This EPPA captures private sector insights measured against the above six dimensions of good practice. They present views on performance and progress made on the basis of good practice indicators developed for transition economies and take into account other OECD and EBRD studies for Bulgaria and other countries moving towards market based economies (see Chapter 5 - Information Sources).

The EPPA research provides a qualitative “snap-shot” of the SME perceptions of the business and investment environment. It highlights issues in need of policy attention and indicates a number of recommended actions. This report is presented as a contribution to enhance policy dialogue between the key SME representative associations and the supporting State institutions. It will be up-dated on an annual basis, thus allowing a fuller picture of progress to be developed over time.

The methodology employed in the EPPAs is set out in Box 2-1.

#### Box 2-1. EPPA Methodology

- I. The EPPA methodology has been designed to provide insights and assessments of the performance in the *implementation* of policies to improve the investment environment for business. The EPPAs have been conducted on a standard basis in all countries of the region and provide a benchmark for (a) highlighting key reform issues (b) measuring private sector insights and assessments of the business environment (c) assessing progress on a country by country basis and (d) comparative cross-country review for the SEE region.
- II. The main components of the EPPA undertaken in Bulgaria are as follows:
  - A question template was derived from extensive case study work on good practice in transition economies and OECD country experience (OECD-UNIDO, 1999) and used in the research.
  - Country-based experts/consultants were selected for their enterprise policy knowledge and experience.
  - Focus group research: focus group discussions were held with SME representatives.
  - Individual SME interviews: to validate the focus group research and to provide insights on key issues.
  - Expert interviews: to cross reference information from the focus groups and contribute to views.
  - Desk research: examination of existing reports, databases, documents, etc. for Bulgaria.
  - Expertise from OECD, EBRD and experts from OECD countries.
- III. Under the guidance of OECD, the focus group research with the private sector in Bulgaria was carried out by local Bulgarian consultant, *Centre for Economic Development* (CED), using a structured brief and template of questions developed by OECD and EBRD. The focus group research commenced in mid-2002 and other interviews and desk research extended into the second half of 2002. It focused on six dimensions of good practice in the following policy areas:
  - The Institutional Framework for SME policy.
  - Rule of Law and the Regulatory Environment.
  - Tax Policy for Small Businesses.
  - Financial Instruments for Fostering New and Small Businesses.
  - Advisory Services Supplied to New and Small Businesses.
  - The Implementation of Business Incubators.
- IV. Three focus group discussions took place in Sofia, Haskova and Plovdiv. In all, 18 entrepreneurs took part in the detailed discussions, covering the following sectors of activity: manufacturing; services; trade; tourism and transport. The participants included representatives of micro, small and medium-sized companies, ranging from start-ups to well established firms. Standard templates were used for the discussion and the collection of ratings.
- V. In addition to the focus group discussions, individual interviews with SMEs and local experts were carried out during 2002. Representatives of 12 SMEs, as well as 6 institutions, including the National Association of SMEs (a business organisation), the Agency for SMEs (the state implementation institution), BARDA (the association of regional development agencies), the Varna Business Agency (a regional NGO dealing with advisory services), the Bulgarian Craftsmen Chamber and the National Transport Chamber (a branch organisation) took part in the research, allowing for a wider perspective than the focus group discussions. The same template of questions/ratings was employed as for the focus group research.
- VI. The findings from the focus groups and interviews obtained were complemented with additional information provided by the EBRD. The EBRD's Office of the Chief Economist has assessed progress in structural and institutional reform across the region since 1994. The EBRD jointly with the World Bank launched the Business Environment and Enterprise Performance Survey (BEEPS) in 1999. The BEEPS asks enterprises to evaluate economic governance and state institutions and assess the extent to which the business environment creates obstacles to the operation and growth of their businesses. In 2002, a second stage of the BEEPS was undertaken, surveying close to 6,000 firms across 26 countries of the region.

**Box 2-1. EPPA Methodology (cont.)**

VII. The analysis in this EPPA is based on the methodologies described above (focus group research, expert interviews, secondary data collection) and is complemented by the EBRD assessment and the BEEPS 2002 results. All information has been analysed by the OECD and EBRD, resulting in the assessment presented in this EPPA.

**NOTE**

1. The notations SME and small enterprise in this report also includes micro-entreprises, which according to the EU definition ([http://europa.eu.int/comm/enterprise/enterprise\\_policy/sme\\_definition/index\\_en.htm](http://europa.eu.int/comm/enterprise/enterprise_policy/sme_definition/index_en.htm)) are independent enterprises with up to 9 employees and whose turnover or balance sheet asset value are  $\leq$  € 2 million. Small enterprise are likewise defined as having between 10 and 49 employees and turnover or balance sheet asset value of  $\leq$  € 10 million and medium sized companies as having between 50 and 250 employees and turnover of  $\leq$  € 50 million or balance sheet asset value of  $\leq$  € 43 million.



## INSIGHTS FROM SME OWNERS, MANAGERS AND REPRESENTATIVE BODIES

### 3.1. Introduction

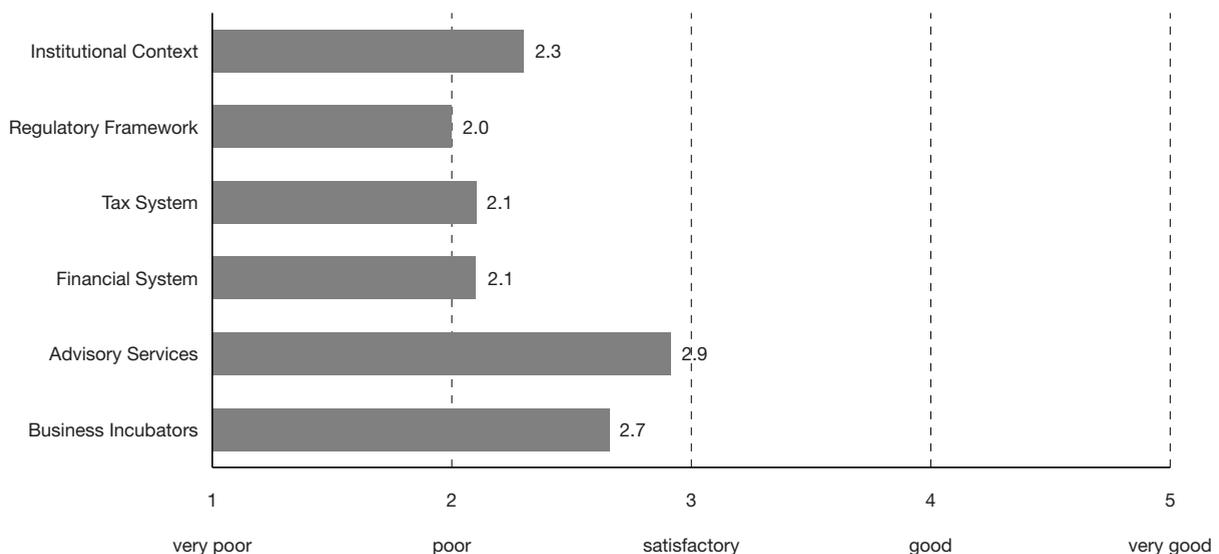
The analysis of the results of the research with the SME focus groups is presented below under six framework dimensions of good practice for the business environment:

- Institutional framework for SME policy.
- Rule of law and the regulatory environment.
- Tax policy for small businesses.
- Financial instruments for fostering small businesses.
- Advisory services supplied to new and small businesses.
- Implementation of business incubators.

The analysis highlights the main issues arising from the discussion with the private SMEs participating in the EPPA research. The key questions dealt with in the focus group research are summarised at the beginning of each section. The average ratings used to represent the views of the entrepreneurs range from 1 to 5 and can be read as follows: 1 = very poor, 2 = poor, 3 = satisfactory, 4 = good and 5 = very good.

The average ratings per dimension of good practice are highlighted in figure 3-1 below. In general, the ratings are low, with the Regulatory Framework (2.0), Tax System (2.1) and Financial System (2.1) rated the poorest of all (i.e. close to “poor”). Business Advisory Services obtained the highest average rating of all (2.9 - i.e. close to “satisfactory”).

Figure 3-1. **Average Ratings of the Six Dimensions of Good Practice by SME Owners and Managers**



The main points made by the participants during the focus groups are reported *verbatim* and the quotations most relevant to the analysis are highlighted. Each section concludes with a summary of the issues emerging from the research.

In addition, this chapter presents selected analysis of the Business Environment and Enterprise Performance Survey (BEEPS) 2002 survey. The BEEPS is a survey of 250 Bulgarian enterprises and, like the focus groups, was carried out in 2002. Of these, 211 were considered to be SMEs (of which 46% micro, 36% small and 18% medium-sized) according to the EU definition for employment (i.e. they had less than 250 employees). The results presented in this document refer only to the responses provided by the SME sub-sample. The BEEPS research is based on a sample survey and provides additional insights. The BEEPS analysis is presented in separate text boxes (for example, see box 3-1. below) and a summary of main results is contained in Appendix I.

### 3.2. Institutional Framework for SME Policy

The issues researched under this heading are:

1. Clear assignment of organisational responsibility for the development of SME policy.
2. The effectiveness of organisation/s in developing an environment to encourage entrepreneurship and the development of SMEs.
3. The quality and effectiveness of the SME development strategy.
4. The local and regional governments' mandate and resources (funding, people and skills) to promote SME development.
5. The information provided and awareness by business people of the government's institutions, policy and programmes to support new entrepreneurs and develop existing SMEs.
6. The quality and regularity of consultation between government and the private sector on SME policy and its performance and assessment.

#### Assignment of Organisational Responsibility

1. Has clear <b>organisational responsibility</b> for the development of SME policy been assigned by Government?	Yes
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Taking into account the discussions in the focus groups and interviews, the SME owners and managers participating in the research believe that the government has created a well-developed national institutional structure whose main purpose and mission is to support SMEs. The great majority of entrepreneurs participating in the research were aware of the fact that the Bulgarian government had assigned organisational responsibility for the development of SME policy to the Agency for SMEs (ASME). However, there is some doubt about its ability to encourage entrepreneurship and the development of SMEs, as indicated by both the BEEPS survey (box 3-1.) and the following quotation:

#### Box 3-1. Obstacles to Doing Business (BEEPS, 2002)

The entrepreneurs were asked to rate the severity of obstacles pertaining to several aspects of the business environment (the scores can be interpreted as follows: 1 = no obstacle; 2 = minor obstacle; 3 = moderate obstacle; 4 = major obstacle). Three areas of analysis overlap with the areas investigated through the focus groups methodology: regulation, taxation and provision of finance. On average they are rated respectively 1.7, 2.4 and 2.9 (i.e. between minor and moderate obstacles). A direct numerical comparison between the two types of analysis is not possible, due to the very different formulations of questions asked, however, the results are broadly consistent. It should be noted that the BEEPS included other areas of investigation in which obstacles of greater severity were identified, such as crime, land (title and access), labour regulations etc.

***“The institution responsible for the SME development [ASME] has been set up ... that means the state relies on it. Hence, it is meant to be efficient, but I don't believe it is.”***

**Issues:** Government is seen to have assigned organisational responsibility to ASME for SME policy implementation. Although there is some knowledge of the newly established institutional structure for SME development, there appears to be little confidence in it.

### Effectiveness of the Organisation/s

2. Rating given to the <b>effectiveness of the organisation/s</b> in developing an environment to encourage entrepreneurship and the development of SMEs	2.3
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ASME's effectiveness in developing an environment to encourage entrepreneurship and the development of SMEs was not well regarded. Despite the existence of an institutional structure, there is an absence of confidence in general in the ability of the system to meet the needs of SMEs. This problem is perceived by the focus group participants as:

***“...absence of an integrated institutional environment for business development.”***

***“Entrepreneurship in Bulgaria does not yet have appropriate structures to represent it.”***

Participants believe that the State does not really prioritise SME businesses:

***“A theoretical [rather than a concrete] SME policy approach is practised at ministerial level. Everything is based on documents ... which often have no basis in reality.”***

The participants feel that making the institutional framework more useful for them would mean a much greater focus on and customisation of support for SMEs' actual needs rather than on more abstract priorities. It would also require building effective connections and communication among institutions involved in the SME policy community, so that the entrepreneur is not turned into a mere ***“courier for those institutions”***, as is argued is broadly the case at present.

**Issues:** ASME's effectiveness in meeting the needs of SMEs in developing an environment to encourage entrepreneurship and the development of SMEs was not well perceived. The approach to support the SME sector is not considered to be sufficiently practical in nature to meet the needs of small businesses.

### SME Development Strategy

3. Rating given to the <b>quality and effectiveness</b> of the SME development strategy	2.9
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On a more positive note, the private sector rated the quality of the second and recently adopted National Strategy for SME development, which is now in its second version, as close to “satisfactory”:

***“The strategy envisages many good initiatives for SME encouragement – both at the regional and at the structural levels.”***

However, there is a concern amongst SME owners and managers in the focus groups that the strategy only pays “lip service” to SME development and:

***“... will just implement some scheme [or other], with no guarantee of a positive impact for us [SMEs].”***

**Issues:** The approval of the second National SME Strategy has not resulted in a substantial change in focus by the Government towards SMEs. There is a belief that it needs to be implemented in a more coherent manner and with adequate funding.

### Local and Regional Governments

4. Rating given to the <b>local and regional governments' mandate and resources</b> (funding, people and skills) to promote SME development	2.1
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Both regional authorities and local government have a mandate to promote SME development, however they are assessed as having limited legal powers and a poor mandate (rating of 1.8 for regional and 2.1 for local government). Furthermore, there was a common feeling that:

*“There is almost no dialogue between entrepreneurs and the administrations at local level.”*

This suggests scope for considerable improvement in this area. There is also a belief that ASME has not done enough to use its regional network and to get down to the “grass-root” level. ASME is known to be making efforts to tackle this issue, through local meetings with entrepreneurs organised jointly with local authorities, however, this effort is not perceived by SMEs as being sufficient.

The basic concerns of the participants in the focus groups focused on the perception of insufficient funding for the actual implementation of the national SME strategy, as well as the poor communication among the institutions in charge of implementing various components of the strategy's work programme. The very limited resources (rating of 1.3) to promote SME development are seen as a major constraint. There was a slightly better assessment of the human capital available (rating of 2.5) to help development:

*“Local authorities are in the worst position – the competence and the qualifications of their representatives are of very low levels. They do not have a clear idea of the problems faced by SMEs or about planning and developing appropriate regional development strategies.”*

**Issues:** Local and regional authorities are assessed to have limited powers, resources and competent staff to carry out an enterprise development function, limitations that are compounded by the lack of communication/dialogue with enterprises. A successful implementation of the SME strategy requires close co-operation between ASME and the relevant institutions. There is a belief that ASME has not yet done enough to use its regional network and to get down to the “grass-root” level.

### Information and Awareness

5. Rating given to the <b>information provided and awareness</b> of the government's institutions, policies, programmes to support new entrepreneurs and develop existing SMEs	2.2
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Information provision (2.3) and awareness (2.1) of institutions, policies and programmes, received a “poor” rating, with entrepreneurs arguing that they were not very aware of information, institutions, policies and programmes focusing on enterprise development. This was particularly noticeable for the entrepreneurs based outside Sofia. The discussion revealed that this is further complicated by a lack of trust in the State and in related institutions in general:

*“It is hard to trust the [State] institutions due to the frequent changes in legislation, retrospective nature of the starting dates of certain laws and so on.”*

**Issues:** Entrepreneurs were not very aware of institutions, policies and programmes focusing on enterprise development. There is little or no communication between private enterprises and government institutions on SME policy. This was particularly noticeable for the entrepreneurs based outside of the capital city. This is further complicated by a lack of trust in the State and in related institutions in general.

## Consultation between Government and the Private Sector

6. Rating given to the <b>quality and regularity of consultation</b> between government and the private sector on SME policy and its performance	2.0
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A further weakness in the institutional system is the pervasive view that there is a low level of dialogue and consultation between the Government and the related SME institutions and the private sector. The quality of consultation is regarded as poor (2.0). Many of the participants rated the frequency of consultation even worse (1.7). Despite the existence of an Advisory Council on SMEs, entrepreneurs argue that there is little or no communication between private enterprises and government institutions on SME policy. The Council for Economic Growth represents an attempt at enhancing government-business discussions, however, this body could be made more accessible to small businesses.

This suggests that despite the existence of some mechanisms for consultation, these are considered to be insufficient in quantity and unsatisfactory in quality and not focused on the needs of business. What limited consultative effort is made, is considered by the private sector to be “tinkering” with the notion of consultation but not really reaching down to the SMEs:

***“Entrepreneurship in Bulgaria does not yet have appropriate representation structures.”***

***“With the participation of a few big businessmen, that is the end of the matter.”***

This has the consequence that the participants maintain that the real problems of SMEs are not being addressed. Entrepreneurs feel the need for wider discussion and consultation, particularly on the following issues: tax policy, economic policy, incentives for SMEs, state-private business relations and access to information.

**Issues:** Due to insufficient consultation, there is a perception that the real problems of SMEs are not being sufficiently addressed. There is a belief that the institutional system could work better, for example, through better co-ordination and the creation of an integrated institutional environment to support SME development. The Advisory Council needs to be strengthened and SME representation in the Council for Economic Growth improved.

## Overall Summary

Entrepreneurs are aware that an institutional structure for SME development exists. However, they are not confident in general in the ability of these institutions to meet the “real” needs and priorities of SMEs. They believe that the institutional system could work better, for example through better co-ordination and creation of an integrated institutional environment to support SME development. They perceive the quality of the second version of the recently published SME strategy as satisfactory, but needing to be implemented in a more integrated and coherent manner and needing adequate funding.

Entrepreneurs argue that despite the existence of an Advisory Council on SMEs, that there is little or no communication between private enterprises and government institutions on SME policy, they are inadequately consulted, that they were not very aware of information, institutions, policies and programmes focusing on enterprise development and that this problem is accentuated with distance from the capital city. They feel that the Advisory Council should be considerably strengthened.

Local and regional authorities are recognised to have an enterprise development function, however, they have limited powers, resources and competent staff, problems which are accentuated by the lack of communication/dialogue with enterprises. Not enough is being done to reach down to the “grass-root” level, especially in the more remote or rural areas.

### 3.3. Rule of Law and Regulatory Environment

The issues researched under this heading are:

7. The formalities for new company registration and comment on the process.
8. The procedures for obtaining licenses, permits and certificates necessary for business operations and
9. The existence of a government approved programme for reducing the legal / administrative barriers for business and rating of the quality and effectiveness of this programme.
10. The efficiency of the programme for reducing the impact of corruption.
11. The quality and regularity of consultation between government and the private sector / SME policy community on draft legislation and regulations that affect business.

#### Company Registration

7. Rating given to the <b>company registration</b> procedure	2.1
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The procedure for the registration of a new company is regarded as being “poor”, mostly due to bureaucratic and unclear procedures. The participants note that they had recently witnessed some very positive developments, such as the pilot initiative on “one-stop-shops” for company registration, resulting in the processing of the necessary documentation and permits in one location. However, too many different types of documents and licenses are required in order to submit a company for registration, including papers from ministries, sanitary licenses, fire and municipal licenses. There was a strong perception that there were:

*“... simply too many procedures to go through.”* and that *“It takes too long”* to complete the formalities and to a lesser extent, that it *“costs too much.”*

Depending on the legal form (most are sole traders or limited liability companies), the standard applied costs (court fees, stamp duty, etc.) are very low, between BGN 50 and BGN 250 ( 26- 130). However, attorney fees, notarisatation costs, bank account opening costs, etc. must also be taken into consideration and it is the completion of many forms, which is time consuming and constitutes a major burden on entrepreneurs. Many comments arising from the focus group discussions relate to perceptions of officials’ incompetence and inefficiency, which often test entrepreneurs’ patience.

The view is that business registration should be standardised and operate to short timescales. Too much time and effort is required by entrepreneurs seeking to register a firm. Many of them have to rely too much on lawyers to smooth the process of registration:

*“Things are regulated to a certain extent, but there are no fixed time periods for processing the documents by the respective authorities. Every local court has created its own rules of action.”*

In the discussion on the legal framework concerning the SME sector in Bulgaria, the entrepreneurs and their representatives argue that the SME Act does not currently fulfil its aim of promoting SME development. This is because of the frequent amendments to legislation affecting enterprises, which covers too wide an array of elements, including the statutes for an SME bank (Encouragement Bank):

*“It is a framework act serving ad hoc purposes and is, therefore, very unclear.”*

The SME participants’ views are in tune with the views of the experts interviewed, suggesting that the SME legislation may be in need of review.

**Issues:** The procedure for the registration of a new company is regarded as being very difficult. Too many different types of documents are required. SMEs were keen to emphasise that the inadequate nature of the regulatory environment leads to higher conformity costs (time and money) for businesses, especially smaller enterprises, that are often unjustified.

## Licenses, Permits and Certificates

8. Rating of procedures for obtaining <b>licenses, permits and certificates</b>	N/A
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The prevailing perceptions regarding the procedures of obtaining licenses, permits and certificates are focused on the concerns that they are too numerous, time-consuming and much time is lost in securing them, though it was not possible to obtain a rating for this question. An illustrative, albeit extreme example, is of the entrepreneur who wanted to open a shop. It took him six months to obtain the necessary paperwork. In the meantime, a competitor filled-in the market niche and it was no longer worthwhile continuing with that particular kind of trade activity in that location. His business had to be liquidated shortly after opening-up.

In the course of running their businesses, the level of bureaucracy requires managers to employ additional staff simply to handle the volume of official documents in order to comply with the numerous requirements. The administrative difficulties result in much time wasting and additional labour costs that go beyond the usual taxes and charges:

*“Some of the people I employ are actually supernumerary employees of the Ministry of Finance or the Statistics Office ... [except that] I pay for them.”*

It should be noted that a proposal prepared by the Inter Ministerial Working Group on the Administrative and Regulatory Environment has been approved by the Council of Ministers. In addition a new Law on Economic Activities (defining rules for the introduction of licensing regimes, the term of validity of licenses and certificates, the application of the principle of “calm consent” instead of “calm rejection” of administration, etc.) is being prepared which should simplify matters in future.

Further business regulation issues identified in the BEEPS survey are discussed in box 3-2.

### Box 3-2. Business Regulations (BEEPS, 2002)

According to the BEEPS, the aspects of the business environment for SMEs pertaining to regulation (labour regulations, customs and trade regulations, title or leasing of land, access to land and business licensing and permits) are considered to be a less severe obstacle than the focus groups analysis suggests (average rating is 1.7, i.e. minor obstacle on an ascending scale of severity of constraints of 1 = no obstacle to 4 = major obstacle). However, variance in the rated severity of various aspects of the regulatory environment is rather high, with issues related to business licensing seen as the most difficult for entrepreneurs, followed by customs and trade regulations, labour regulations, issues related to titles or leasing of land and to access to land (respectively 2.2, 1.7, 1.6, 1.5 and 1.4).

**Issues:** The procedures for obtaining licenses, permits and certificates are said to be too numerous and time-consuming. The level of bureaucracy requires managers to employ additional staff to handle the volume of official documents in order to comply with the numerous requirements. The administrative difficulties result in higher fixed start-up costs, impacting relatively more on small enterprises than on larger ones.

## Simplification Programme

9. Rating given to the efficiency of the <b>programme for reducing administrative barriers</b> for business	2.0
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Over half of the participants in the discussions believe that there is no government-approved programme for reducing administrative barriers to business. Those who are aware of the fact that such a programme exists rate it as “poor”. Both of these perceptions are mitigated by the fact that the government initiative for reducing administrative barriers is fairly new and its effectiveness and efficiency may only become more obvious in future.

**Issues:** The current activities of the Inter Ministerial Working Group on the Administrative and Regulatory Environment to Business are either not known about or the SMEs do not feel any direct benefits arising for them. There is a need to move rapidly from proposals for reform to concrete changes, which in turn means that the Working Group requires the resources and capacity to push ahead with its agenda.

### Anti-Corruption Programme

10. Rating given to the quality and effectiveness of the <b>Government's programme for reducing the impact of corruption</b>	2.1
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Another major problem facing the business environment is the issue of corruption. Although three quarters of the respondents are aware of a government programme aimed at reducing the influence of corruption, the impact of the programme is assessed as being "poor". Comments include:

*"Over time corruption takes on different forms that are more refined and harder to recognise. It develops. For every change in law that is designed to eliminate corruption, there is always someone lobbying to retain the [tax and regulatory] loopholes."*

Despite the previous comment, it should be noted that the SME owners and managers recognise that it is too soon to assess impact, since the programme started in 2002. Some were up-beat about its likely effects:

*"The programme should prove its effectiveness from now on. I believe that it will not wipe out 100% of the corruption, but it will reduce it to 10% of its present state."*

Even if the previously expressed opinion may be on the optimistic side, there was appreciation that efforts were being made to combat corruption:

*"The good thing is that there is a predisposition to fight corruption."*

The constantly changing regulatory environment dealt with above contributes to this situation by creating ambiguity and uncertainty, thus generating scope for rent-seeking activities (see box 3-3.).

#### Box 3-3. Corruption (BEEPS, 2002)

Some evidence of corruption affecting the SME sector also emerged from the BEEPS analysis. It found that SMEs pay 1.9% of total annual sales in unofficial payments/gifts to public officials. This percentage is higher than the finding of the 1999 BEEPS (1.3%). Also, a greater percentage of firms is affected by corruption with respect to 1999, according to the same sources. In 1999, 23% of those interviewed admitted to having made frequent bribe payments, whereas in 2002, 32.8% of firms did so. Corruption is the seventh most severe obstacle to doing business (out of 21) and is rated 2.7 (i.e. between minor and moderate).

**Issues:** Corruption came through as a pervasive issue affecting the business environment. The private sector is grateful for the government focus on this issue, but most participants were realistic about its likely impact. It is too soon to assess its impact, since the programme only started in 2002.

### Consultation between Government and the Private Sector

11. Rating given to the <b>quality and regularity of consultation</b> between government and the private sector on draft legislation and regulations that affects business	1.8
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A further major problem that entrepreneurs identified is the absence of communication between them and the legislative bodies with respect to the legislation and regulations affecting businesses. The quality of consultation undertaken is considered to be “poor” (2.0) and the frequency of consultations is assessed as being even worse (1.5). This applies both at the level of individual entrepreneurs and their representative associations. A typical comment was:

**“Our association has spent a year and a lot of money to analyse the Procurement Act and to develop amendment proposals. In the end, it turned out that neither the Agency for SMEs nor the Advisory Council had the authority to influence legislative changes.”**

The previous comment reflects critical views that tend to be even worse outside Sofia:

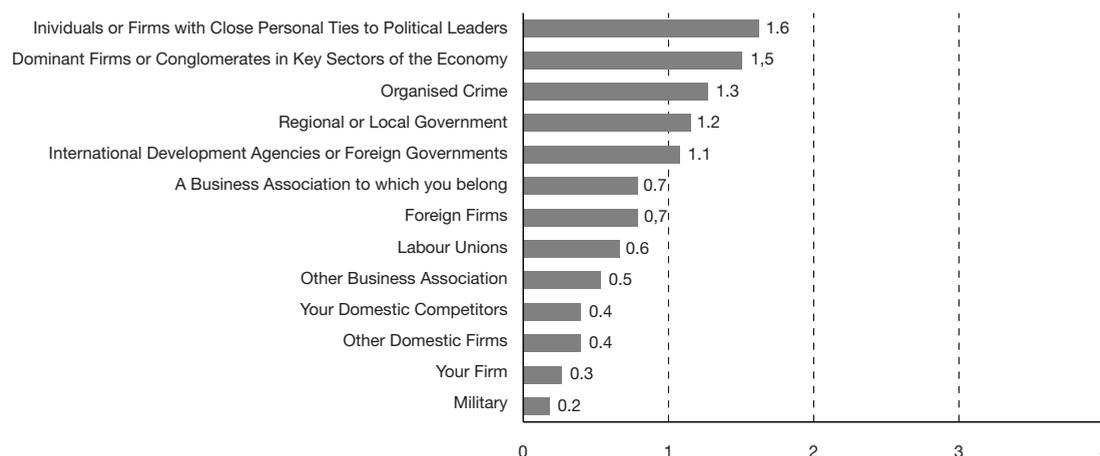
**“No one pays attention to the companies in remote areas. The State does not seek to use business organisations in order to obtain views and feedback.”**

The BEEPS survey also examines the private sector’s perceptions of the lobbying power of various organisations on the making of laws and regulations (see box 3-4.).

#### Box 3-4. Private Sector Perception of Lobbying Power of Various Entities (BEEPS, 2002)

The entrepreneurs were also asked about the link (in terms of lobbying power) between the legislative powers and regulatory authorities with various organisations and economic agents (the scores can be interpreted as follows: 0 = no impact; 1 = minor influence; 2 = moderate influence; 3 = major influence; and 4 = decisive influence). As can be seen from the chart below, firms with ties to political leaders, large firms and conglomerates in key sectors of the economy, organised crime and regional or local government are believed to be able to exercise, to a minor degree, some sort of lobbying power on the legislative and regulatory authorities. The entrepreneurs interviewed in the BEEPS believe that SMEs and their business associations have almost no impact on the making of laws and regulations.

##### How much influence do you think the following groups actually had on recently enacted national laws and regulations that have a substantial impact on your business?



**Issues:** Both the entrepreneurs and their representative bodies believe that the current mechanisms for consultation on draft legislation and reforms to the regulatory environment are inadequate and in need of considerable improvement.

## Overall Summary

The procedure for the registration of a new company is regarded as being very difficult. Too many different types of documents and licenses are required in order to submit a company for registration. SMEs were keen to emphasise that the inadequate nature of the regulatory environment leads to higher compliance costs for businesses, especially smaller enterprises, yet such costs are often unjustified. Entrepreneurs believe that business registration should be standardised and take place within a short time frame.

Entrepreneurs and their representatives were of the opinion that the SME Act does not currently adequately fulfil its aim of promoting SME development and may need review. Overall, SMEs perceive that the legal and regulatory framework is characterised by frequent changes, instability, contradiction and lack of clarity. License and permission regimes are also characterised by instability, with frequently changes. Permits and licenses are granted for too limited a period, leading to higher costs for the business preparing documents again and paying charges. They believe that consideration should once again be given to the implementation of the principle of “silent” otherwise known as “calm consent” of administration.

The current activities of the Inter Ministerial Working Group on the Administrative and Regulatory Environment are either not known about or the SMEs do not feel any direct benefits arising for them. There appears to be little confidence that the improvements proposed will be translated into real action and it will take a long time before the benefits are felt “on-the-ground” by entrepreneurs. The authorities need to move rapidly from proposals for reform to concrete changes, which in turn means that the Working Group requires the resources and capacity to forge ahead with its agenda.

Corruption came through as a pervasive issue affecting the business environment. The private sector is grateful for the government focus on this issue, but sceptical about the effectiveness of the new anti-corruption measures adopted. However, it recognises that it is too soon to assess their impact, since the programme only started in 2002.

Both the entrepreneurs and their representative bodies believe that the current mechanisms for consultation on draft legislation and reforms to the regulatory environment are inadequate and in need of considerable improvement.

### 3.4. Tax Policy for Small Businesses

The issues researched under this heading are:

12. Whether the present tax policy encourages new enterprise and rating of the tax system in terms of the encouragement, support and ease of use that it provides to new and existing SMEs.
13. The stability and transparency of the tax system for small enterprises.
14. The consultation and communication between government and the private sector on tax rates and incentives for enterprises.
15. Co-ordination of tax policy with other government policies.

#### Encouragement of Enterprises

12. Effectiveness of tax policy in terms of the <b>encouragement, support and ease of use</b> that it provides to new and existing SMEs	N/A
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Tax policy and its administrative structures are considered by many entrepreneurs to inhibit, rather than encourage the development and expansion of new enterprises. Only 11% of the SMEs participating in the research felt that the tax policy was effective in encouraging new and existing SMEs, whereas 78% felt that it was not, with the remainder unable to make a judgement. Despite recent reductions in the tax burden and a recognition that the tax system is improving and becoming more sophisticated, the private

sector is very critical of the tax administration system, not least of the poor collection rates and the levels of tax evasion. Entrepreneurs feel that this results in unfair competition and puts a higher burden on compliant taxpayers.

**Issues:** Tax policy is believed to inhibit SME development. SME owners and managers are very critical of the tax administration, low collection rates etc. which result in unfair competition and increases the burden on them.

### Stability and Transparency

13. Rating given to the <b>stability and transparency</b> of the tax system for small enterprises	2.4
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The SMEs participating in the focus groups assess the stability of the tax system as “poor” (2.2) due mainly to the many fiscal changes that they experience. This lack of stability adds to the costs of compliance and makes SMEs feel permanently vulnerable vis-à-vis the various representatives of the State since they cannot be certain that they are complying fully with the requirements of the law. This results in an unnecessarily confrontational environment between SMEs and the central/local administration:

*“... We pay a ‘penalty’ due to the underdeveloped administration and waste of time caused by the VAT Act.”*

The SME participants assess the transparency of the tax system as being between “poor” and “satisfactory” (2.6) with respect to SMEs. The main recent development in the field of corporate taxation has been a reduction in the tax rate from 20% to 15%. Nevertheless, the discussions with the entrepreneurs also reveal dissatisfaction with both the tax legislation and the perceived lack of competence of the tax administration system. Participants found it difficult to reconcile a more sophisticated tax policy with continuing poor tax collection rates. Whilst they recognise that the tax administration is constantly *“improving its work”*, they feel *“that the relevance of the ‘grey economy’ is probably increasing.”*

The common perception is that entrepreneurs will always seek to minimise their tax liability but that in Bulgaria a significant number of enterprises manages to evade taxes, thus unfairly competing with law-abiding firms. Some SME owners and managers considered that the existing tax regulations and burdens are actually pushing them to give-up or operate on the *“edges of legality”* in order to compete:

*“Everybody avoids paying taxes if they can. This is perfectly possible in Bulgaria.”*

In the focus group discussions participants proposed the following changes:

- Introducing differentiated VAT tax rates for selected goods to encourage economic development, similarly to the practice in most European countries.
- Setting a target of a 30-day VAT refund period to be achieved as soon as practical.
- Permitting SMEs to register for VAT at their own discretion.
- Reducing the time span for capital depreciation.
- Tax incentives for SMEs (e.g. tax credits for start-ups, investment in machines and R&D, new jobs).
- Making tax payment more flexible, so as to improve cash flow for small enterprises.
- Improving the administration and collection rates to widen the tax base and reduce the burden on compliant taxpayers through reduction of tax rates.

**Issues:** The tax system is not perceived to be either particularly stable or transparent, reflecting the frequent changes and the perceived lack of information and communication between government, the tax administration system and entrepreneurs. Simplicity, stability and clarity in tax policy are crucial to the enterprises and were given particular emphasis by the participants in the research.

### Consultation and Communication on Tax Policy

14. Rating given to the <b>communication between government and the private sector</b> on tax rates and incentives for enterprises	1.5
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The quality of business-government communication in the field of tax policy is perceived to be quite “poor”. The inadequacy of the current tax policy is something that, in their view, is evidenced by the lack of incentives for start-ups and the equal tax treatment, regardless of size of firm. Some highlight the point that sectors of activity which have been traditionally important:

*“... are not being promoted. Crafts are on the wane, just like the production of rose-oil, etc.”*

*“There is a general failure [by Government] to understand or want to understand what it means to do business.”*

Box 3-5. examines the ratings the BEEPS survey results for tax administration and tax rates.

#### Box 3-5. Taxation Issues (BEEPS, 2002)

According to the 2002 BEEPS, the two aspects of the business environment for SMEs pertaining to taxation, tax rates and tax administration are at 2.8 and 2.1 respectively on the BEEPS scale, indicating moderate/minor obstacles to doing business. Nevertheless, tax rates were assessed as the fifth most severe obstacles to doing business in Bulgaria (see Appendix 3).

**Issues:** The quality of business-government communication and consultation in the field of tax policy is perceived to be quite poor.

### Co-ordination of Tax Policy

15. Rating given to the tax policy <b>co-ordination</b> with the <b>overall government policy</b>	2.5
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Tax policy is not perceived to be satisfactorily integrated in the overall government policy:

*“The tax policy is not implemented in line with the economic policy of the Government and doesn’t create any incentives for SME start-up and development ... Changes are even introduced in the middle of the fiscal year, which gives companies no chance to plan.”*

Respondents were keen to point out the barriers to effective operation of their businesses. They highlighted the prolonged period of VAT refunding (theoretically three months but is said to be effectively about five months) which impedes the operation of enterprises by reducing working capital. A further issue is the duplication of tax legislation procedures, where companies have to register twice under VAT and PITA (patent taxes) and incur time and financial costs dealing with tax administration. Furthermore, businessmen argued that the handling of numerous documents and the necessity to comply with complex tax requirements takes much time and effort.

The participants perceived a contrast in policy between small and large enterprises. They argued that small enterprises are severely penalised if they do not meet their obligations in due time. The best they can hope for is to find “*small subterfuges*” in order to continue operating and even survive. By contrast, they maintain that both state-owned enterprises and certain large firms systematically fail to meet their tax obligations without experiencing any consequences. The lack of co-ordination and consistency in the application of tax policy results in perceptions of unfair competition and special privileges for large firms.

**Issues:** Entrepreneurs believe that the tax system is not co-ordinated with the overall government policy and does not encourage start-ups or development of existing small businesses. There is lack of incentives

for SME development. There is a perceived unequal treatment of SMEs vis-à-vis large enterprises. The length of the VAT refund period causes problems for smaller enterprises in particular.

### Overall Summary

The tax system is not perceived to be either particularly stable or transparent, reflecting the frequent changes and the perceived lack of information, communication and consultation between government, the tax administration system and entrepreneurs. Simplicity, stability and clarity in tax policy are crucial to the survivability and prosperity of enterprises and were given particular emphasis by the participants in the research.

Despite recent reductions in the tax burden and a recognition that the tax system is improving and becoming more sophisticated, the private sector is very critical of the tax administration system, not least of the poor collection rates and of its failure to deal with tax evasion. This results in unfair competition and puts a higher burden on compliant taxpayers.

Entrepreneurs believe that the tax system is not co-ordinated with the overall government policy and does not encourage start-ups or development of existing small businesses. They pointed to the lack of incentives and the perceived unequal treatment vis-à-vis large enterprises. Problems with the length of the VAT refund period were also mentioned.

### 3.5. Financial Instruments for New and Small Businesses

The issues researched under this heading are:

16. The stability, competitiveness and services of the banking system.
17. The commercial banks' interest in extending credits to the SME sector and lending attitude with respect to the SME sector.
18. The SME access to the following main sources of finance:
  - Own/family capital.
  - Micro finance.
  - Venture capital/Equity.
  - Others (e.g. credit unions).
  - Repatriation capital (from family / friends abroad).
  - Commercial banks.
  - Leasing.
  - Credit reference sources.
  - Bank personnel skills.
19. The availability of finance for SMEs at local and regional level.
20. The availability of funding for all sectors including technology companies.

#### Stability, Competitiveness and Services

16. Rating given to the <b>stability, competitiveness and services</b> provided by the banking system	2.7
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An increasing confidence in the banking sector is reflected in the results of the research. Entrepreneurs participating in the focus groups assessed the stability (3.5) of the banking system between “satisfactory” and “good”:

***“As compared to 1996 [when the bank crisis occurred], the banking system is stable, given the current state of the economy.”***

The degree of competitiveness was rated as close to “satisfactory” (2.5). But the services provided were regarded as “poor” and inadequate to meet demand (2.1).

**Issues:** The banking sector of Bulgaria is perceived as increasingly stable and its competitiveness is not yet satisfactory.

#### Banks' Interest / Attitude to SMEs

17. Rating given to the commercial banks <b>interest in developing SMEs</b> and their <b>lending attitude</b> to the SME sector	2.1
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Entrepreneurs assess the willingness and attitude of the commercial banks to finance SMEs as "poor". It is not uncommon for the following view to be expressed:

*"The banks should serve Bulgarian businesses, but they are not that interested in lending money [to SMEs]."*

There were also other views about the difficulties in applying for credit from commercial banks:

*"The banking legislation is to blame. The barriers to lending are numerous."*

*"The process of gaining credits is very time-consuming and the collateral requirements are unaffordable, especially for small companies".*

**Issues:** Banks are still not perceived to be very willing to supply credit to SMEs, due partly to the restrictive legislation in force, though the situation is improving, especially in the field of access to micro-finance.

#### Access to Finance

18. Rating given to the <b>access to key sources of finance</b> and guidance on financial matters to small businesses	2.5
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Access to capital is perceived by the SME owners and managers participating in the focus groups to be less than "satisfactory" in Bulgaria. In the opinion of the entrepreneurs, the key form of financing available to the SMEs is family capital, leading to the oft-repeated conclusion that: *"The only resource [credit] is family capital and funds from friends."* Access to this type of financing is rated as being "good" (4.1).

By comparison, access to credits from commercial banks is assessed as "poor" (2.2). The low level of lending is considered to be a major failure of the banking system. Entrepreneurs say that they find it difficult to obtain loans: the procedures are perceived to be time-consuming and loan security requirements are viewed to be too high. Focus group participants would like to see the establishment of a mortgage market to enable the more efficient use of immovable property in providing access to finance. Businessmen believe that: *"alternative financing schemes"* should be actively pursued, such as credit guarantee schemes, like the one recently submitted by ASME and the Encouragement Bank to the Ministry of Finance.

Table 3-1. **Relative Importance of Main Financial Sources Accessed by SMEs**

Financial Sources	Rating	Ranking
Own/family capital	4.1	1
Leasing	2.7	2
Micro finance	2.4	3
Commercial bank crediting	2.2	4
Others (e.g. credit unions)	1.8	5
Remittance capital	1.8	6
Venture capital/Equity	1.7	7

Access to micro-finance is assessed above that of commercial banks (2.4). Even though ProCredit Bank, dedicated to providing credit to the micro and small enterprises, is a relatively new institution, it has already had an impact and the Government has also been aiding the development of micro-finance through certain commercial banks. This leads to the view that:

***“This is the first time I could say that a bank was interested in my business. It is the only one that visits my premises and evaluates my ability to pay back credit and interest.”***

Access to leasing is assessed as nearly “satisfactory” (2.7) and reflects an increase in the scale of activity of Bulgarian leasing companies. According to the participants in the focus groups, access to venture and equity capital is quite poor, due partly to the fact that only a couple of the venture capital funds actually target SMEs. The low availability of venture capital activity is due mainly to the lack of viable exit opportunities for the funds. Access to financing from other sources and credit unions is also assessed as “poor”. This type of financing is scarce because of a problem rooted in the events of 1996, when many banks collapsed and caused a national bank crisis. An expert respondent feels that “... **a Credit Union Act should be adopted.**” which would allow them to collect deposits, thus filling some of the gaps in the access to finance at regional level. Remittances of capital from abroad are negligible in Bulgaria, compared with other countries in SEE.

Over and above the issue of access to finance, the quality of bank personnel skills were assessed by entrepreneurs as slightly above “satisfactory” (3.3). This may reflect the experience with individual bank managers and procedures, as well as the influence of the foreign banks that have invested in Bulgaria.

However, information on the various financial sources is considered to be of poor quality and does not meet the needs of the businesses, an issue for organisation such as ASME to address through their activities. The access to credit reference is assessed as “poor” (2.2), due to the undeveloped reference channels at both financial institutions and supplier levels.

Boxes 3-6. and 3-7. examine respectively the sources of finance for SMEs’ needs and their perception of the ease of obtaining bank loans.

#### **Box 3-6. Sources of Finance for SMEs’ Needs (BEEPS, 2002)**

According to the BEEPS, the two aspects of the business environment for SMEs pertaining to finance (cost of and access to capital) are rated between modest and moderate obstacles to doing business (respectively at 3.0 and 2.9). They are ranked third and fourth in the set of 21 potential obstacles to doing business. Overall, the survey results highlight that the relative severity of the financial obstacles appears to be secondary only to economic policy uncertainty and macroeconomic instability. Supporting this finding, an analysis of the sources of finance used by the Bulgarian entrepreneurs in the past to finance both their working capital needs and new investments shows a very heavy reliance on internal funds and loans from family and friends. This is not unlike any other country in the world, however, the dimension of the reliance on internal funds is far larger than in western economies. Private local banks account for a very small share of financing needs (3.7% for working capital requirements and 3.8% for new investment requirements), even smaller than that satisfied by state-owned banks (4.3% for working capital needs and 2.9% for investment needs). Supplier credit (6.5%) appears to be of some relevance to satisfy the financing needs for working capital and leasing companies that provide credit have some relevance in supporting new investments (2.6%). However it needs to be noted that whereas almost all companies could access some source of finance for their working capital needs only 68% of interviewed entrepreneurs could find the finance they needed for new investment. In other words only two thirds of planned investment could be realised. At present, foreign-owned banks are virtually irrelevant in the provision of finance to the SME sector. The following table presents the relevance of sources of finance used by interviewed entrepreneurs for working capital needs and to finance new investments in percentage of total.

**Box 3-6. Sources of Finance for SMEs' Needs (BEEPS, 2002) (cont.)**

Working Capital		New Investment	
Internal Funds	68.1	Internal Funds	73.2
Family/friends	7.3	Family/friends	5.7
Supplier credit	6.5	State-Owned banks	4.3
State-Owned banks	4.6	Private local banks	3.8
Private local banks	3.7	Leasing	2.6
Government	2.9	Government	2.3
Money lenders	2.1	Other	2.1
Other	1.5	Money lenders	1.6
Customer credit	1.2	Supplier credit	1.5
Foreign banks	1.2	Foreign banks	1.5
Leasing	0.9	Equity	1.4
Equity	0.1	Customer credit	0.0
Credit cards	0.0	Credit cards	0.0

**Box 3-7. SMEs' Perception of Ease of Obtaining a Bank Loan for Working Capital/Investment Needs (BEEPS, 2002)**

A further question was asked regarding the entrepreneurs' perception of the ease with which they would be able to obtain a loan from a commercial bank for both working capital needs and for financing a new investment. The answers appear to be very negative and supportive of the reality in terms of sources of finance used in the past as presented in the previous box. It is worth noting that SMEs believe that accessing bank loans for the financing of new investments is relatively more difficult than accessing working capital loans from banks. The entrepreneurs' responses to this question are presented below in percentage of total.

	Working Capital	New Investment
Impossible	7%	12%
Very Difficult	41%	40%
Fairly Difficult	27%	27%
Fairly Easy	14%	11%
Very Easy	4%	3%
N/A	6%	7%

**Issues:** The availability of alternative sources of finance is very limited, the key form of financing available to the SMEs is family capital. Access to venture capital, credit unions, etc. is underdeveloped. Lending is considered to be a major problem of the banking system and the procedures are perceived to be time-consuming with high loan security requirements. By contrast, SMEs acknowledge the increasing opportunities offered by micro-finance but would like to see targeted efforts to develop additional financial vehicles and information on the various financial sources is considered to be of poor quality and does not meet the needs of the business.

#### Access at Local and Regional Levels

19. Rating given to the access to finance at **local and regional levels**

1.4

Access to finance at both the local (1.2) and regional (1.5) level is assessed to lie between “poor” and “very poor”, with over 25% of the entrepreneurs believing that such sources are not in fact available.

### Access by Sector

20. Rating given to the access to <b>financial sources for all sectors</b> including technology companies	1.8
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The availability of financing to all sectors of economic activity is equally assessed as being “poor”. Financing is normally available to the sectors perceived by financial institutions as having good medium-term prospects and important for the economy, such as food, agriculture and tourism. Although the high technology sector is trumpeted as a major priority for government, the actual financial support to the sector remains limited in the view of the SMEs participating in the focus groups.

### Overall Summary

The banking sector of Bulgaria is perceived as increasingly stable which might be an indicator that confidence in it is returning.

Banks are still perceived as not being willing to supply credit to SMEs, partly due to the restrictive, albeit improving, legislation, especially in the field of micro-finance provision.

The availability of alternative sources of finance, as well as of local and regional funding sources, is very limited, and targeted efforts should be made to develop those financial vehicles.

Information on the various financial sources is considered to be of poor quality and does not meet the needs of the business.

### 3.6. Advisory Services for New and Small Businesses

The issues researched under this heading:

21. Satisfaction with the range and quality of advisory services available to new entrepreneurs and SMEs and rating of the present services and comment on the changes needed.
22. Efficiency of advisory services operations.
23. Responsiveness of advisory services provided to demand and the needs of enterprises.
24. The skills, experience and quality of the staff providing business advisory services.
25. The continuity of business advisory services available.

### Range of Advisory Services

21. Rating given to the satisfaction with the <b>range of advisory services available</b> to new entrepreneurs and existing SMEs	2.7
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Entrepreneurs note that recent years have witnessed rapid developments in the field of business advisory services in Bulgaria. A rating close to “satisfactory” was obtained for both the range and the quality of advisory services available to new entrepreneurs and existing firms. No distinction was made between private firms and donor/government-funded business advisory centres – both are perceived to offer close to a “satisfactory” range of advisory services to SMEs and start-ups.

### Efficiency of Advisory Services

22. Rating given to the <b>efficiency of advisory services</b> available to SMEs	2.7
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Again a fairly “satisfactory” assessment was made of the efficiency of the advisory services on offer. Entrepreneurs trust foreign advisors more than local ones. This may be partly due to the concerns over use of commercially sensitive information if provided to local advisers. However, another reason seems to be the perception of:

***“The extremely uncommercial approach of Bulgarian companies.”***

There is a consistent perception that:

***“Consultancy activities in Bulgaria are very expensive and few companies can afford to use them.”***

The respondents would prefer to see alternative forms of advisory services, such as free advisory services and also:

***“A [greater degree of] co-ordination of donor advisors and business organisations to guarantee that services reach the maximum number of firms.”***

**Issues:** The efficiency of the existing advisory services is rated as being “satisfactory” but foreign advisors are trusted and used more than local ones. Greater co-ordination would be beneficial.

### Responsiveness to Demand

23. Rating given to the <b>responsiveness of advisory services</b> to demand and needs	2.7
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There is a feeling that the services on offer are fairly responsive to the needs of the entrepreneurs. Nevertheless, as mentioned above, entrepreneurs prefer to receive such services from foreign consultants, rather than locals and ideally for free:

***“Naturally, free advisory services are useful and they are adequate to meet my needs, whereas paid consultancy is too expensive for small companies.”***

But there was also the view that:

***“Both free and paid for advisory services are useful. All information is helpful, but I think that paid services are the best. Free services are mostly in the form of seminars and meetings. In many cases, they do not touch the concrete problems of entrepreneurs. They are too general.”***

Entrepreneurs felt that tax planning and tax protection, insolvency, investment strategies, cash flow management, insurance, credit, import and export, and quality certification, were areas where it would be useful to have advisory services. Access to market information, EU quality standards and advisory information databases are also regarded as areas of interest to SMEs.

**Issues:** Although the services on offer are considered to be fairly responsive to SMEs’ needs, they tend to be quite general and there are a number of gaps in provision which need to be covered by the market.

### Human Capital

24. Rating given to the <b>skills, experience and quality of the staff</b> providing advisory services	3.3
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There is satisfaction with the skills (3.5), experience (2.9) and quality (3.6) of the business advisory services experienced by the SMEs participating in the research. Entrepreneurs perceive a gradual improvement of the skills, experience and quality of the staff offering business services and thus delivered an assessment between “satisfactory” and “good”:

*“The quality of the advisory services provided is high enough. The advisors should possess certain high-level qualifications and skills, and they have been gaining in experience.”*

**Issues:** There is broad approval of the consultants' skills and professionalism, however, the cost is perceived to be unaffordable for many companies. Donor advisors and business organisations need to co-ordinate activities to ensure that services reach the maximum number of people.

### Continuity of Business Advisory Services

No issues emerged on this topic.

### Overall Summary:

Businesses are generally satisfied with the range and quality of the business support services available in Bulgaria and would use them in future. The skills and quality on offer to entrepreneurs are also regarded positively. No distinction was made between private firms and donor/government-funded business advisory centres.

The efficiency of the existing advisory services was rated as being “satisfactory”. However, entrepreneurs trust and use foreign advisors more than local ones. The range of services on offer is regarded as being fairly responsive to the needs of the entrepreneurs. There is broad approval of the consultants' skills and professionalism, because relevant and useful experience is gradually being developed. Entrepreneurs appreciate the services offered, however, they regard the price of these advisory services to be too high, making them unaffordable for many companies, with some wanting to have the services provided for free.

It was proposed that donor advisors and business organisations should work more closely together with a view to ensuring that services reach the maximum number of people.

The main areas in which advisory services are needed are market information tax planning and tax protection, insolvency, investment strategies, cash flow management, insurance, credit, import and export EU quality standards and quality certification.

### 3.7. Business Incubators

The issues examined under this heading were:

25. Experience with business incubators and importance to new entrepreneurs and existing SMEs.
26. The efficiency of the government policy and programme encouraging business incubators.
27. The state of the business incubators' governance structures.
28. The locations, the infrastructure and facilities of business incubators.
29. The extent the business incubators' activities are focussed on the needs of the local entrepreneurs.
30. The extent to which the operating conditions, services and charges are transparent and clear.

### Experience of Business Incubators

25. Rating given to the business incubators' <b>importance</b> to new entrepreneurs and existing SMEs	3.4
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Given the poor level of information possessed by entrepreneurs on business incubators, the following assessments should be treated with some caution. The great majority of SME entrepreneurs in the focus groups did not have any idea about the nature, aims and the functions of business incubators. Only a small circle of people was aware of the services provided by business incubators and these tended to be the representatives of associations, chambers of commerce branches and business organisations. The main reasons for this are the limited number of business incubators and the lack of information about them in business circles.

***“What are business incubators?”***

This was a question frequently asked. Businessmen are not familiar with the types of services provided, the operation conditions and the rents involved. Notwithstanding this, there was a distinctly positive predisposition towards the development of business incubators in Bulgaria. The participants recognised that such initiatives could be significant for both start-ups and established companies:

***“Business incubators provide firms with useful production space, facilities, cover certain start-up costs ... and provide advice.”***

**Issues:** The majority of the entrepreneurs in the focus groups did not have any idea about the nature, aims and the functions of business incubators but consider them to be an important tool for supporting enterprise development.

**Government Policy**

26. Rating given to the <b>efficiency of the government policy</b> encouraging business incubators	2.5
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Participants assess the Government's policy for promoting business incubator as less than “satisfactory”, mainly because they do not know much about it. Despite the lack of detailed knowledge about incubators, the participants recognised that such a service could be significant for both start-ups and established companies. Anything that supports businesses in Bulgaria is attractive to entrepreneurs, some arguing that:

***“It would be useful even if there were no benefits. It would be worthwhile just for the possibility of establishing contacts.”***

**Issues:** Business incubator is an unknown SME development policy tool to the entrepreneurs. They are not well aware of government policy for the establishment of business incubators.

**State of the Business Incubators Governance Structures**

The business incubator project implementation is regarded, by those that have some knowledge of this, as being overly complicated by its administrative procedures and implementation. The general lack of knowledge about business incubators means that they were not able to rate the state of the governance structures in Bulgaria.

**Business Incubators Location, Infrastructure and Facilities**

27. Rating given to the <b>location, infrastructure and facilities</b> of the business incubators	2.8
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Participants believe that the number of business incubators should be increased, to help raise Bulgarian companies' competitiveness upon accession to the European Union. A view was expressed that:

***“It is advisable to multiply projects related to complementary companies, mutually beneficial companies, and not to a particular branch, with a view to create business oases.”***

This suggests that entrepreneurs in Bulgaria tend to mix-up the concept of business incubators with that of industrial clusters.

**Issues:** SMEs believe that business incubators could help raise Bulgarian companies' competitiveness upon accession to the European Union but are unclear about the concept.

**Focus on Needs**

29. Rating given to the extent to which the business incubators' activities <b>satisfy the local entrepreneurs' needs</b>	2.1
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SME owners and managers participating in the focus groups felt that these activities currently do not satisfy the entrepreneurs' needs, mainly because of the entrepreneurs' ignorance, compounded by the limited number of existing incubators.

The general concept of business incubators, aiming to promote start-ups and established companies, was treated with caution by some participants in the focus groups. This reflected some respondents' doubt that donor funds in Bulgaria are actually used for their intended purpose. There is a prevalent view that:

*"We've survived without business incubators, so the others can also do without them."*

**Issues:** Some SMEs were not entirely convinced about the concept of business incubators, reflecting some concern that donor funds may not be actually used for their intended purpose in Bulgaria.

**Transparency**

Due to the lack of specific knowledge by participants, no feedback was obtained on this question.

**Overall Summary**

Entrepreneurs are largely ignorant of the existence and potential benefits of business incubators. The participants who do know about them, mainly from the business associations, recognised the potential offered by business incubators with respect to start-ups and early stages of business development.

Participants assess the policy promoting business incubator as being rather ineffective and those that know about them felt that these activities currently are poor at meeting entrepreneurs' needs. At the same time, some believe that donor resources may not always be used as originally intended. They would be interested in benefiting from business incubators and urged the government to promote these initiatives, partly as a response to overcoming the major problems experienced in obtaining business premises.



## ANALYSIS AND ASSESSMENT

The analysis of the discussions with the owners and managers of SMEs were presented in the preceding chapter of this report. This chapter presents the OECD-EBRD analysis and assessment of the six dimensions of good practice for the business environment. It reviews the current situation in each of these areas; takes into account other OECD and EBRD studies and analyses of good practice; and the private sector views, based on the qualitative research presented in the previous section. The assessment of the current situation leads to a series of recommendations by the OECD and EBRD, presented in chapter 1.

### 4.1. Implementation of the Institutional Framework for SME Policy

#### *The Situation on the Institutional Framework*

The *Small and Medium-sized Enterprises Act* (SMEA) passed in 1999, sets the following targets:

- Formulation of a comprehensive definition of SMEs.
- Establishment of a register of SMEs.
- Provision of information and training to SMEs.
- Elaboration of the statute for the Agency for Small and Medium-sized Enterprises (ASME), first set-up in 1997.
- Establishment of an Advisory Council for SMEs as an advisory body for ASME.
- Elaboration of the statute for the Encouragement Bank whose mandate is to provide finance to SMEs.
- Establishment of a Credit Guarantee Fund.
- Provision of preferential treatment to SMEs in the privatisation and the lease of state-owned and municipal property.

Both the development of SME policy and its implementation is the responsibility of *Agency for Small and Medium-sized Enterprises* (ASME). With the adoption in 1999 of the SME Act, ASME started operating and reporting to the Council of Ministers, though it receives its budget from the Ministry of Economy. Its focus is on helping develop government SME policy and the promotion and implementation of the National Strategy for Encouragement of SME Development and its associated Work Programme. ASME has six regional offices (in Bourgas, Varna, Vidin, Plovdiv, Rousse, and Sofia) and 29 staff, however, it operates with very limited financial resources, mainly provided by donors.

ASME's functions and priorities currently include:

- Improving the business environment by simplifying licensing, permission and registration regimes, which impact on the work of SMEs. ASME co-ordinates its activities with the *Inter Ministerial Working Group on the Administrative and Regulatory Environment*, charged with proposing measures for reducing and simplifying the regulatory regime.
- Developing a Credit Guarantee Fund to promote SME development.
- Implementing a Training Programme for small entrepreneurs.
- Developing a web site dedicated to provision of relevant information for the SME sector.

- Developing regional co-operation with SMEs in the South East Europe region.
- Organising a Balkan Forum of SMEs to improve contacts and co-operation.

There has been a long-running discussion about the *future of ASME*. The on-going uncertainty about the structure of future institutional support to SMEs is damaging. Several options are being considered:

- Downgrading AMSE from a “governmental” to an “executive” agency.
- Making ASME report to the Ministry for Economy, as well as being funded by it (as prior to 1999).
- Merging ASME with the Agency for Trade Promotion, resulting in a combined executive agency.
- Transforming ASME into a Ministry with a specific SME remit, etc.

The SME Act resulted in the creation of the *Advisory Council for SMEs* as a consultative body to support the work of ASME in defining the priorities for the SME promotion and development. Its representatives include ministries, chambers, unions and branch organisations. Its functions include analysing the current state of SMEs and preparing an annual report on legislative initiatives. There is common agreement that the Advisory Council, though well intended, has failed to live up to SME expectations. It is in the process of being reformed by ASME in order to represent the interests of the SME sector in an effective and proactive manner. In this respect, ASME has considered creating *sub-regional Advisory Boards* to enable improved representation outside the capital city, however, this has yet to happen.

The *National Strategy to Encourage SME Development (2002-2006)*, the second of such strategies, seeks to create a favourable environment for the development of a competitive SME sector by:

- Creating a simplified administrative and regulatory environment for SMEs.
- Enhancing access to financial sources.
- Supporting innovation and technological development.
- Stimulating increased European orientation/ globalisation of SMEs.
- Providing improved access to business information and services.
- Creating conditions for SME development at regional level.
- Promoting a culture of entrepreneurship.

The *Working Programme*, developed in accordance with the National Strategy, contains short-, medium- (2003 – 2004) and long-term (2005 – 2006) objectives, including specific measures and actions identified to achieve the objectives of the National Strategy.

Several *ministries* have a direct influence on SMEs: Economy, Finance, Regional Development and Public Works, and Transport and Communications. Others with an influence on the formation and implementation of the government policy on SMEs include Agriculture and Forestry, Foreign Affairs and Environment and Water.

*Regional state administration and local self-government* have an important role in enterprise development. Research (CED, 2001a) reveals that as many as 309 structural units have administrative influence on SMEs, with 19 hierarchy levels in central government administration alone, and at least a further four in the local administrations. This amounts to a complex and fragmented structure.

A growing number of *other institutions* are of importance for the SME sector, the most notable ones being the Trade Promotion Executive Agency, Export Insurance Agency, Bulgarian Foreign Investment Agency, Bulgarian Association of Regional Development Agencies and Business Centres (BARDA), Bulgarian Chamber of Commerce and Industry, Bulgarian Industrial Association, Union of Private Economic Enterprises and National Association of SMEs.

Box 4-1. sets out the current situation with respect to EU accession, the associated pre-accession funds and the Small Enterprise Charter, which was signed by Bulgaria in 2002.

#### Box 4-1. EU Accession, SME Funds and the Small Enterprise Charter

The European Commission (EC) supports Bulgaria (and Romania) in achieving their objective to join the EU in 2007. A detailed “roadmap” for accession outlines the process involved, as well as the pre-accession assistance funds available, including SME support (EC, 2002a). Negotiations on the SME chapter of the *acquis communautaire* have been provisionally closed. It covers the areas of enterprise policy, distributive trades, tourism and social economy, and consists largely of decisions setting up consultation procedures and Community programmes, and recommendations. These do not require transposition into the national legal order of the candidate countries, nor implementation and enforcement measures. The only exception is a Directive on tourism statistics (95/57/EC). The subject of this chapter of the *acquis communautaire* is important in the context of economic development and the capacity to withstand external competitive pressures. Three areas are of particular relevance:

- Overall enterprise/SME policy formulation and implementation.
- General business environment in the country.
- Adoption and application of the SME definition.

The policy issues of particular importance to small enterprises are set out in the “European Charter for Small Enterprises” (EC, 2002b), which was adopted by EU countries in June 2000. The candidate countries endorsed this Charter at a meeting in Mariborg (Slovenia) in April 2002. The key lines of actions, as defined in the Charter, are:

- Education, Training Entrepreneurship.
- Cheaper and Faster Start-up.
- Better Legislation and Regulation.
- Availability of Skills.
- Improving Online Access.
- Getting more out of the Single Market.
- Taxation and Financial Matters.
- Strengthen Technological Capacity.
- E-Business Models and Small Business Support.
- Representation of Small Business Interests.

Bulgaria has made some progress in preparing the institutional framework to administer firstly the pre-accession assistance and, in due course, the structural and cohesion funds. A National Development Plan covering the period 2002-2005 was approved in 2002. The Bulgarian Association of Regional Development Agencies (BARDA) was created in 1997 and now consists of 33 agencies and business centres for regional economic development. BARDA’s mission is to enhance the economic environment in Bulgaria by increasing entrepreneurial initiative and employment at regional level, in concert with economic development strategies of regions, as well as through participation in regional development policy making. BARDA member agencies gather together representatives of local government, chambers of commerce, branch unions, local business associations, vocational training institutions, academia, banks, and private companies. They reflect a broad representation of regional actors involved in the SME and regional development support area. However, weaknesses remain in the effective implementation of the funds, such as legal framework, the provisions for management, monitoring, evaluation, financial and budgetary management and control, etc. (EC, 2002a, p.17).

#### Assessment

The Bulgarian Government and ASME have made considerable efforts to develop an extensive institutional framework for SMEs in Bulgaria and to engage with and be more visible to the SME policy community. However, SMEs feel that much more needs to be done, as they still have insufficient familiarity with the key institutions in the country supporting SME development and with their mandate and they rate the effectiveness of these institutions as “poor”.

Entrepreneurs thought that the SME Act does not currently fulfil its aim of promoting SME development. The major achievements the SME Act to date have been the regulation of the ASME statute and the normative definition of SMEs. The implementation of the initiatives for improving access to financing and

for preferential treatment of SMEs in the privatisation and the lease of state-owned and municipal property has not yet taken place. The nature of the Act, covering a large number of diverse issues, mean that there may be a need for a review four years after it became law in 1999.

The allocation of powers and responsibilities between the key organisations in the central government administration is not entirely clear. The SME Act determined that ASME, as a governmental agency, should both determine policy and implement it. The result is that it reports to the Council of Ministers but its budget comes from the Ministry of Economy. This results in unclear reporting and accountability, and lack of effective co-operation to the detriment of SME development.

The institutional context needs to be clarified and stabilised. The history of SME development in Bulgaria suggests that it is essential to have a stable and effective institution to co-ordinate and implement SME policy and strategy, with sufficient resources to fulfil its remit. The effectiveness of ASME has been variable but improving, as acknowledged by the SMEs participating in the research. For accountability and synergistic reasons, ASME should report to the organisation that funds it, presently the Ministry of Economy. Merger with another agency is likely to lead to a dilution of ASME's mandate, at a point in time when it needs to prove itself to the SME community. The debate about the future of ASME and the associated uncertainty has lasted over six months. There is an urgent need for a decision about the future structure of SME policy making and implementation.

The quality of the second National Strategy for SME development is regarded by entrepreneurs as being satisfactory. The priorities of the National Strategy are well formulated and largely reflect the current situation and the basic problems that the Bulgarian SME sector faces. The issue of the financial resources needed for its implementation needs to be addressed, since funds have not been explicitly allocated. This leads the participants in the research to assume that the Government might only be paying "lip-service" to the needs of the sector, without being seriously committed.

In general the public sector institutions seem to be committed, however, their efficiency is still low. Entrepreneurs, particularly those outside the capital city, are generally unaware of institutions, policies and programmes available to support SME development. This is accompanied by low trust in the State and institutions in general. Firms located in less dynamic and more remote regions in Bulgaria, especially the smaller ones, simply do not feel that they are included in the policy-making process and thus that their views do not count. There is a need for mechanisms to encourage greater participation and input in the policy-making process, perhaps building on ASME's concept of sub-regional Advisory Boards.

There are many administrative layers of responsibility for economic development. The district and municipal administrations have very limited powers and almost are almost completely lacking financial resources and the expertise of the staff in these units is in need of development. The large number of structures dealing with the SME sector makes efficient co-ordination and subordination of these structures a key priority. There is a need to develop and present a more coherent view to government with respect to SME policy and development than is the case at present, where numerous organisations undertake their own activities with little co-ordination or reference to each other.

Entrepreneurs think that the institutions supporting SME development neither provide SMEs with sufficient information nor offer equal access to their programmes to all SMEs. They also believe that measures introduced and/or repealed are not necessarily geared to develop the small business sector. Participants in the research believe local government currently does not have sufficient resources or skills for promoting and advising on SME development.

The issue of consultation and dialogue with the SME policy community and the business sector is of paramount importance. Whilst recognising that the government has taken steps to improve the consultation mechanism and that it is not practical to consult with individual enterprises, entrepreneurs think that consultations are just for appearance's sake and that the institutions are not really interested in the SMEs' problems. The Advisory Council, the main mechanism for regular dialogue between ASME/Ministry for SMEs

and SME representatives, is not operating effectively. There is a need to enhance the mechanisms for regular dialogue between government and the enterprise sector at national and regional level.

## 4.2. Implementation of the Rule of Law and the Regulatory Environment

### *The Situation on the Rule of Law and the Regulatory Environment*

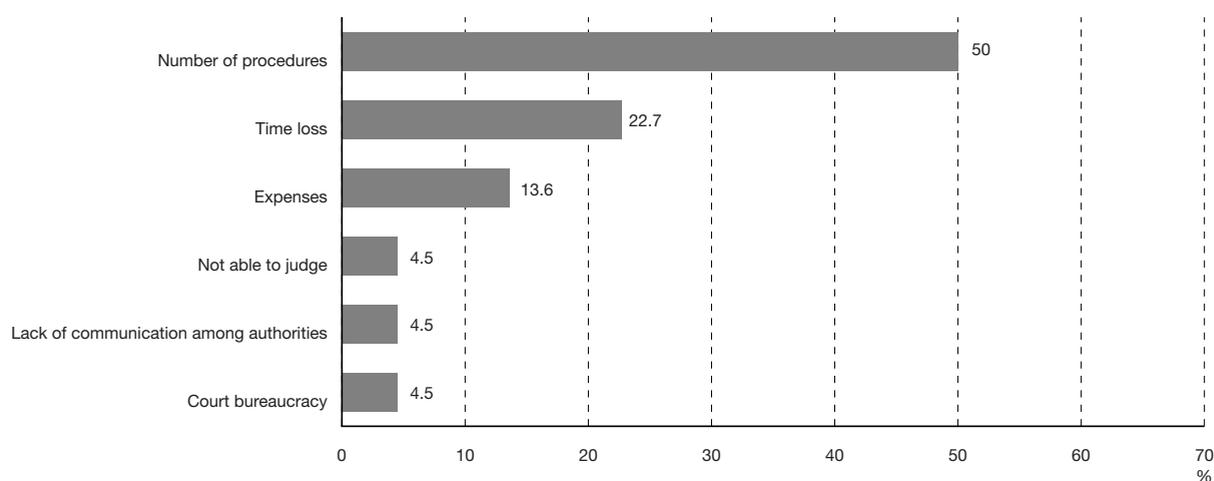
The legal requirements for *company registration* in Bulgaria involve a number of distinct steps:

- Certificate of “uniqueness” of the company issued by the National Statistical Institute.
- Court decision for registration of the company in the Companies’ Register.
- Entry in the BULSTAT (Bulgarian Statistics Office) Register.
- Registration with the National Social Security Institute.
- Registration with the Tax Administration.

It should be noted that in every stage of the registration procedure, the applicants must often submit copies of the same documents to different institutions.

The finalisation of all five different types of required registrations takes at least one month. The entry of a new firm in Bulgaria requires an average of 10 *documents*, a period of 27 *business days* and costs 199 (see World Bank, 2001a). Figure 4-1. presents the views of SMEs emerging from the focus groups on the main barriers to a new company registration and shows that 50% ranked the number of procedures as the major issue, followed by time spent completing forms (23%).

Figure 4-1. **Views Of SMEs On The Main Barriers To New Company Registration**



Source: EPPA Focus Groups.

*The process of starting up a business* involves considerable costs. The standard costs of between BGN 50 and BGN 250 (€26-€130) only represent a small proportion of the cost involved in practice since attorney fees, notarisational costs, bank account opening costs, etc. must also be taken into consideration. However, the entrepreneurs in the focus groups believe that the need to fill a large number of complex forms constituted the biggest burden at the time they started their business. Every administration has worked out its own forms to be filled with the required information, in many cases leading to duplication of information provided to the various institutions.

According to a study by the Agency for Social and Economic Analysis (2000), entrepreneurs mainly obtain information about the necessary documents for registration and licensing from colleagues, the Official Gazette etc. ASME has developed a database where company registration procedures are stored and up-dated. This is a welcome initiative that will result in cost reductions for start-ups and established enterprises.

Two pilot “one-stop-shop” initiatives are under-way. The first was launched in six local administrations in June 2000 by a decision of the Council of Ministers. A similar USAID project is planned for 30 municipalities. In December 2002 the Council of Ministers agreed to improve the administrative services to enterprises, based on the principle of “one stop-shops”. The first of the resulting offices are expected to open in 2003 in Sofia and Russe.

Start-ups need to apply for many permissions and licenses, introduced to protect public interest. However, in practice, these often create unnecessary barriers increase the costs. Entrepreneurs find that conforming to the complex and often inconsistent rules and legislation can be difficult, time-consuming and expensive. Studies reveal that the costs of compliance are 3-4 times higher than in the EU (Harvard Institute et al, 2001).

The regulatory regime has been developed in an *ad hoc* manner through by-laws or individual administrative acts, without sufficient consideration being given to consistency with other economic development policies. The resulting bureaucracy, lack of clarity and ineffective implementation generates scope for corruption, which in turn adds to the costs of starting businesses. According to the Agency for Social and Economic Analysis, an average of around 10 documents need to be presented in order to obtain one license (2002).

The *Inter Ministerial Working Group on the Administrative and Regulatory Environment* was created in February 2002 to deal with such issues and has a high level mandate. It is headed by the Deputy Prime Minister and Minister of the Economy, and comprises representatives of all ministries and government agencies, that are responsible for the introduction and/or application of regulatory regimes. Its task is to make an inventory of the effective national regimes and to prepare a mechanism for introduction of a public register of the regulatory regimes, with ASME support.

As a result of its activities, 360 *licensing regimes* have been reviewed and proposals were approved by the Council of Ministers to reform, simplify or abolish about 200 of these. In May 2002, the Council of Ministers decided that 74 licensing and permission regimes would be eliminated and another 120 would be simplified. A new Law on Economic Activities is being drafted. This will define rules for the introduction of licensing regimes, the period of validity of licenses and certificates and introduce the principle of “silent” or “calm consent”, according to which if the relevant public body fails to answer within a prescribed period, consent is deemed to have been given. The World Bank supports the reform process and OECD plans to undertake a Regulatory Impact Analysis in 2003.

There have been changes to the *Civil Procedure Code* (e.g. changes in the second instance proceedings, the introduction of summary proceedings, etc.), which have accelerated legal proceedings, but case determination remains a time-consuming and expensive process. The availability of summary proceedings for claims arising out of loan, deposit, rent, leasehold, manufacture contracts (with a value of up to BGN 1,000 - €520) does deliver predictable outcomes. However, there is a pervasive lack of trust in the legal system and the enforcement of court judgements remains problematic.

An amendment of the *Statute of Executive Magistrates* is under preparation, which should help make the work of magistrates more effective. Continuing manual processing of files and cases, poor administrative support and the inadequate equipment are major causes of delay. Judges are overworked. Magistrates need continuous training in specific aspects of the dynamically changing legislation (e.g. intellectual property, protection of competition), as well as in EU law. A Centre for Training of Magistrates has opened, however, there is some way to go before the benefits can be felt by enterprises.

*Arbitration* as a means of settlement of economic disputes is becoming more popular. According to Article 9 of the Civil Procedure Code, the parties to property litigation may agree on its resolution by an arbitration court, except in a few cases such as rights on real estate. A number of arbitration courts have been set up at business and professional organisations such as Bulgarian Industrial Association (BIA), the Bulgarian Chamber of Commerce and Industry (BCCI), the National Union of Legal Advisors in Bulgaria, etc. The legal validity of arbitration awards is the same as court judgements.

Bulgaria's *bankruptcy legislation* is regulated through the Commercial Code and is relatively modern. Special departments for bankruptcy cases have been set up in the district courts. The bankruptcy procedure has two stages: initiation of bankruptcy (which may be followed by a company rehabilitation procedure) and declaration of bankruptcy, which ends with liquidation. Sole traders are subject to separate regulations.

*Payments to SMEs* are subject to the general regime as applied to commercial/civil law transactions. Regulation in line with the EU's Recommendation 95/198/EU setting out payment periods of commercial transactions is not yet in place. Where there are delays, the parties to a contract may claim interest on the payment due amounting to the basic interest rate plus 10 percent points for the liabilities in BGN. The *Public Procurement Act* creates conditions for access of SMEs to public procurement, such as ensuring reasonable costs to companies for obtaining the relevant documentation.

The share of the *grey economy* accounts for 20-35% of Gross Domestic Production (see NSI, and Agency for Economic Analysis and Forecasts of the Ministry of Finance, Harvard Institute for International Development surveys in 2000-2001). Several studies have stressed that it is the high tax rates and associated administrative costs and social security burden that lead to an increase in the share of the grey economy in Bulgaria. In the SME sector this is manifested in the undeclared hiring of employees, failure to use cash registers, etc. Changes under consideration, such as in the privatisation regulations and increasing indirect taxes, are expected to lead to a reduction in the share of the grey sector in the economy.

Corruption is still considered a major problem, the main sources being the registration and licensing regime, customs officers, the police and the judicial system. A *National Anti-Corruption Strategy* was adopted in October 2001 to create a legal and institutional framework to promote anti-corruption co-operation and to implement specific measures. SMEs acknowledge the effort but are sceptical about its prospects for success. They agree that it is too soon to assess its impact.

### **Assessment**

The Bulgarian Government is working towards improving the regulatory environment for SMEs. The private sector is strongly supportive of this effort and in particular the progress in introducing the "one-stop-shops". Nevertheless, the private sector has yet to perceive significant practical improvements as a result of the activities, such as that of the Inter Ministerial Working Group on the Administrative and Regulatory Environment.

Research confirms that the initial stages of company registration and starting a business remain complicated, time-consuming and very costly for entrepreneurs and that much of the regulatory framework for business is still overly complex and opaque. The frequent changes, contradictions, lack of clarity and obscurity of general regulations were highlighted by the entrepreneurs and there is scepticism about the effectiveness of special legislation (SME Act in particular) to really promote development of SMEs.

The poor quality of adopted regulations and failure to ensure consistency with other government policies often leads to high and unjustified costs for the business. License and permission regimes are also overly complex and frequently changing. Permits and licenses granted for a limited validity period lead to higher costs for the business through repeated preparation of documents and payment of charges, providing scope for corruption. Entrepreneurs feel handicapped by the lack of transparency and the rent-seeking that persists in the licensing environment. It is vital that the process of simplifying the business environment started by the Inter Ministerial Working Group in co-operation with ASME and the "one-stop-shop" initiative

are vigorously pursued to their conclusion and implemented in a way that SMEs may benefit from immediately. The SME sector needs to see concrete improvements and reforms within pre-specified deadlines, rather than further proposals for change.

Because of corruption, SMEs feel highly vulnerable. Further steps are needed to ensure greater transparency and certainty for all businesses, together with a greater focus on an “enabling” rather than the current “negative” framework which tends to focus on stipulating what enterprises can and cannot do.

More effective consultation is needed between Government and the SME sector on the process of regulatory reform. It is not enough to disseminate decisions. Opportunities must be created for discussion of the practical effect of new initiatives and how they can best be implemented. SMEs should perceive that their views and feedback are being taken into account in national policy making.

### 4.3. Implementation of Tax Policy for Small Businesses

#### *The Situation on Taxation Policy for Smaller Businesses*

The focus of tax policy in recent years has been to reduce income tax rates and transfer the tax burden to indirect taxes.

The *profit tax* rate was reduced in January 2002 from 20% to 15%. A combined profit tax rate (including the municipal tax) of 23.5% of taxable profit has been introduced. The highest *personal income tax* rate is now 29% of taxable income, compared to 38% in 2001.

The VAT *regime* follows the regulations of the EU's 6<sup>th</sup> VAT Directive. Goods and services and imports are subject to a VAT rate of 20%, but exports are zero rated.

The VAT *refund period* has been reduced from 4 to 3 months, but since VAT is refunded under a procedure with a period of 3 months plus 45 days, this means that effectively, nearly a five-month period elapses before refunds are received by entrepreneurs. The cash flow consequences for small firms can be significant.

To be taxable, a person/firm must be *registered* under the VAT Act and the taxable turnover for the previous 12 months must exceed BGN 75.000 (€39.000), but registration is available for enterprises with turnover above BGN 50.000 (€26.000). This threshold, is one of the highest compared to EU countries (CED, 2001a) with the consequence that a large proportion of SMEs are ineligible for VAT registration and thus unable to recover VAT paid on goods and services purchased.

Indirect taxes are now levied on a wider range of goods and services. A 20% VAT on medicines was introduced in January 2002, while tourism services sold abroad but consumed in the country are subject to a reduced 7% VAT rate (likely to increase in the near future). In addition, *excise tax* rates have increased and the range of goods that fall into the excise regime has been widened.

There are *no tax incentives* and instruments to support existing SME development and there are no incentives to promote the start-up of new enterprises.

There are currently no effective *forums for consultation* and discussions between SME representatives to consider proposed changes to the fiscal regime, which will affect business. This can have major implications, such as planning difficulties, cash flow problems, late or non-payment of taxes.

#### **Assessment**

The thrust of the recent changes in tax policy is broadly appropriate and SMEs agree with the general objectives. Recent developments such as the reduction in the corporate tax, reductions in the VAT refund

period and the general efforts to achieve greater simplicity in the tax system are noted and appreciated by SMEs. However, the implementation of the shift from direct to indirect taxation, for example, the late adoption of changes in December 2001, created problems for the enterprise sector, with some companies facing difficulties in meeting their tax liabilities. Also, the changes to the patent tax in 2002, developed without consultation with business representatives, combined with the tripling or quadrupling of the rates on certain activities and imposition of additional conditions, caused major compliance difficulties. Both businesses and government would benefit from more timely and regular consultation on proposed tax changes.

The major problem of Bulgarian tax policy is that it is not yet perceived to be co-ordinated with the general economic policy. The tax system is subject to unpredictable change and the meaning of rules is often unclear. The rapidly evolving tax system makes it hard for small businesses to keep abreast of changes and to ensure that they can plan ahead with a degree of confidence. The result is that the tax system is perceived by SMEs to discourage competitiveness, business development and creation of new jobs.

Because of scale factors, tax administration and payment issues are much more burdensome for SMEs. In addition, SMEs believe that the tax system is much more favourable to large firms, resulting in unfair competition. There is a need for improve tax administration in order to enhance tax collection rates and reduce arrears, irrespective of the size of the firm in question.

Continuous changes in the tax system are resulting in the inability of enterprises to forecast and plan for expected tax levels. This leads to lower investment and less job creation. It adds to the compliance cost burden on firms and encourages operation in the grey economy. Enterprises value a tax system which, in addition to having fair and equitable rates, is a) simple, allowing for easy compliance and low administrative costs; b) clear, ensuring transparency and reducing the scope for interpretation; and c) stable, allowing for medium-term business planning. A simple, clear and stable tax system responsive to the concerns of small businesses should be the target for future fiscal policy development.

#### 4.4. Implementation of Financial Instruments for Fostering New and Small Businesses

##### *Current Situation on Financial Instruments*

Following the successful stabilisation of the Bulgarian economy, and the intense and successful reform efforts undertaken, the Bulgarian *banking system* appears to be evolving into a stable, well capitalised, and profitable sector and was assessed by the IMF in August 2002 as able to absorb significant credit risk. On the other hand, the non-banking financial sector is still at an early stage of development.

The Bulgarian banking sector is currently dominated by Western banks, which at June 2002 controlled some 67% of banking assets. This is expected to rise to above 80% after the privatisation of the State Savings Bank (currently DSK Bank) in the first half of 2003.

With the clean up of the banks' balance sheets and the successful privatisation of most of the Bulgarian banks, the banking system has tended to become very risk-averse. This resulted in the sharp collapse of bank credit to the private sector and the build-up of significant liquidity in the system. Deposits in foreign

Table 4-1. **Domestic Credit to the Private Sector (in % of GDP)**

1996	1997	1998	1999	2000	2001	2002
35,3	5,6	8,0	10,4	11,9	14,3	18,7

Source: EBRD and national authorities.

banks are an important part of banks' assets (under one quarter). Only in the fourth quarter of 2001 since the 1996 crisis, the bank balance sheets showed loans in excess of placements in foreign banks. Since 1998, banking sector credit to the private sector has been gradually increasing. However, its level is very low if compared to both the EU average and the more advanced transition countries.

Growth was strongest in the field of corporate lending (including medium sized lending) and consumer finance. However, as margins are diminishing for larger business loans, and the consumer loan market shows first signs of saturation<sup>2</sup>, Bulgarian banks can be expected to pay increasing attention to small - although only to a lesser extent to micro - businesses. Yet, until now, lending capacity is increasing (and quality of credit staff improving), but the local banks' focus is still on larger clients.

Foreign currency denominated assets and liabilities are both increasing, with the banks trying to reduce currency mismatch on both sides of the balance sheets, with foreign loans accounting for 20% more than foreign deposits at the end of 2002. Also, about 55% of lending to private enterprises is in foreign currency. Because the level of bank intermediation is so low, SMEs are constrained to using their own liquidity and/or alternative informal sources. About 54% of deposits are the amount retained in cash, outside the banking system. The IMF estimates that only a third of the population has a bank account.

The Bulgarian financial sector is dominated by the *commercial banks*. At the end of 2002, the total consolidated assets of the commercial banks amounted up to BGN 14.6 billion, of which BGN 4.6 billion represented loans to private sector enterprises. The most optimistic estimate of the total outstanding financing by *alternative sources* (venture capital, direct equity, leasing, credit unions, bond issues, etc.) does not exceed BGN 0.2 billion. This implies that, at least in the short-run, SMEs will continue to rely on banks for their financing needs. Encouraging the development of other sources of financing that have proven in more developed economies to be effectively supportive of small businesses, will help the long-term development of the SME sector.

*Encouragement Bank* is a state-owned bank (BGN 29.573m<sup>3</sup> capital equivalent to €15.2m, managing two credit lines worth about € 15 million) designed specifically to support SMEs. It provides credits for SMEs up to €20.000, and for export credits up to €500.000. It focuses primarily on long-term investment finance (four years) and has about 200 clients after 30 months of operation. Encouragement Bank, in conjunction with ASME, has developed a proposal for the development of a national SME State Guarantee Fund.

Only one bank offers micro-loans on a significant scale. That is *ProCredit Bank*, which started operations in October 2001 to address the shortage in credit supply to Bulgarian MSEs with a particular focus on micro enterprises and to a lesser extent on small businesses. At the end of December 2002, after just over a year of operation, ProCredit Bank had extended 6.827 business loans for a total amount of US\$ 42.9m loans (average loan amount less than US\$ 4.207).

Since 1999, four local banks (United Bulgarian Bank, Raiffeisenbank, Hebros Bank and Union Commercial Bank) have been active in lending to small and micro enterprises with the support of the EU/EBRD SME *Facility*. At end of 2002, the credit lines extended under this facility accounted for a total of 1.294 loans to the micro and small enterprise sector, equivalent to €27.8m (average loan amount €21.500). The banks participating in this Facility receive a financial incentive to make micro and small loans and technical co-operation funds from the European Commission to help them streamline their lending procedures and improve their products and services for their micro and small clients.

A *guarantee scheme* through United Bulgarian Bank (UBB) was set up by the American Agency for International Development (USAID). The amount of guarantee provided is €5.5m for credits to SMEs until 2004. USAID guarantees up to 50 % of the credit portfolio of UBB and provides funding for up to 50 % of the SME loans.

Other *government funded programmes* and *NGO run programmes* also address the financing needs of the SME sector. The impact of the former has so far been minimal. Among the latter the programmes which had the highest outreach in terms of number of small clients are the USTOI micro-finance programme (financed by

USAID and targeted to enterprises in trade and services only) and the Nachala Co-operative, which targets micro companies owned/managed by women and which would use the loans to create jobs. Both NGOs are run on the framework of mutual guarantee funds.

The following table offers an overview of the cost of credit available from official sources. Micro-loans are defined as loans of less than US\$ 10,000 and small loans are defined as above that threshold. It is important to note however in comparing the rates charged by different providers that commercial banks almost never extend loans to the corporate sector below US\$ 5,000. In order to calculate the real interest rate for local currency loans, note that inflation was 3.9% in December 2002 on a year-on-year basis.

Table 4-2. **Cost of Credit Available from Official Sources**

	Foreign Currency Denominated Loans			Local Currency Denominated Loans		
	Pro Credit Bank	Other providers Banks	NGOs/ Programmes	Pro Credit Bank	Other providers Banks	NGOs/ Programmes
	Interest Rate			Interest Rate		
Micro loans	14-16%	13%	N/A	17-20%	15%	20-24%
Small loans	12-14%	9-13%	N/A	13-17%	10-15%	N/A

Source: Group for Small Business, EBRD, 2003.

*Equity financing* is also in theory available, but the investment funds operating are targeting larger business than SMEs. The average investment size is between US\$ 0.2-1m. Only Caresbac, among the existing funds targets lower investments in the range of US\$ 50,000-250,000.

The government at the end of 2001 set up a *Guarantee Scheme for micro-loans*. It operates mainly as an instrument of industrial policy, by targeting specific regions (those affected by the highest rates of regional unemployment).

*Leasing* is available in Bulgaria, but its impact on financing the SME sector is still small. The potential for this area is however significant, especially at a time when banking intermediation is still low.

### Assessment

The EBRD's Office of the Chief Economist has assessed progress in structural and institutional reform across the region since 1994 based on its assessment of progress in key aspects of the transition process. According to the EBRD's own assessment banking sector reform has progressed steadily in the last three years. By using EBRD's standard scoring system (1=little or no progress from the command economy starting point, to 4+ = standards equivalent to those of a well functioning market economy), the Bulgarian banking system has been rated 3.3 in 2002. On the other hand the non-banking financial sector is still lagging behind at 2.3 in the same year.

Table 4-3. **EBRD Score of Financial Sector Reform**

		1997	1998	1999	2000	2001	2002
Financial Institutions	Banking reform & interest rate liberalisation	2.7	2.7	2.7	3.0	3.0	3.3
	Securities markets & non-bank financial institutions	2.0	2.0	2.0	2.0	2.0	2.3

Source: EBRD.

The entrepreneurs in the focus groups value the reforms undertaken to strengthen the banking system and adapt it to domestic needs. SMEs view the banking sector as being fairly stable, competitive and providing a wider range of services. However, the general view remains that the banking system is not yet responsive to the needs of SMEs, particularly in terms of the range of services available to SMEs. They believe credit application procedures are too cumbersome and costly and that banks need to become less conservative and more pro-active in their SME lending practices.

A healthy, profitable financial sector is the key pre-requisite for providing access to finance for SMEs on a sustainable basis. Profitable private financial intermediaries are the necessary link between domestic savings and investment by private sector enterprises, in particular SMEs, and the only way to ensure sustainable SME access to finance and other financial services. Despite the positive trend of deepening bank intermediation, the private sector views the financial constraints, both access and cost, as very important obstacles to doing business. The main sources of finance for the Bulgarian SMEs are internal funds and loans from family/friends. Commercial sources of finance play a minor but growing role. Among these, local commercial banks are the most important, although only few players effectively target the micro and SME sector, in particular the partner banks of the EU/EBRD SME Facility and Procredit Bank. Non banking sources of finance are so far insignificant for SME financing needs. However the potential for growth of some of these, such as leasing companies, is critical in trying to boost the development of the SME sector at a time when banking intermediation is still low.

#### 4.5. Implementation of Advisory Services to New and Small Businesses

##### *The Situation on Advisory Services*

In Bulgaria a wide variety of business advice is provided to entrepreneurs, potential entrepreneurs, or business managers to promote the setting-up, growth or improvement of SMEs. *Services* typically include: provision of information, business advice and consultations, advice on entrepreneurship, management training and specialised advisory services, such as marketing studies and supporting the development of economic partnership between companies (organisation of fairs, exchange of trade offers, etc.).

As mentioned in Section 4.1, there are currently over 300 *organisations* in Bulgaria providing services to SMEs. These include:

- ASME with its six regional offices.
- The Foreign Investment Agency.
- The Agency for Trade Promotion.
- The Bulgarian Export Insurance Agency.
- The Employment Executive Agency with its regional offices, etc.

A number of *business support centre networks* are active, among which:

- ASME with its six regional offices.
- BARDA (34 agencies for regional economic development with business centres).
- Euro Info Centres (8).
- Technology and Innovation Centres (5).
- Network of Agribusiness centres/business incubators (JOBS Project of MLSP and UNDP - 24).

In addition, there are a number of business associations providing services, such as the *Bulgarian Industrial Association (BIA)*, the *Bulgarian Chamber of Commerce and Industry (BCCI)* and various branch and regional associations.

In addition to projects for creating business incubators (see section 4.6), there are five initiatives under PHARE, USAID, German Marshall Fund and others to develop *industrial clusters in sectors* such as: wine industry, tourism, textiles, wood processing and furniture.

Finally there are a large number of business consultancies, training organisations, legal/accounting firms and other types of *private sector firms*, which provide services to SMEs on a commercial basis.

### **Assessment**

Bulgaria has experienced a notable expansion of state, donor and privately-funded advisory services, resulting in what may be an oversupply of such services on offer. Possibly as a result of the competition in the market, the range and quality of the business support services available is considered to be close to satisfactory by SMEs. The gradual improvement of the skills, experience and quality of the staff offering business services was noted by the entrepreneurs. At the same time, there is an ambivalent attitude to using local consultants and indeed paying for advisory services.

Research on SMEs needs (ASME, 2002) reveals a declining demand for services related to business planning, partners search, know-how advice, legal experience and specialist training in recent years. At the same time, there is parallel growth in demand for information and advice on leasing, franchising, innovative technologies and marketing and how to establish business contacts with local / foreign partners.

Advisory services, mainly those provided by foreign consulting firms, received a good overall rating from SMEs. The main deficiency of publicly funded organisations providing advisory services to SME seems to be that some of them are not responsive enough, and most of them have insufficient skills or resources. Previous research by OECD and EBRD has identified the necessity to develop an “effective network of business support centres” in similar countries (OECD-EBRD, 2001, 2002).

Smaller companies, with the exception of start-ups, rarely use outside advice and assistance. ASME (2002) suggests that SMEs do not make adequate use of the information and services available in business centres and business support institutions. On the whole, entrepreneurs expect to obtain advisory services for free. Reasons given for the low demand include:

- Inability by SMEs to recognise the benefits of advisory assistance.
- Absence of specialised information and qualified advisors in many regional business support centres.
- Business centres' necessity to self-finance their work forces them to look for high-return projects and clients.
- Belief that the prices of the business services offered to SMEs are unreasonably high, etc.

Bulgarian business associations tend to provide services to larger companies, as they are not always able to cover their expenses from membership fees or services provided to small companies. Consequently small businesses often encounter difficulties in obtaining support, except when it is subsidised through various programmes.

The Trade Promotion Executive Agency is supposed to provide information and services to SMEs, help establish international business contacts, develop databases for exporters, carry out marketing studies and support participation of companies in international fairs and exhibitions. Its activities are not well known to SMEs (ASME, 2002) and there appears to be little demand for their services among SME owners. This is possibly because of a perception that the Agency is not significantly focused on SMEs export development.

SMEs have problems in exporting because of the need for an appropriate management system, certified according to the international standard ISO 9000 and for registration to obtain the relevant bar code and enjoy trademark rights. According to the Bulgarian Club 9000 at the Bulgarian Federation of Science and Technical Unions, the number of certified companies in 2002 was just over 600; and 1,400 Bulgarian companies possess their own bar code. Not all SME companies are aware of the advantages provided by ISO certificates and having their own bar code.

According to the SME focus groups, small businesses are particularly in need of advice in the following fields: tax planning and tax protection, investment and reinvestment, cash flow management, insurance,

crediting, import and export, and certification. They also require information and advice for new services such as leasing, franchising, innovative technologies, marketing and help in establishing business contacts with local and foreign partners.

Introduction of standards and certification for providers of advisory services (qualifications, membership of relevant bodies, confidentiality principles, charging policies and other general quality standards) would go some way towards generating both greater confidence and willingness to use and pay for advisory services.

#### **4.6. Implementation of Business Incubators**

The business incubator is a particular form of business service that offers potential in transition economies. There appears to be a lack of understanding about what exactly are business incubators. Business incubators were generally defined as special areas for new and young developing businesses that provide such businesses with premises, infrastructure, a comprehensive range of services and support that can improve their ability to initiate and run their operations during the early developmental period. The combined features of physical facilities; focus on start-ups and SMEs and “soft” advisory and support services provided are what distinguish business incubators from other industrial centres or industrial estates. (OECD-UNIDO, 1999, pp.51-53).

##### ***The Current Situation on Business Incubators***

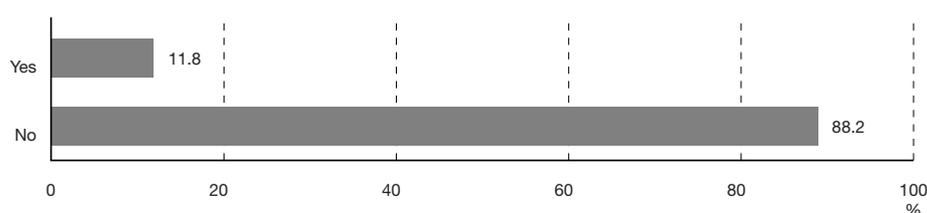
Despite the fact that the Bulgarian *government has stated its support* for setting up business incubators, the concept has not yet been significantly developed. The main reasons for this appear to be the lack of awareness of the ideas and principles of this type of business support institution, the lack of demand from entrepreneurs, and insufficient state support. These initiatives tend to rely heavily on financial and technical assistance from foreign donors.

The *Employment Through Business Support Project (JOBS)* run by the Ministry of Labour and Social Policy, with UNDP support, provides support to SMEs in regions of high unemployment by creating opportunities for the generation of new jobs. A network of 24 business centres, *business incubators* and three information business centres is being implemented through JOBS. There are seven operational business centres in the municipalities of Aitos, Vidin, Gotse Delchev, Isperih, Karlovo, Nova Zagora, Samokov, Silistra, Sliven, Turgovishte and Shoumen. Their function is to let premises for production or services to start-up or early-stage companies. They offer preferential rent levels, accountancy and various other kinds of office services for eligible entrepreneurs. In addition, there are four “virtual” business incubators, meaning they have no physical offices and facilities, but provide consultancy and support *in situ*.

There are *two PHARE projects* on business incubators. The first is *the High-Tec Business Incubators Project* (€ 10.5m) launched at the end of 2001, whose main objective is to create six business incubators for support of high tech entrepreneurs. A further PHARE project, the *Investment in Business Incubators in Under Developed Regions* (€ 3.8m), aims to create seven business incubators focusing on assisting start-ups in Montana, Mezdra, Vratsa, Belogradchik, Pazardzhik, Kurdjali and Madan. However, it is still not clear whether these two projects will be implemented.

##### ***Assessment***

The private sector remains largely unaware of the Government's policy supporting the creation and development of business incubators. Although the term itself is familiar to them, few entrepreneurs understand what business incubators actually do. The most probable reason is the limited number of business incubators operating and the scarce information made available to potential entrepreneurs. Figure 4-2. shows that only 12% of SMEs have ever used services offered by a business incubator. This is probably an overestimate as many respondents confused business incubators with other initiatives such as industrial clusters.

Figure 4-2. **Have You Ever Used Services Offered by a Business Incubator?**

Source: EPPPA Focus Groups.

However, SMEs recognise the potential offered by business incubators. They are perceived as necessary and useful instruments in assisting start-ups. When the objectives and advantages of the business incubator were explained, most focus group participants agreed that they presented a positive opportunity for development of Bulgarian entrepreneurship and could, in the longer term, enhance Bulgaria's reputation and potential in sectors of activity such as high-tech, agribusinesses, tourism and energy.

The organisation of business incubators is included in nearly all government and municipal administration programmes, but in practice apart from the JOBS project, very little is done to support start-up companies using this mechanism. While business incubators under the JOBS project have already yielded positive results and have justified the efforts and funds invested in their building, delays in finalising the two PHARE-funded business incubator projects, mean that the network of business incubators is not likely to be extended in the near future.

The implementation procedure is perceived as being complicated by the government administration. SMEs are suspicious that the commitment to development of business incubators has only been included as a general aspiration rather than as a real objective to be achieved. SMEs would like to see greater activity by the government in either supporting the existing network of business incubators or in expanding it.

## NOTES

1. The notations SMEs and small enterprises in this report also includes micro-enterprises, which according to the EU definition ([http://europa.eu.int/comm/enterprise/enterprise\\_policy/sme\\_definition/index\\_en.htm](http://europa.eu.int/comm/enterprise/enterprise_policy/sme_definition/index_en.htm)) are independent enterprises with up to 9 employees and whose turnover or balance sheet asset value are  $\leq$  € 2 million. Small enterprises are likewise defined as having between 10 and 49 employees and turnover or balance sheet asset value of  $\leq$  € 10 million and medium sized companies as having between 50 and 250 employees and turnover of  $\leq$  € 50 million or balance sheet asset value of  $\leq$  € 43 million.
2. There are currently more than 450,000 consumer loans outstanding. This compares to a total number of employees in Bulgaria of 2.6 million
3. The figure includes the BGN 9.9 million capital increase approved in January 2003, with funds provided by the European Union Phare programme.



Chapter 5.

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*Chapter 6.*

**WEB SITES**

Agency for SMEs - <http://www.asme.bg/>

Bulgarian Foreign Investment Agency - <http://www.bfia.org/>

Bulgarian Association of Regional Development Agencies and Business Centres - <http://www.barda.net/>

Bulgarian Chamber of Commerce and Industry - <http://www.bcci.bg/>

Bulgarian Export Insurance Agency - <http://www.baez-bg.com/>

Bulgarian Industrial Association - <http://b2b.bia-bg.com/>

BULSTAT Register - <http://www.bulstat.nsi.bg/>

Center for Economic Development - <http://www.ced.bg/>

Club "Economika 2000" - <http://e2000.hit.bg/index.html>

Economic Policy Institute - <http://www.epi-bg.org/>

Employment Agency - <http://www.nsz.government.bg/>

Euro Info Centres - <http://www.eic.bcci.bg/>

Foundation for Entrepreneurship Development - <http://www.fed-bg.org/>

Innovation Relay Center - <http://www.irc.bg/>

Institute for Market Economics - <http://www.ime-bg.org/>

National Association of SMEs - <http://www.nsmsb.org/>

National Employment Office - <http://www.nsz.government.bg/>

National Statistics Institute - <http://www.nsi.bg/>

Trade Promotion Executive Agency - <http://www.bepc.government.bg/>



Appendix 1.

## OBSTACLES TO DOING BUSINESS

The main results of the 2002 Bulgaria Business Environment and Enterprise Performance Survey (BEEPS) are summarised in the following table. It contains the average score assigned by respondents to each aspect of the business environment, where the scores can be interpreted as follows: 1 = no obstacle; 2 = minor obstacle; 3 = moderate obstacle; 4 = major obstacle.

**Rating of Severity of Obstacles to Doing Business (BEEPS, 2002)**

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Economic Policy Uncertainty	3.4
Macroeconomic Instability	3.0
Cost of Financing	3.0
Access to Financing	2.9
Tax Rates	2.8
Corruption	2.7
Anti-Competitive Practices of Other Producers	2.6
Street Crime	2.3
Organised Crime	2.3
Functioning of the Judiciary	2.2
Contract Violations by Customers and Suppliers	2.2
Business Licensing and Permits	2.2
Tax Administration	2.1
Skills And Education of Workers	1.8
Customs and Trade Regulations	1.7
Labour Regulations	1.6
Electricity	1.6
Title or Leasing of Land	1.5
Telecommunications	1.5
Transportation	1.5
Access to Land	1.4

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Source: EBRD.

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**The Organisation for Economic Co-operation and Development (OECD)** groups 30 member countries sharing a commitment to democratic government and the market economy. With active relationships with other countries, Non-Governmental Organisations and civil society, it has a global reach. Best known for its publications and statistics, its work covers economic and social issues from macroeconomics, to trade, education, development and science and innovation. Over time the OECD's focus has broadened to include extensive contacts with non-member economies and it now maintains co-operative relations with some 70 of them. These contacts aim to further economic integration by making the OECD's experience available to other countries and enabling the OECD to profit from the insights and perspectives of non-members. (see [www.oecd.org](http://www.oecd.org))

**The European Bank of Reconstruction and Development (EBRD)** was set up in 1991 to support the development of market economies in central and eastern Europe and the Commonwealth of Independent States following the collapse of communism. The EBRD supports the economies of its 27 countries of operations by promoting competition, privatisation and entrepreneurship. Taking into account the particular needs of countries at different stages of transition, the Bank focuses on strengthening the financial sector, developing infrastructure and supporting industry and commerce. The EBRD is the largest investor in South Eastern Europe and is also an active contributor to the Stability Pact. (see [www.ebrd.com](http://www.ebrd.com))

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