

Small Firms and Economic Transformation in Bulgaria

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ABSTRACT. The pace of transition to a market economy has been slower in Bulgaria than in some other east European countries in the 1990s. Output levels in the state owned sector, which has not yet been subject to mass privatisation, have fallen sharply and there has been a dramatic increase in unemployment. There has however also been a rapid growth in the number of small firms, and the ability of this sector to generate new jobs will be an important component of labour market dynamics in the future. Some of the main characteristics of this emergent sector are identified on the basis of a sample survey of nearly 400 small Bulgarian firms, covering competitiveness, entrepreneurship, innovation, networking, labour relations and business performance of the small firms. Key features of a subset of small firms with an orientation towards employment growth are identified.

1. Introduction

Recent research on the small firm sector has revealed the important role played by this segment of an economy in the most highly developed western market economies (Loveman and Sengenberger, 1991; Storey, 1994). In contrast to the stereotypical view that large firms have inherent economic advantages over small firms owing to the benefits provided by economies of scale, the new theories emphasise the special advantages of small firms in certain key areas such as improving competitiveness, innovation and job creation (Acs and Audretsch, 1993). In many respects these

attributes of small firms are even more important in transition economies such as Bulgaria where the ideology of “bigness” was particularly influential throughout the post war period. This gave rise to an inherited industrial structure which was amongst the most highly concentrated in eastern Europe and lacked international competitiveness.

In the absence of a radical restructuring, the privatisation of the large scale state owned sector on its own would be unlikely to improve the competitiveness of the economy as it would give rise to a market with a high degree of monopoly. In any case, as in some other post communist economies in south east Europe, the process of privatisation has been agonisingly slow. The growth of the small firm sector is therefore one of the few ways open to the Bulgarian economy to break out of this deadlock. Moreover, the development of a small firm sector is linked to the general process of political and social democratisation and emancipation which accompanies the process of economic transition (Futo and Kallay, 1994). The expansion of the sector can be expected to contribute to a dispersal of economic power and influence, and to the creation of a strong independent middle class which can support the development of a liberal democracy.

Small firms may also play an important role in the area of innovation and productivity growth. There is some evidence from research on small firms in advanced market economies that small firms are an important source of both the generation and diffusion of innovations (Acs and Audretsch, 1988). Under the central planning system in Bulgaria great efforts were made to develop the areas of manufacturing industry connected to electronics and other areas of high technology. However, levels of productivity in Bulgarian manufacturing were stagnant or

Final version accepted on August 28, 1995

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declining. Small firms, especially in the area of high technology, can be expected to contribute to a reversal of this trend (Bartlett and Rangelova, 1995).

In addition small firms have a particularly important role to play in the process of job creation. Since small firms operate in more labour intensive sectors of an economy than do large firms, the creation of a new small business sector may play an important role in the process of economic regeneration and job creation. Certainly, this seems to have happened in many western market economies. Several studies surveyed by Storey and Johnson (1987) have found that small firms contribute disproportionately to net job creation. For example in the U.K., between 1985 and 1989 firms employing fewer than 20 people created around one million jobs, more than twice as many as those created by larger firms (Storey, 1994). Other studies in west European countries reach similar conclusions, although there is a new stress on the important role of a minority of fast-growth small firms. In view of the rapidly increasing level of unemployment in Bulgaria the job generation role of small firms is particularly important.

This paper presents the results of a sample survey of small firms in Bulgaria. It is designed to investigate their key characteristics in the areas of market competition, entrepreneurship, innovation, networks, and labour relations in order to assess the extent to which the advantages of small firms are applicable in the Bulgarian case. The paper also identifies some features of the performance of small firms and the barriers to entry and growth which they face in order to identify some main areas of policy action. In view of the importance of the small firms sector in the process of job generation an analysis of the relationship between employment growth performance and each of the various firm characteristics was carried out. Where statistically significant correlations were identified they have been reported in the text. The next section of the paper sets the context with a brief outline of the recent economic and political developments. Section 3 outlines the development of the small firm sector in Bulgaria, and section 4 summarises the findings from previous studies. In section 5 the main findings from the Bulgarian small firms survey are presented and

conclusions and policy implications are set out in section 6.

2. Economic and political background

Throughout the post-war period until the end of the 1980s Bulgaria had pursued a strategy of rapid industrialisation of an agrarian economy based on state ownership of industrial enterprises and a system central planning. With the exception of some private activities in agriculture and widespread private owner occupation in the housing sector, there was virtually no private economic activity in the economy. Industrialisation was assisted by substantial financial and technological transfers from the ex-U.S.S.R., high domestic investment rates, and growing specialisation in machinery exports into the protected market of the CMEA countries.

However, the negative side of this progress became more and more evident in the 1980s: environmental degradation, difficulties in maintaining high economic growth, a rapid increase of the external debt in convertible currencies. According to one estimate (Minassian, 1992), industrial output based on a pattern of extensive development eventually stopped growing and began to fall from 1983 onwards.

A key feature of the Bulgarian industrial structure developed under the previous regime has been over-concentration of the economic activities in very large scale enterprises. In the early 1980s the size of enterprises in Bulgaria in comparison with the enterprises in other Eastern European countries ranked immediately after that of the ex-U.S.S.R. The negative consequences from this over-concentration were expressed in decreased economic effectiveness, low returns on investments, high energy consumption per unit of production, inadequate investment in the modernisation of fixed capital assets, a low level of innovation and a drop in employees' motivation.

Eventually, as elsewhere in eastern Europe, continuing poor economic performance led to political instability. The fall from power of the party leader Zhivkov in 1989 and precipitated a process of a transition to a market economy. This process however has been slow and hesitant due to the lack of a clear parliamentary majority committed to economic reform. The absence of a

strong independent middle class contributed to the return of the Bulgarian Socialist Party (BSP – the renamed Communist Party) by a narrow majority in the first free elections in 1990. Continuing economic difficulties produced further political uncertainty, and in January 1991 the BSP agreed with the main opposition force, the Union of Democratic Forces (UDF – a coalition of twelve non-socialist parties), to hold new elections later in the year. These elections, held in September 1991, produced a narrow overall majority for the UDF. Since the end of 1992 the country was ruled by a coalition government led by the a politically independent economic historian, Liuben Berov. However, government policy with respect to the transition to a market economy lacked a sense of direction and the introduction of serious institutional reforms in the field of privatisation has therefore occurred somewhat later than in other east European countries such as Poland and Hungary. A new caretaker government led by Renata Indzhova was installed in autumn 1994, and following elections that December the Bulgarian Socialist Party was returned to power with an absolute majority in the parliament.

In 1990 a series of economic shocks led to the beginning of rapid economic decline, and Bulgaria defaulted on its \$10b external debt repayments held mainly with commercial banks. Bulgaria faced a particularly difficult economic situation. As a small country her development depends to a great extent on foreign trade, which was previously concentrated on the ex-CMEA and ex-Soviet market. The break up of this market, the disruption to oil supplies following the Iraq-Kuwait war and the U.N. embargo on Yugoslavia all contributed to a large fall in the domestic output of the state sector of the economy.

A stabilisation policy was introduced in January 1991 involving price reform, a unified flexible exchange rate, an incomes policy, and tight fiscal and monetary policies (Wyzan, 1993). Whilst the incomes policy was not very successful, the increase in expenditure on the salaries of state employees was offset by curbs on the remaining expenditures. This policy brought about a significant reduction in domestic demand. The monetary policy was based upon credit-ceiling control of leva credits and the foreign currency transactions

of the National Bank. The policy brought about a sharp jump in nominal interest rates from 4.5% to a peak of 54% by 1992 (AECN, 1992). Despite the high level of inflation (producer prices rose by 22% in 1992) the high nominal cost of credit and tight credit control has been particularly problematic for the small firm sector.

In an attempt to promote structural reform, a privatisation law was passed in May 1992, but by March 1994 only a tiny proportion of state owned companies had been sold, including one sixteenth of large enterprises, seventeen out of 870 medium sized enterprises and 69 out of 5,000 small state enterprises (EBRD, 1994). Around 90% of the fixed assets in Bulgaria remain state-owned, although some of the larger state owned firms in light industry and services have been subjected to a process of decentralisation and restructuring. The new government has sought to push forward the privatisation process and in March 1995 a new plan for mass privatisation was approved. The process is intended to run from November 1995 to October 1996, and it was hoped that a further 20% of state property would pass into private hands by the end of 1995.

However, overall these policies were not able to prevent a general downturn in production in the state sector verging on a collapse which resulted from the abandonment of central planning and the loss of traditional export markets. Indeed, the restrictive macroeconomic stabilisation policy may itself have contributed to this situation. By 1992 the number of loss making enterprises exceeded the number of profitable enterprises. According to the Agency for Cooperation and Development in 1992 there were 2,921 loss making state enterprises against 2,477 profitable state enterprises, and three quarters of the latter had a profit rate of less than 5% (AECN, 1992). It is estimated that GDP declined by 23% in 1991 and by a further 8–10% in 1992 (Borensztein *et al.*, 1993). This resulted in a rapid increase in unemployment (Paunov, 1993).

As can be seen from Figure 1, the level of unemployment began rising immediately after the introduction of the economic reforms at the beginning of 1991, from less than 100,000 to reach a peak of around 600,000 by the middle of 1993 (over 20% of the labour force in the state sector).¹

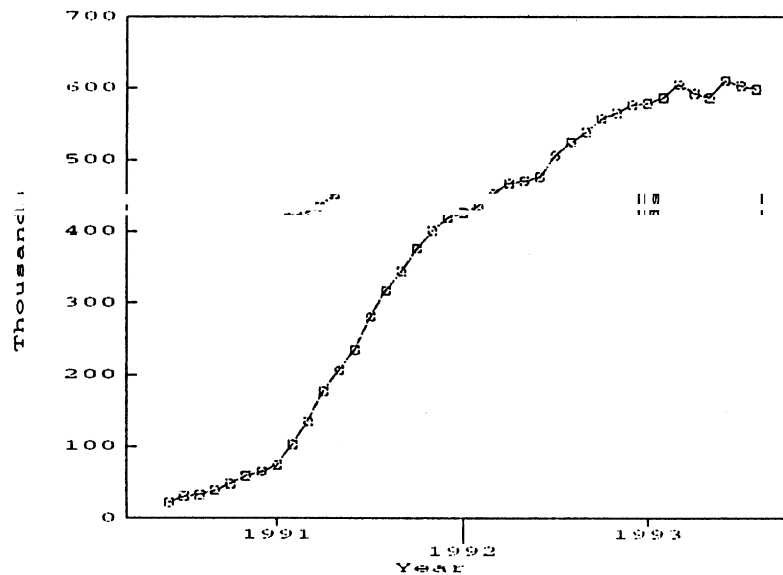


Fig. 1. Unemployment in Bulgaria.

3. Development of the small firm sector in Bulgaria

In response to the declining efficiency of the industrial sector an experimental policy to enable the creation of new small and medium-sized enterprises within the structures of the large state-owned enterprises in the 1980s (Puchev, 1990). Although this policy achieved some success, the extent of the new economic activity generated remained marginal. In 1989 the first steps were taken to liberalize the regime facing private enterprise within what was still essentially a centrally planned economy. Decree 56, which was adopted in January 1989, was the last piece of legislation of the Zhivkov era. It provided a comprehensive legal framework for the development of private enterprises. It permitted small private firms to hire labour for the first time (but only up to 10 permanent workers, while seasonal workers could be employed without limit). By February 1990, 14,011 new private firms had been registered under this law, of which 11,285 were sole proprietorships; 2,556 were partnerships; and 170 were co-operative firms (Jones and Meurs, 1991).

More recently, a new constitution has been introduced which guarantees private property and a modern commercial code, inspired by the pre-war Bulgarian commercial code, has been adopted.

New laws have been introduced which provide a legal and institutional framework for the operation of the private sector, including laws on accounting, ownership and use of farm land, co-operatives, property restitution, competition, foreign investment, and privatisation. However, the implementation of this new regulatory framework has been slow, perhaps partly because the change of established patterns of behaviour takes time, but also perhaps because of inertia and resistance from established interest groups (Izvorski, 1993). At present, the forms of ownership and legal status of private firms in Bulgaria are treated by three main laws, Decree 56 (1989), the Law on Commerce (1991) and the Law on Cooperatives (1991).

The Law on Commerce provides a framework for new forms of private enterprise such as limited and unlimited partnerships, private and public limited companies, and unlimited firms under individual ownership. However, the Law does not regulate commercial transactions and insolvency which are still governed by earlier legislation (Decree 56). There had been a long tradition of cooperative enterprise in Bulgaria in the pre-war period (Fotev, 1992), and the Law on Cooperatives provides an opportunity for the creation of a new sub-sector of small firms based on a co-operative form of ownership.

Another important feature of the Bulgarian path of economic transformation has been the introduction of a Restitution Law which was adopted in February 1992, and provided for the return of property which had been nationalised under the post-war communist regime to the original owners, on the basis of documentary evidence of ownership. This law has made an important contribution to the growth of the small firm sector.

Over the last three years the emergence of a private sector and the rapid increase of the number of small firms was only partly a consequence of the moves to abolish the monopoly of state ownership. It occurred mainly as a spontaneous reaction of individuals to the process of social and economic democratisation. However, after the initial exultation with economic freedom, entrepreneurs have become acutely aware of the problems of both market saturation and the associated problem of a greatly decreased consumer demand. Nevertheless, there has been a rapid increase in the number of private firms in Bulgaria since 1991. The latest data published by the National Statistical Institute indicate that by February 1993 nearly 164,000 new private firms had been registered (NSI, 1993) although some estimates indicate that only 70,000 are actively trading. Overall, the private sector in Bulgaria probably accounts for no more than 10% of GDP.² In contrast, in other transitional economies in eastern Europe such as Poland and Hungary the contribution of the private sector is beginning to approach 40–50% of GDP. Therefore, despite the rapid development in the number of new small enterprises, the main bulk of employment and output is still accounted for by state owned companies.

Thus far there has been little in the way of explicit policy support for small business development in Bulgaria. A very limited range of measures to support small firms was introduced through Decree 108 of June 1991. This established a special fund for the support of small firms which was set up in September 1991 with 70 million leva capital which was designed to provide financial subsidies to small firms through a variety of specialised schemes. The various forms of assistance on offer included a subsidy of up to 50% to cover interest costs of a small business; grants of up to 25,000 leva (or up to 50% of the registration fee)

to be paid to incorporated firms; subsidies to cover up to 50% of the costs of communications, energy and water supplies; and grants to support product and process innovations. The small initial capital of the Fund was all quickly disbursed to only 17 firms in the food processing industry, although none of it through the scheme to support innovations.

A second phase of funding was channelled through the Bulgarian Chamber of Commerce and Industry in 1992, but at an even lower level of funding. The Chamber's Small Business Encouragement and Promotion Fund, had a total value of only 10 million leva. To qualify for support firms were required to have fewer than 30 staff, create new jobs, and should manufacture necessities. The coverage of the scheme was also highly restricted. In 1992 for example, only three food processing and retailing companies were chosen from 13 competing applicants to receive tied low-interest loans. These firms received soft loans at 18% interest on 12 month loans of 300,000 leva each, which was less than half the effective central bank rate.

In addition to central state support, small firms are also eligible to receive support from local and municipal governments. This usually takes the form of joint ventures between local governments and private firms, with limited equity participation in a private firm (equity participation limited to a maximum of 30%). Otherwise, however, local authorities offer little practical help to small firms.

Bulgaria has received substantial financial and policy assistance from the EC PHARE programme which has instituted a number of specific policy measures including the creation of enterprise development institutions (agencies, advice centre) both in Sofia and in a number of local regional centres. However political uncertainty and the lack of a coherent strategy for the development of small business has meant that outside assistance has been used less efficiently than it might have been.

4. Previous studies of small firms in Bulgaria

In the context of the very recent development of the small firms sector in Bulgaria it is not surprising that there have as yet been very few studies

of their development. The policy of promoting small firms within the state sector in the 1980s (under Decree 12 of 1982) has been studied by Puchev (1990, 1991) and Jones and Meurs (1991). By June 1989 there were 650 such small firms established in all sectors of industry with a concentration in food processing, machine building and metal processing, textiles and knitwear, light industry, electrical engineering and electronics and construction materials (Puchev, 1991). Some of these firms were established and owned by local municipalities (34% in 1985), and some 35% (in 1985) were engaged in the production of consumer goods. Jones and Meurs (1991) argue that the programme failed in its attempt to stimulate competition in the domestic economy since the new small firms established under this programme were confined to niche markets in the consumer goods and high technology sectors.

Nevertheless the experiment did point to some advantages of small scale production. Between 1984 and 1988 mean labour productivity in these small firms was estimated to be between 1.4 and 2.7 times greater than in their large scale counterparts (Puchev, 1990). The productivity differential was partly associated with the incentive effects of decentralised management of these units: management was free to choose both the type and quantity of output. But it was also associated with favourable treatment by the planning authorities: the new small firms received up to 5% of the investment funds allocated by the Plan.

Another study of small and medium sized firms (SMEs) in state, municipal and co-operative ownership (Parvulov, 1992) supported the conclusion that small enterprises had a productivity advantage over larger firms. The study looked at a total of 463 small firms (with up to 50 employees) and 1,813 medium sized firms (with 51–200 employees) These represented 44% of the total of 5,158 firms in state, municipal and co-operative ownership in all sectors of the economy in 1989. In small sized firms, the ratio of value added per sales was 20% higher than the national average levels of productivity, whilst in medium sized firms it was 29.5% higher. The productivity gap was also reflected in improved profits in relation to both sales and assets.

However, as noted above, since the onset of the recent economic reforms and the liberalisation of

private economic activity there has been a rapid expansion in the number of small firms in the private sector. This development represents a key component of the transition to a market economy. However, little is yet known about the social characteristics of the new entrepreneurs and the economic performance of their businesses. In the next section we report the findings from the first major study of this new sector of economic activity in Bulgaria.

5. Findings from the survey

The survey, carried out in 1993, covered 394 small firms,³ employing at least one and no more than fifty workers in all sectors of the economy apart from agriculture, and so excluded consideration of self-employed individuals. The survey was organised as a representative sample survey selected from lists of firms registered with the regional offices of the National Statistical Institute and was carried out by face to face interviews with entrepreneurs and managers of the small firms.⁴

Table I shows the sample distribution of firms by legal status in comparison with the official distribution of all firms in the economy. More than half the firms (58%) in the sample were individual ownership firms (sole proprietors), whilst partnerships and limited liability companies each accounted for just under one fifth.

The sectoral composition of the sample also differs considerably from the overall distribution of firms. Over one third of the sample firms are in the manufacturing sector, a quarter are in trade (both retail and wholesale), and a fifth are in service activities. A tenth of firms have mixed activity and cannot be allocated to a particular sector (see Table II).

TABLE I
Distribution of the small firms by legal status (% of firms)

Legal status	Survey firms	All firms*
Individual	58.0	67.7
Partnership	19.2	15.6
Limited Liability Company	17.7	4.8
Other	5.1	11.9

* Data provided by National Statistical Institute.
"Other" includes public, state, municipal and cooperative firms.

TABLE II
Distribution of small firms' activity by sector (% of firms)

Sector	Survey firms	All firms ⁺
Manufacturing	35.3	11.6
Services	18.2	8.6
Construction	7.2	4.2
Trade	24.3	61.3
Transport	1.6	10.9
Mixed	10.7	n.a
Other	2.7	3.4

⁺ Data provided by National Statistical Institute.

Firms are allocated to sectors when they report more than 50% of their principal product in that sector; otherwise they are referred to as firms of mixed activity. "n.a" is "not applicable".

The difference between the distribution of firms in the sample and the distribution of all officially registered firms can be taken to indicate the substantial influence of one person firms within the small firm sector. As already noted these firms are explicitly excluded from our research design, as we are not concerned in this study to examine the special characteristics of self-employed individuals, which require separate research studies. Furthermore, the distribution of firms in the sample reveals that the manufacturing sector holds a far greater prominence among small firms which actually generate employment than previous studies have recognised. On the other hand the great majority of these manufacturing firms are in light manufacturing and food processing activities such as clothing and dressmaking (11%), and production of confectionery and soft drinks (5%). A further important minority of firms are in electronics products (6%) which have developed as spin-offs from the legacy of prior investment in high technology manufacturing under the central planning system (Bartlett and Rangelova, 1995).

Not surprisingly, all the firms in the sample began trading in the period between 1989 and 1993. Only 6% of firms began trading in 1989, whilst 21% of firms began in 1990, 32% of firms began in 1991 and the rest (33%) began in 1992.

Reflecting the slow pace of privatisation over nine-tenths of firms had been founded *de novo* and only 9% had been converted from some other legal form. Of these most had previously been under

"collective" ownership. Some had been partnerships, a few had been individual firms and one firm had been a students' cooperative. The average size of firm in terms of employment was just over 12 employees,⁵ but this varied by sector from an average of 18 employees in construction and 15 in manufacturing, to as few as 5 employees in both retail trade and transport. Since our research design involved a cut-off at 50 employees these figures probably under-estimate the average size of all Bulgarian private firms (not including one person firms). However, it may be considered a reasonable estimate as very few private firms employ more than 50 workers. The distribution of the small firms by number of employees for the three largest sub-sectors of activity is shown in Table III.

The size distribution of firms shows that the majority of firms are very small micro-firms. Over half of all small firms (61%) employed fewer than 11 employees, and less than 10% of firms employed more than 30 employees. This is not surprising in view of the virtually complete absence of any private sector activities outside agriculture in the period before 1989. In the trade sector the size distribution of firms was particularly concentrated among micro-firms: 90% of trade firms had fewer than 10 employees. In manufacturing the distribution was more even, but even here almost three quarters of firms had fewer than 20 employees. The size distribution of firms also differed by the form of ownership. Very small micro firms were more often under individual ownership, whilst limited liability companies tended to be among the larger firms in the sample. Respondents were asked whether they had plans to expand employment over the year following the

TABLE III
Size distribution of the small firms (% of firms)

Employee size group	All	Manufacturing	Services	Retail
1-5	37.4	22.0	44.1	67.2
6-10	25.4	26.5	22.1	22.4
11-20	18.4	25.0	17.6	5.2
21-30	9.4	12.9	8.8	3.4
31-40	7.2	10.6	4.4	1.7
41-50	2.1	3.0	2.9	0.0
N	374	132	68	58

date of the survey. The sample firms were then divided into two groups: "growth firms" which did have plans to expand and "non-growth firms" which did not. A set of bi-variate tests⁶ were run to search for characteristics of growth firms, and results are reported in the text where these showed statistically significant correlations.

5.1. *Competition and markets*

As indicated in the introduction, the development of the small business sector can be expected to make a potentially important contribution to the increase in competitiveness of the transition economy in Bulgaria. However, given the large increase in the number of small firms over the previous three years it is surprising that the survey reveals that many small firms in Bulgaria face little competition. Over one quarter of the entrepreneurs (30%) judged that they faced no competition at all on the domestic market, although an equivalent proportion (32%) judged that they faced fierce or very fierce competition. The large proportion of small firms facing no competition indicates that there is room in the market for further substantial entry of new firms.

Most small firms had a primary orientation to the domestic market, which accounted for 91% of sales. In addition, their propensity to import was significantly higher than the propensity to export. In fact the average share of inputs imported (at 15%) was nearly twice as high as the share of sales in exports. Four fifths of firms did not export at all, although a small minority (10%) of firms exported more than a quarter of their output. This has potentially serious implications for the contribution of the small firms sector to the process of economic recovery, since the balance of payments constraint is a key element holding back non-inflationary growth of the economy. If restructuring from state to private economic activity involves a deterioration in the balance of trade then Bulgarian growth will depend upon increased access to foreign resources to finance the payments gap. This is unlikely to come from private foreign investment (either direct investment or portfolio investment) so the implication is that Bulgaria will become more exposed to foreign debt than it is at present. In this context the minority of small firms which are export ori-

entated should provide a particular focus for industrial policy.

5.2. *Ownership, control and entrepreneurship*

There is normally a close connection between ownership and control in small firms which tends to avoid the agency problems associated with manager control of large corporations. This is reflected amongst small firms in Bulgaria in the finding that sole proprietor firms in the survey were almost entirely owned by the main owner, who on average held 94% of the firms' assets. In only 20% of individual firms was there any further financial participation by members of the owner's own family. These firms were also mainly independently controlled by their owners.

Only a few firms (8%) employed a professional manager, and in most firms the owners or partners managed the firms themselves. This is a typical pattern for small firms in the early stages of development. Only as firms grow does the absence of specialised management become an obstacle to growth. However, studies of firm growth in the U.K. suggest that firms with specialised management may tend to grow faster than owner managed firms (Storey *et al.*, 1987). Analysis of this relationship reveals a similar picture among Bulgarian small firms: firms with a hired manager were significantly more likely to have plans to expand employment than firms without ($s = 0.09$).

In view of the rapid increase in unemployment in Bulgaria, one might expect that the rapid growth of the small firm sector reflects a defensive reaction based upon the necessity for economic survival rather than the reflection of an emerging entrepreneurial culture. However, only 12% of entrepreneurs reported that the reason they set up in business was due to the loss of a previous job. The majority of entrepreneurs (59%) reported that the most important reason for entering business was the availability of a good business opportunity. A further 21% entered business because of a correspondence between the occupational area and their education and training (most entrepreneurs were trained as engineers or economists).

In terms of education level, the entrepreneurs fall into two broad categories, those with only elementary, primary or secondary education (41%),

and those with higher education, either at college or university (59%) These data indicate the high education level of the entrepreneurs. In addition, the form of education they had received was mostly vocational training (received by 64% of entrepreneurs). Most of these had been trained as engineers (64%) or in economics (14%). Firms in which entrepreneurs had a university level education were significantly more likely to have plans to expand employment than other firms ($s = 0.07$).

Only 5% of firms that formed part of a larger firm. In these cases the larger firm was most often either under private or foreign ownership, and least often under state ownership. A small minority of firms had some form of external financial participation in terms of asset ownership, by local government (3% of firms), state (5%) or foreign firms (2%). In most small firms there was almost no external finance available except the entrepreneur's personal or family capital. Reflecting the influence of high nominal interest rates and restrictions on credit expansion pursued as part of the process of macroeconomic stabilisation the main sources of start-up finance were from the owners own funds (63%), and only 16% originated from bank credit. This is hardly surprising in view of the underdeveloped state of the commercial banking sector in Bulgaria. A further 8% of start-up finance came from family funds, 4% from friends, 3% from central government funds, and 3% from other firms.

Small firms in Bulgaria appear to be surprisingly growth orientated in view of the problems they face. The most important business element of business strategy of the entrepreneurs was the future growth of the firm (ranked at 4.6 on a scale of 1 = "not important" to 5 = "very important"). Reinvestment of profits in the firm was also an important objective (ranked 4.1). Least important were current profits (3.1) and current sales (also 3.1). The growth orientation of the entrepreneurs is also shown by the way in which they made use of any profits which they earned. The alternative uses of profit chosen by the entrepreneurs is shown in Table IV.

The table shows that on average over half of profits were reinvested in the firm. Other major uses of profits included the repayment of loans, bonus payments made to employees, and financial savings. The payment of dividends to

TABLE IV
Use of profits (% of profits)

Reinvest in new assets for the firm	58.4%
Repay money borrowed	15.5%
Bonus payment to employees	9.8%
Put in savings deposit	7.2%
Dividend (or income) payment to owners	5.7%
Other	3.4%

owners absorbed only 6% of profits. The willingness to reinvest profits was closely related to a firm's willingness to create jobs. Analysis of this relationship indicates that growth firms (i.e., those which had plans to expand employment) tended to reinvest a significantly greater proportion of profits than non-growth firms ($s = 0.015$).

5.3. Innovative activity

The most innovative firms were found in the manufacturing, services, construction and "mixed" sectors. Least innovations were reported in trade and transport services. Almost half the firms in the manufacturing and mixed sectors and just over half of those in services and construction reported having introduced an innovation in the last 2 years. Amongst these innovators, the type of innovations introduced were distinguished according to whether they were innovations in the product, the service, the production process or in marketing. Product and process innovations were most common in the manufacturing sector. Over three quarters (79%) of the innovators in the manufacturing sector had introduced product innovations (compared to an average of 58% for all sectors), and 56% had introduced process innovations (compared to an average of 34%). Not surprisingly service innovations were most common among service sector innovators, where 78% of firms had made this type of innovation (compared to an average of 46%). In contrast there were no statistically significant differences between sectors with regard to marketing innovations, which were made by 45% of the innovators.

The machinery used in the production process by the firms in the sample was relatively new. More than one fifth (22%) of machines used were less than 1 year old, and over half of them (53%) were between 1 and 5 years old; 17% were between 5 and 10 years old, and only 8% were

obsolete being dated at over 10 years old. However, over three quarters (76%) of new machinery was imported which emphasises the negative foreign exchange impact of the small firm sector. On average firms made use of two production line machines, nearly a third of which (32%) were numerically controlled. Growth orientated firms which reported plans to expand employment used significantly more numerically controlled machines than non-growth firms ($s = 0.008$).

5.4. *Business networks*

Recent theories of small firm development stress the importance of business links and networks in the improvement of the economic performance of small firms. The benefits of network linkages are associated with the development of trust relationships which underpin viable market transactions. These trust relationships are strengthened through network linkages based upon reciprocity, interdependence, mutual adaptation, and externalities in information flows based upon "loose coupling" between firms (Grabher, 1993). The example of the Italian industrial districts is often taken as a paradigm for the development of the small business sector (Goodman and Bamford, 1989). However, in Bulgaria, the development of such network links is at present at a very rudimentary stage.

Less than one third (31%) of the firms in the sample were involved in subcontracting a part of their activity from another firm. In those firms the average proportion of their turnover involved was less than one third. Larger firms with more than thirty employees were more likely to be engaged in subcontracting than smaller firms. Linked to this, firms under individual ownership were less likely to be involved in subcontracting than other types of firms. Most of these subcontracting links were on a regular basis from the same firms (in 80% of cases), and the main relationship had been established for approximately one and a half years. Since the average age of firms was around one and a half years this indicates that firms involved in long term subcontracting had probably always been involved, and were probably established on that basis. Hardly any (8%) of the firms contracted work out to a subcontractor themselves, typically involving about one third of output and usually

involving the use of domestic home-workers. In general, the small firms expressed an average degree satisfaction with their subcontract relations. Only 10% were not satisfied, and for these firms delays in payments were the main problem experienced by nearly a half of such firms.

The business links among the firms were fairly well established in the areas of purchasing inputs and the exchange of information. Over two thirds (68%) of firms reported having links with other firms in the area of purchasing, and a similar proportion (65%) reported links in the area of exchange of information. Inter-firm linkages were less well developed in the area of marketing (only 29% of firms had such links), and joint research (14%). In addition, financial inter-linkages were also weakly developed. Hardly any small firms (7%) had a financial stake in any other firm, and in even fewer cases (4%) was there any equity participation by other firms in the entrepreneurs' firms. Where such financial inter-linkage took place it was usually in the nature of a minority interest, involving around one quarter of the asset base. Overall, over three quarters of the entrepreneurs considered that greater linkages of these types would be a positive benefit to their businesses.

5.5. *Labour relations*

In general, the entrepreneurs were "quite satisfied" (42.8%) or even "very satisfied" (33%) with the relations with their employees, and also mainly "quite satisfied" (38%) or "very satisfied" (22%) with their labour skills. Altogether 41% reported that they had no problems at all with their labour force. Of those which did, the main problems were lack of discipline, absenteeism, and a low level of skills.

The average income differential between owner managers and unskilled production line workers was 2:1. This is quite low by most international standards and possibly indicates the legacy of a prevailing ethic of egalitarianism inherited from the socialist period. In addition to basic incomes, three quarters of the firms' in the survey paid their employees additional bonuses for good results.

In only one fifth of firms were employees involved in any form of training programme. In these firms the proportion of turnover spent on

staff training in the previous year was 8.5%, and the on average 30% of the labour force in these firms had attended some sort of a training course. The most useful form of training was felt to be in the areas of marketing and accounting (both ranked 3.5 on a scale of 1 to 5), technical education (3.4) and financial training were also felt to be important (3.2).

5.6. Performance

Not only have the numbers of small firms risen dramatically in Bulgaria since 1989, but (as already indicated) the small firms themselves have been surprisingly growth orientated. Over half of the firms in the survey (59%) report having taken on new employees in the six months prior to interview. In addition, most small firms had plans to expand over the following year. Over two thirds of firms (67%) planned to expand employment over the year following the interview; whilst three quarters (75%) planned to expand the level of capital assets; the former on average by 40%, and the latter by 52%. However, the very smallest firms (with between one and five employees) were least likely to have plans to expand employment ($s = 0.004$).

The actual employment growth of a minority of firms was exceptionally fast. One tenth of firms in the sample increased their employment by 100% or more between 1992 and 1993. These fast growth firms accounted for the creation of 47% of jobs created by all firms in this period. As with growth oriented firms in general reinvestment of profits was an important factor underpinning employment growth. Fast growth firms were more likely to consider reinvestment of profits an important business objective ($s = 0.21$). Moreover, such firms were also likely to be favourably placed on the export market. Nearly two thirds had identified a market niche in which they faced no serious competition, compared to only two fifths of other firms ($s = 0.05$). In terms of internal labour relations, fast growth firms were also distinguished by their greater readiness to involve employees in decisions over the introduction of innovations. Employees participated in decisions on innovations in nearly one third of fast growth firms compared to less than one tenth of other firms ($s = 0.001$).

TABLE V
Factors contributing to firms' success

Skills in management	4.42
Skills of workforce	4.35
Good relations among the employees in the firm	4.21
Support of family	3.58
Innovation in marketing	3.36
Innovation in production	3.30
Assistance of the state	3.20
Innovation in production process	2.97
Assistance of other firms	2.78
Assistance of local government	2.57
Assistance of business associations	2.01
Support of friends	1.99
Political support	1.62

Used is a scale of 1 to 5 with scores of: 1 = not important; 2 = just a little; 3 = medium; 4 = quite important; 5 = very important.

Firms were asked to indicate the importance of various factors contributing to successful business performance. Table V reports the ranking given to these factors.

Table V indicates that internal factors were most important in contributing to firms' success, in particular labour skills and labour relations. The importance of management skills and good labour relations scored significantly more highly among growth firms than among non-growth firms (with $s = 0.001$ and $s = 0.042$ for each factor respectively). External factors such as support of friends or political links were least important. Based on their research in Hungary, Czako and Sik (1993) identify such social connections, which they call "network capital", as key factors in the development of successful small firms in eastern Europe. However the evidence of this survey throws doubt on this theory at least for the Bulgarian case.

Despite this evidence of rapid growth within the sector small firms continue to face a difficult economic environment in Bulgaria. Only a fifth of entrepreneurs reported being "satisfied" or "very satisfied" with their recent economic performance over the three months before the survey, whereas over a quarter (28%) reported being not at all or just a little satisfied with recent performance. Also, many of the entrepreneurs reported difficulties in paying taxes (31%), social contributions (24.8%), and for the goods or services purchased (41%). A half (51%) of the firms reported a problem in receiving payment for work done, with

over one fifth suffering payments delay in excess of 60 days.

In explanation for the difficulties currently facing them, entrepreneurs gave greatest importance to high taxes (ranked 4.6 on a scale of 1 to 5) and high interest rates (4.3). Reflecting this concern with the cost of credit nearly half of firms (46%) reported that raising capital from an external source was "very difficult".

Overall, the biggest problems preventing small firms from increasing sales on the domestic market was lack of demand cited by 26% of firms. Other factors included unfair competition (11%); saturation of the market (10%); lack of capital or finance (9%); cash flow problems (8%); the poor legislative framework (8%); and lack of raw materials (6%). Many firms operated with spare capacity at the time of the interview, with an average level of capacity utilisation being only 75%. Lack of demand was most frequently cited as the main reason for operating below full capacity (in 27.4% of cases). The general perception of a currently difficult situation which would nevertheless improve is also reflected in the expectation that capacity utilisation would increase to 90% over the subsequent year.

Despite the rhetoric in favour of development of a market economy, there were many complaints that the administrative apparatus is not user-friendly towards new private sector projects, and that much red-tape remains in place which hinders the entry and growth of firms. Asked about such regulatory obstacles, entrepreneurs in the sample reported that bureaucratic procedures and social security taxes were the most important obstacle facing the firms at the stage of entry or expansion. Over a half (52%) cited bureaucratic procedures as a very severe obstacle to entry, and only slightly fewer (48%) cited this factor as the most important obstacle to expansion.

The lack of coherent policy framework reported in the introduction is reflected among the firms in the sample. Only one tenth of firms received any tax relief or any form of assistance at all on start-up. Among those firms which did receive start up assistance the main forms of assistance were preferential credits (from banks, friends and central government) and low cost premises (from central and local government, non-profit organisations, friends and other firms). Only 6% of firms

were still in receipt of assistance at the time of interview. The most important forms of continuing assistance were tax relief (from central and local government), business counselling (from central and local government agencies, banks, business associations, friends or even in eight cases from other firms), and low cost premises. Tax relief, preferential credits, business counselling and low cost premises were felt to be more useful types of assistance than employment subsidies or training subsidies. Asked about their response to a 50% reduction of labour taxes, entrepreneurs replied that they would on average increase employment by 56%.

6. Conclusions and policy recommendations

Since 1989 there has been a surprising expansion of the small firm sector in Bulgaria, starting from a position of virtually complete absence of such firms at least in the private sector. Whilst the state sector has shrunk and unemployment has risen six fold, the private sector starting from a virtually zero base now contributes by some estimates 10% of GDP. Although nowhere near the extent of private sector development in Poland and Hungary this development represents a radical break with the past. Whether it will lead to the creation of a fully developed market economy is as yet unclear. The continued dominance of the state owned sector and the lack of political determination to pursue a policy of mass privatisation suggests that some new form of public and private sector hybrid may develop (Bartlett and Hoggett, 1995). What is clear however is that the emerging small firm sector is a new dynamic force within the Bulgarian economy, and it has been the purpose of this paper to investigate the characteristics of this sector and its contribution to job creation. In this section we summarize the main findings of the research.

Perhaps the most surprising finding is the growth orientation of many of the entrepreneurs in the study. Almost two thirds of the firms had taken on new employees in the six months prior to interview, and a similar proportion had plans to expand employment over the following year. To support these plans the entrepreneurs in the survey reported that they reinvest over half of their profits for future growth. A subset of fast growth firms were also identified. They comprised one tenth of

all firms but accounted for nearly a half of net job creation over the year prior to the survey. These firms had carved out a niche for themselves on foreign markets, they regarded reinvestment of profits in the firm as a key element business strategy and had adopted procedures of employee participation in decisions about innovations.

The entrepreneurs were also surprisingly optimistic. Nearly half expected economic conditions to improve and only one in seven expected them to worsen over the following year. However, it should be noted that this optimism occurred in the very early stages of transition when most firms were newly established and before many entrepreneurs had encountered the painful experience of business failure. Future studies will need to address the issue of business survival and failure in a more normal and well established market context.

The survey has shown that small firms in Bulgaria are mostly family owned, operating mainly under sole proprietorship but with a significant minority of partnerships and limited liability companies. They are largely self-financed from the entrepreneur's own capital, and are independent of outside control. The entrepreneurs had not on the whole entered business as a defensive reaction in the face of unemployment. Most had previously been employed as white collar workers from the state sector who saw and took advantage of favourable business opportunities. On the other hand the survival of the firm was a key consideration. The defence of real incomes, rather than a large improvement, was perhaps all that could be expected under the existing conditions.

Another feature of the small firms in Bulgaria which reflects the legacy of the recent socialist past is the evidence of the persistence of an egalitarian ethic. Income differentials between owner-managers and unskilled workers were found to be surprisingly low, with an average ratio of only 2:1. The labour relationships within the firm are experienced as very satisfactory, and the skills of the labour force are appreciated as one of the key factors contributing to firms' success.

Most firms operate in a competitive environment, but it is not surprising in view of the under-developed state of the market that nearly a third of firms report facing no competition. This is likely to change as the entry of further new firms

takes place, which should be encouraged. However, the great majority of firms operate mainly or exclusively for the domestic market, and import more than they export. There is a small minority of firms which export orientated and export more than a quarter of their product. These firms should be candidates for a particular focus of policy attention in the future.

There is little evidence of much in the way of workforce training. Only one fifth of firms bother to send their workers on training courses. The entrepreneurs reported that the most useful form of training is in the area of marketing and accountancy. On the other hand the small firms appear to be surprisingly innovative, especially in the manufacturing and services sectors. There is evidence of the widespread diffusion of new machinery and techniques, although there is a large tail of firms with older and outdated equipment.

In view of the rapid increase in unemployment in Bulgaria small firms have an important role to play in the area of job creation. The results from the survey indicate that about half the small firms in Bulgaria plan to expand employment. Of those which do not have plans to expand employment most face external constraints to expansion, and only a small proportion have no job creation potential at all. The subset of firms with an orientation towards employment growth have a number of distinct characteristics.⁷ Their owners are more likely to have university education and to employ hired managers to run their firms. They are more likely to report that management skills and good labour relations are the most important factors in their business success. They tend to reinvest a greater proportion of their profits in their business and are more likely to operate advanced numerically controlled machines. They are likely to already employ more than five workers. Firms with these characteristics are more likely to have plans to generate additional employment than other firms. Therefore, in addition to the continued promotion of entry of new firms, small firms policy in Bulgaria should be focused on facilitating the further development of these growth orientated firms which have the capacity to generate new jobs.

The main problems facing small firms in Bulgaria are low levels of demand, high interest

rates, high taxes and bureaucracy. These factors reflect the special conditions of economic transition in Bulgaria. Low demand reflects the collapse of the state sector partly due to external shocks but also reflecting the restrictive fiscal and monetary policies. High interest rates are also a feature of the conventional macroeconomic stabilisation policies. Bureaucratic obstacles and high taxes reflect the lingering resistance to small business development. Reflecting this feature of the transition almost no firms report receiving support from the state, and even fewer from local government bodies. There is therefore a need for more focused policies in the area of local employment initiatives and through the further development of a network of business advice centres. In addition there is a need to create and foster stronger social and economic networks. Small firms in Bulgaria are not closely or extensively networked. Although networking links are quite extensive in the area of purchasing, reflecting the legacy of a supply orientated economy, there are only weak links in the area of marketing, and virtually no financial inter-linkages between firms. Network capital, reflected through political connections and friendship ties are the least important factors in promoting business success. In addition there is a very tenuous linkage to business associations, to which only a small minority of firms belong. The small firms sector could be encouraged to improve its networking capability especially in the area of marketing, and in the development of business associations. In the absence of a large inflow of foreign capital, innovative local financial techniques need to be developed such as credit cooperatives. However, in the long run the development of the Bulgarian economy depends upon the development of wider international linkages and the return of political and economic stability to the Balkans.

Acknowledgements

This paper arises from a research project on "Small Firms in South East Europe: New Forms of Ownership and Control" carried out in collaboration with Peter Futo, Paul Hoggett, Laszlo Kallay and Janez Prasnikar. The project formed part of the East-West Research Programme of the U.K. Economic and Social Research Council

whose support is gratefully acknowledged. We are also grateful for financial support received from the British Council and the European Union "ACE 1994" Programme. We are grateful to Yuri Aroyo in assisting in the process of data collection for this study, and to Anton Angelov, Antonina Stoyanovska, and Anna Vidivona for their advice and assistance at various phases in the research project.

Notes

¹ Data obtained from the International Labour Office, Bulletin of Labour Statistics, 1994.

² Although according to estimates of the Agency for Cooperation and Development it accounted for 50% of retail trade turnover and 20% of household incomes in 1992 (AEC, 1992).

³ The results reported in this paper cover a subset of 374 of the sample firms excluding 20 firms which entered the survey but which were subsequently found to employ more than 50 workers or to be in the agricultural sector.

⁴ The survey firms are taken from a wide spread of geographical locations. Seven of the nine districts in the country are included in the survey: Sofia city, part of Sofia district, Bourgas, Lovetch, Montana, Plovdiv, and Haskovo. The sample does not cover the district of Varna, which is quite similar to Bourgas by geographical and economic position, or the district of Rousse. However, 87% of the total number of registered firms in Bulgaria are located in the districts covered by the survey. The survey was organised with the help of the regional statistical offices of the National Statistical Institute, which drew a random sample from their records of registered firms in each region covered by the study. The aim of the survey was to interview the entrepreneurial decision makers in the small firms. These would generally be owners, partners, or owner-managers. In the event, more than half of the respondents in the survey were owners, and nearly all had been involved in the foundation of the firm. In discussing the results of the survey we refer to the respondent's as the "entrepreneurs", recognising however that in some cases it was the managers or other administrative staff who were interviewed. The majority of the interviewers regarded the information collected as fairly reliable.

⁵ About a third (34%) of the employees worked part time, which indicates that the number of full time equivalent employees was lower than the head-count for the size of firms presented above. If we assume that all part timers worked half time then the average size of firms in terms of full time equivalents would be around 10 employees. The survey also revealed that 40% of the labour force was female, and that only 10% were members of a trade union.

⁶ T-tests were used for comparisons of means of ratio variables, and chi-squared tests were used for crosstabulations with nominal and ordinal variables.

⁷ It should be noted that these results have been established on the basis of examining the statistical significance of a set

of bivariate relationships. Interactions between the different variables may be better accounted for in a multivariate context, and may give rise to a somewhat different assessment of the importance of each factor in determining plans for growth. Moreover, plans for growth and actual growth performance may not necessarily correspond. Therefore there is a need both for caution in interpreting these results and for further research in developing multivariate models of employment growth behaviour.

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