JULIA DOBREVA

University for Finance, Business and Entrepreneurship (VUZF) , Bulgaria

INNOVATIONS: A KEY DRIVER FOR SUSTAINABLE DEVELOPMENT IN BULGARIA

Abstract:

This paper aims at highlighting the role of innovations for achieving sustainable development in Bulgaria. It identifies the need for innovative mechanisms in transition economies as a measure against the post effects of an unstable political system and the recent financial crisis. The analysis provides an overview of the Bulgarian economy over the last 20 years - the dropdown of industrial production, the difficulties in setting up and managing SMEs, and the general decline in the country's economic activity. Furthermore, the paper explores the development impacts which will be achieved through the introduction of innovations in production facilities as well as in service management. The environmental and social implications are considered in terms of defining the major outcomes of implementing green business practices in Bulgaria. A comparison is made with the sustainable development levels in some EU countries to serve as a basis for identifying and further elaborating the main political and economic targets for Bulgaria in the short and the long term.

Keywords:

innovations, post-crisis, SMEs, sustainability, sustainable development

JEL Classification: O13, O31, O44

Introduction

The countries from the former Eastern block have gone through a number of drawbacks in terms of their economic and industrial development as a result of the long period of transition. This has led to an abundance of underutilized resources and a deterioration of the production technology. The severe economic downfall has also significantly contributed to the fragmentation and polarization of the party system, which in turn undermines the capacity to manage the economy effectively (Haggard, 1995). Many firms in emerging economies have become trapped in dependent relationships as low-cost providers of technology, low-value manufactured goods or services, and have failed to develop their own design of new products (Bessant and Tidd, 2009).

The Bulgarian economy, in particular, went through all stages of the transition period – high inflation, drastically decreasing GDP, unemployment and income inequality, industrial stagnation, political instability and corruption. The accession of the country to the European Union in the beginning of 2007 and the following years that coincided with the financial crisis have also contributed to the transformations in the profile of the Bulgarian economy. Therefore, the analysis on the transition period of the country is of crucial importance in forecasting future trends of its economic development and drawing up scenarios for sustainable policy implementation, based on the increase in innovations.

Most commonly, in an economic downturn the response of the industrial enterprises is to make employees redundant, to sell out assets and to dispose of adjoining business operations in order to bridge the gap of financial resources. This, respectively, results in a significant reduction of valuable resources, alienation of key customers and loss of competitive markets. A number of macroeconomic studies in the late 90s have analyzed the determinants of growth in transition economies (Havrylyshyn et al., 1998; Fischer et al., 1996; Svejnar, 2002 and Abed and Davoodi, 2000). Among their key findings is that structural reforms and reduction of government expenditures are required in all sectors of the economy and albeit the initial effect of reforms on output may be negative, over time the best growth performances are in those countries which make their greatest progress when implementing reforms. Also, growth performance in general is better in those economies where stabilization has been achieved earliest and where structural reforms have progressed most (Havrylyshyn et al., 1998).

It was generally believed that the transition would start with a recession, caused both by restrictive macroeconomic policies and by restructuring of the economy as a result of the shift to a market economy (Fisher, 1996). All countries experienced almost similar initial setbacks in their economic growth. Hence, they also carried out similar reforms in terms of macroeconomic stabilization, price liberalization, small-scale privatization and the break-up of state enterprises. Countries that developed a functioning legal framework and corporate governance have performed better than others (Svejnar, 2002).

The privatization process of state industrial enterprises was of paramount importance but it was performed in a disorderly manner and at a rather slow pace. The first laws on privatization were adopted in 1991-1992 but only for the small-scale enterprises, whereas the privatization of the heavy industry commenced in 1994-1996 and in some countries in 1997-1998. The mass privatization, carried out by privatization funds, ended up in the formation of corporate holdings. In Bulgaria, the majority of these state enterprises were bought by the new holding structures at a price which was below the market price of the assets. Due to the loss of markets, outdated technology, vague competition and poor management, the privatized industrial enterprises gradually became insolvent and were declared bankrupt in the late 90s.

In genetral, all of these factors contributed to the severe negative transformations in the structure of the GDP. In the 90s, in 2/3 of the CEE countries the industrial share in the GDP was drastically reduced and the agrarian sector aquired a growing proportion. This tendency continues nowadays and characterises the economies with sectoral imbalances along with output produced in the shadow economy, which slow down the R&D process and the introduction of industrial innovation in the 21 century.

This paper identifies the need for innovative mechanisms in transition economies as a measure against the post effects of an unstable political system and the recent financial crisis. It aims to highlight the role of innovations for achieving sustainable development in Bulgaria, particularly in the undertakings of small an medium enterprises.

The first part of the analysis provides an overview of the Bulgarian economy over the last 20 years - the dropdown of industrial production, the difficulties in setting up and managing SMEs, and the general decline in the country’s economic activity.

Furthermore, the paper explores the development impacts which will be achieved through the introduction of innovations. A comparison is made with some sustainable innovation levels in EU countries to identify and further elaborate the main political and economic targets for Bulgaria in the short and the long term. The last part of the paper summarizes the main findings and concludes.

The Bulgarian economic transition

Since the start of market reforms in 1989-1990, the socio-economic transformations in Bulgaria have passed through several stages, thus accelerating the social polarization in the country. Economic modernization was severely hindered as a result of a number of deficiencies in economic policy making, significant industrial decline, collapsing infrastructure and the loss of human capital after a sequence of emigration waves. Bulgarian early transition is marked by scarce progress in social reforms, caused by a variety of economic, social and also psychological burdens, inherited from the 50 years of centrally-planned economy. Hence, the core of policy making for the last 20 years has been to respond to the public expectations for building successful mechanisms to implement anti-poverty measures.

Since July 1997 Bulgaria has adopted a currency board arrangement, thus facilitating the macroeconomic stabilization and the gradual economic growth in the years prior to the country's EU accession in January 2007. According to the data from the Bulgarian National Statistical Institute, real GDP growth rates varied between 4.1% and 6.6% in the period 2001-2008 and at the same time the nominal GDP per capita has increased from 1919 EUR in 2001 to 4 475 EUR in 2008. According to initial data, during the first quarter of 2013 the GDP is 8,2 MEUR while per capita GDP is 1 100 EUR. Meanwhile, the official average income level in Bulgaria is still the lowest among the new EU member states.

As observed by Mintchev, Boshnakov and Naydenov (2011), during the last 20 years Bulgaria was affected by various adverse economic and demographic processes, which were particularly severe during the first half of the 1990s. The Bulgarian population decreased by about 13% during the first 15 years of transition (1989-2004) – or 1.2 million in absolute figures – of which 500 000 were due to natural disease and 700 000 due to emigration. Additionally, the increased migration from underdeveloped regions to more developed ones intensified the existing regional disparities.

Innovation in the Bulgarian post-transition environment

According to a recent World Bank report (report number 66263-BG, 2012) Bulgaria's transition was characterized by considerable macroeconomic turbulence and structural transformation, during which export-oriented industries generally declined. The country's competitiveness has improved in the last years but not strongly enough to catch up with its EU peers. While in 1990 the industry comprised 50% of GDP and 43% of employment, in 2001 it fell down to 18% GDP and 23% of employment. It is precisely innovation that could help industries in which Bulgaria has a comparative advantage to move up the value chain and expand the high-tech export base of the country. The Bulgarian government has committed to meeting a target of R&D/GDP of 1.5% by 2020, which is three times the current level. A large share of the new investments is expected to come from industrial enterprises. However, the report points out that while greater R&D levels are important, it is also important to upgrade relevant institutions, policies and legislation. These would ultimately provide the necessary strategic support to research and innovation and thus respond to the urgent need to reverse the erosion of Bulgaria's technical and scientific competences.

In order to meet the targeted R&D/GDP level of 1.5% by 2020 there should be a substantial increase in R&D investments to exceed the current level of 0.48% (compared to 1.85% in the EU-27). Due to the economic downturn and its impact on the capacity of the state budget, there have been 2 consecutive years of real decline in public spending on R&D (2011-2012). The propensity to export is higher for innovating firms with foreign ownership and, according to the World Bank data, in 2008 only 28% of Bulgarian companies invested in R&D. Meanwhile, annual sales for innovating firms grew 26% per year in the pre-crisis period (2005-2007).

Another World Bank report (report number 62774-BG, 2012) elaborates further by pointing out that Bulgaria's per capita income at PPS is only about 44% of the EU-27 average. Given the country's unfavorable demographic situation, higher productivity is critical for sustainable growth and only significant improvements in production competitiveness would allow a shift to export-led growth, making the economy more resilient to external shocks.

Recent data shows that Bulgaria's economy has performed relatively well during the crisis and it is gradually reviving. During the period 2000-2010 output expanded by close to 50% (4.7% per year). In 2009 the GDP declined by 5.3% and remained flat in

2010 (World Bank, report number 63457-BG, 2011). Thus, in 2010 the country lost 3 years of economic growth and household consumption fell by 7.5% in 2009 and 1.3% in 2010.

Sustainability benchmarks for SMEs

The role of SMEs in contributing to sustainability could be discussed in *five major aspects: innovation development, social contribution, environmental contribution, good management and leadership practices, contribution to local networking incentives and NGOs (Fig. 2).*

SMEs are the most appropriate environment for *generation of innovation and development of innovative mechanisms.* They are easily adaptable to macroeconomic fluctuations and most ready to respond to the needs to invest in improvements of processes and products (incremental improvement) or developing products/services which are entirely new (radical innovation). In most cases, innovation in SMEs is an imitation of existing practices through the process of learning by using or learning by doing (Favaretto, 1989). The indicators which are most often used to monitor the level of innovation in SMEs are R&D expenditure, personnel employed in R&D and number of patents.

The next aspect is *social contribution* of small and medium businesses. Social entrepreneurship is particularly promising in SME environment, when social problems are to be adequately solved – e.g. alleviating poverty, providing employment opportunities, integrating people with disabilities, etc. Hence, SMEs have high levels of social contribution as they are easily adaptable to changing economic and social environment.

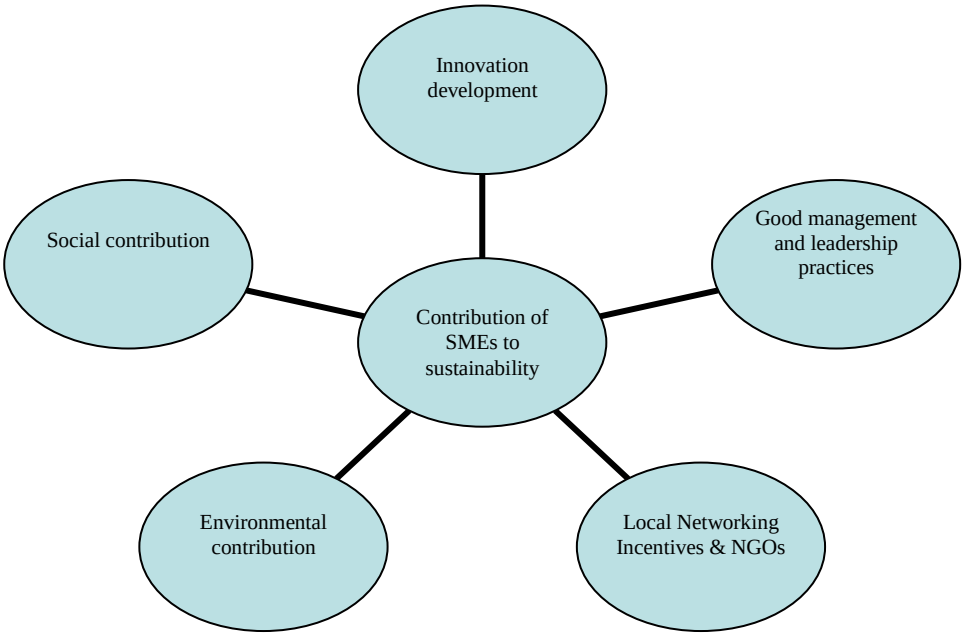
Equally important is the contribution of SMEs in solving problems of *environmental concern*. Small and medium sized organizations (SMEs) individually have, by definition, very limited operations, and therefore would not have the potential to impact the environment, to the same degree, as very large businesses (Gadenne et al., 2009). Yet, it is primarily in the limited scope of their performance that we can expect to identify motivating factors for environmental contribution of such companies. They are largely driven by the high competition among SMEs occupying the same market position as well as the close relationship established both with customers and

suppliers, which provides for tight environmental requirements being set out by both parties.

Good management and leadership practices are of paramount importance when developing sustainable SMEs. They are particularly manifested in environmental management and pollution control (Perez-Sanchez et al., 2003), as well as in managing activities with significant social impact. Hence, SMEs are the proper environment for implementing CSR practices with local as well as national impact.

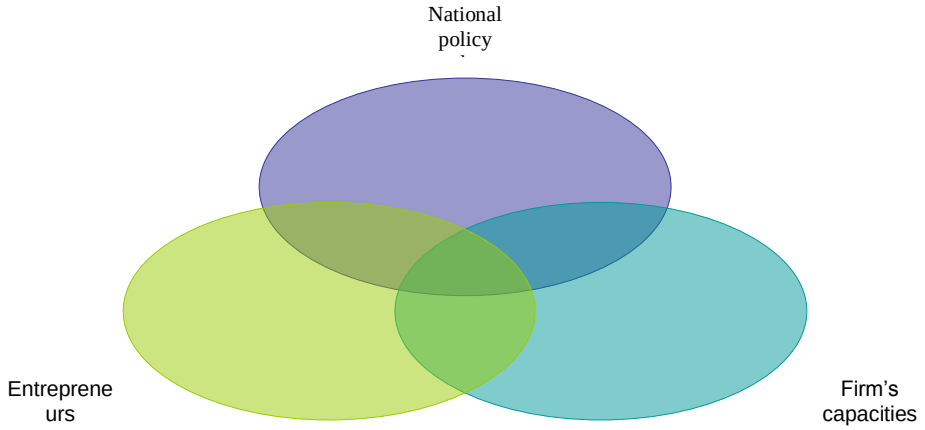
Local networking incentives and NGOs work in close cooperation with SMEs, acting as intermediaries between the government and the business as well as between local communities and small companies. NGOs and SMEs might work together in developing sustainable local markets and this cooperation is expected to be organized on several levels of networking aggregation, although they might have different perspectives on sustainability. While NGOs' main aim is to promote development, SMEs' main aim is to produce products or deliver services at the market (Castro, 2013).

Figure 1: Contribution of SMEs to sustainability - own model



We could also distinguish three key players in the process of innovation development – national policy makers, entrepreneurs and the companies' own capacities in terms of technology and financial resource.

Figure 2: Three key players for innovation development - own model



Current status of Bulgarian SMEs

There is a growing tendency of a socio-economic division between the northern and southern part of Bulgaria. According to the most recent data provided by the National Statistical Institute, the regions in the northern part of the country keep high unemployment levels, low income, and decreasing population (Bulgarian National Statistical institute, 2015). The capital Sofia keeps the first place as the most developed region in terms of social and economic development. With the phasing out of the economic crisis, the last three years have shown a slow but steady economic revival of certain regions – mainly the central and southern regions. Yet the spiral high unemployment – low income – decreasing population keeps investment activity far below the pre-crisis levels.

There is a negative tendency in the infrastructural development, especially with regard to the declining levels of road maintenance which is only 39% as of the end of 2014. Negative tendencies have been also identified in education and healthcare – the percentage of health insurances has decreased to 86% and the attendance level in primary education has also decreased to 79%. The only strong economic region in northern Bulgaria is Varna, yet it is situated too far from the other economically underdeveloped regions and thus they cannot benefit from its economic influence. In addition, the last three years have been marked by worsening local governance and high corruption levels, which has been a major drawback for the city to develop its

main potential in tourism and harbor infrastructure. The rest of the regions are marked by low entrepreneurial activity, which significantly reduces the production volumes, increases the unemployment levels to 12% (6% being the average for the country) and consequently decreases the income levels.

In this socio-economic environment, it is highly predictable that the economic performance of SMEs would be low. According to the statistical data, in 2011 the average profitability of the top 100 firms was 43%, declining to 40% in 2012 and 33% in 2013. In terms of regionalization, 43 out of the top 100 SMEs are based in the capital – Sofia. The sector which is mostly represented in agriculture with 19 companies, followed by construction works which totals 14 companies and machinery and equipment with 10 companies.

Statistical trends since 2003 provide clear evidence of dynamic development of the Bulgarian SME sector in recent years. The growth in the number of Bulgarian enterprises was only temporarily slowed down during the crisis in 2007 and 2008. However, growth levels picked up again relatively quickly, driven by small and medium sized enterprises.

Table 1: SMEs in Bulgaria – basic trends

	Number of enterprises			Number of employees			Value added		
	Bulgaria		*EU27*	Bulgaria		*EU27*	Bulgaria		*EU27*
	Number	Share	*Share*	Number	Share	*Share*	Billion €	Share	*Share*
Micro	252,137	90.0%	*92.1%*	532,880	28.9%	*28.7%*	3	16.9%	*21.1%*
Small	22,871	8.2%	*6.6%*	447,581	24.3%	*20.4%*	3	20.8%	*18.3%*
Medium-sized	4,325	1.5%	*1.1%*	412,065	22.3%	*17.3%*	4	24.9%	*18.3%*
SMEs	279,332	99.8%	*99.8%*	1,392,527	75.5%	*66.5%*	10	62.6%	*57.6%*
Large	676	0.2%	*0.2%*	451,752	24.5%	*33.5%*	6	37.4%	*42.4%*
Total	280,008	100.0%	*100.0%*	1,844,279	100.0%	*100.0%*	16	100.0%	*100.0%*

These are estimates for 2012 produced by London Economics, based on 2008-10 figures from the Structural Business Statistics Database (Eurostat). The data cover the 'business economy', which includes industry, construction, trade, and services (NACE Rev. 2 sections B to J, L, M and N), but not enterprises in agriculture, forestry and fisheries and the largely non-market service sectors such as education and health. The advantage of using Eurostat data is that the statistics are harmonised and comparable across countries. The disadvantage is that for some countries the data may be different from those published by national authorities.

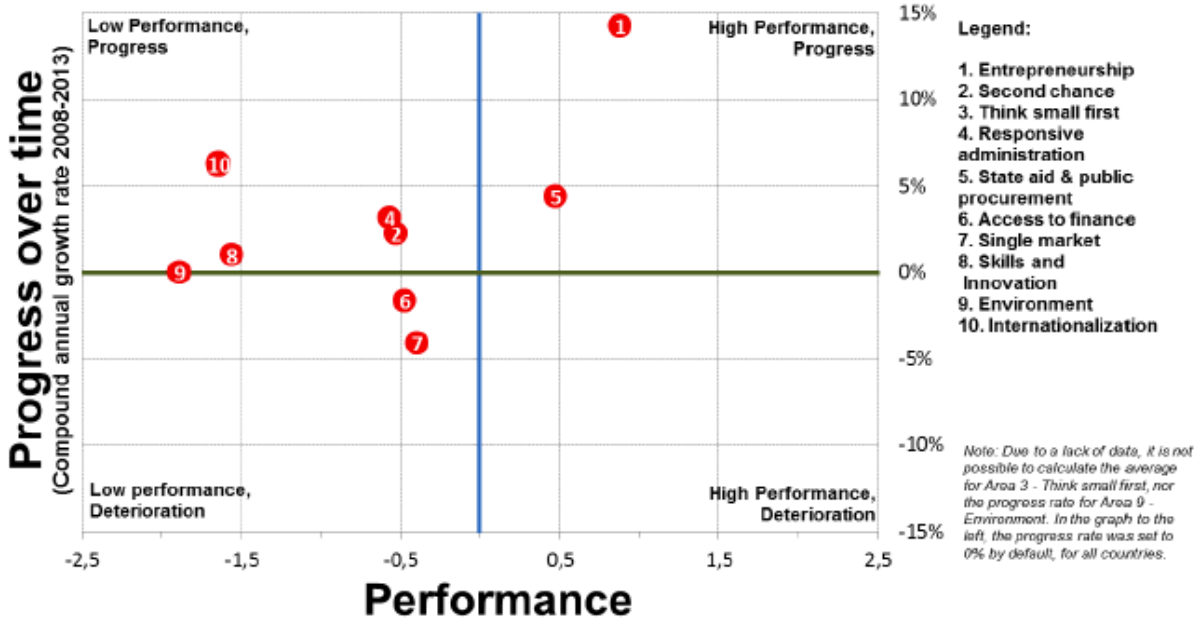
Source: SBA, 2013

The data in the table demonstrates that the contribution of SMEs in creating value added and especially in providing jobs exceeds the EU average, moreover, the share of SMEs compared to Large Enterprises (LEs) in value added and employment in almost all sectors is higher than the EU average. However, this has resulted in labour productivity far below the EU average due to the lower capacity to benefit from

economies of scale in low-value sectors. The Bulgarian economy went through a decline in value added and employment in the period 2008 – 2012, when both SMEs and LEs were affected. The decline in value added for the SMEs was by 4% without a corresponding fall in employment - the SMEs are much more reluctant than LEs to fire their workforce, as they have difficulties in attracting skilled employees once they re-hire.

Another specificity of the Bulgarian SME sector is its concentration in the wholesale and retail trade sector, where almost 50% of the Bulgarian SMEs are active, and the low innovation activities of Bulgarian SMEs, which tend to specialize in bringing to market less expensive and better quality products from abroad. Foreign direct investment is concentrated in the construction and real estate sectors and it has declined ten-fold since 2008 as a result of high speculative movements before the crises, which significantly exceeded stable growth levels and did not correspond to actual demand. In 2011 about 37 000 SMEs closed down and more than 36 000 were created due to the financial shortcomings of the Bulgarian SME sector – companies face a lack of access to finance while at the same time there is a high level of inter-company indebtedness and late payments for work that has been delivered.

Figure 3: Bulgaria's SBA performance: status quo and development over 2008-2013



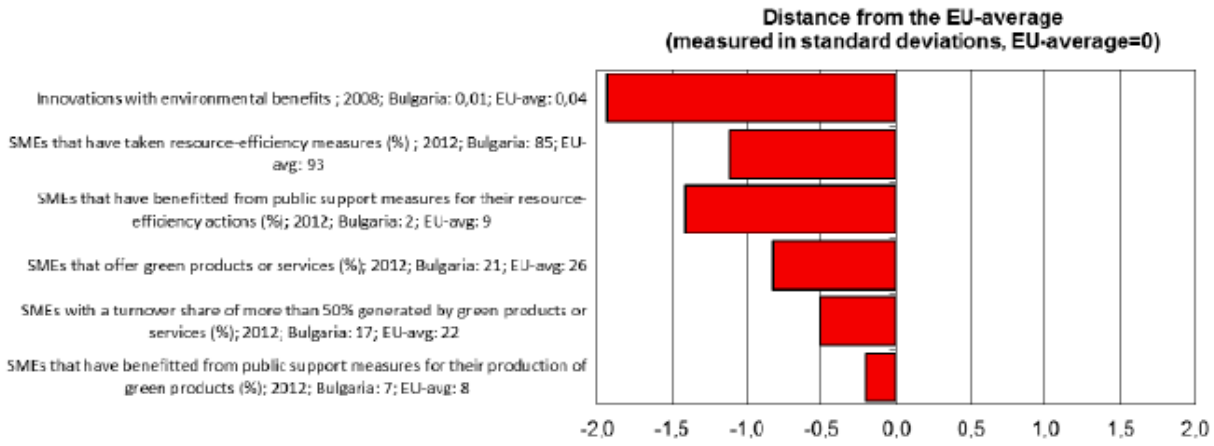
Source: SBA, 2013

Bulgaria's performance in the area of entrepreneurship is above the EU average although the self-employment rate falls behind the EU average (11% compared to EU 15%), which is an evidence for unused potential, considering that the share of adults that have taken steps to start their own business is 36% (EU: 23%). Overall, the proportion of entrepreneurs who started their own business to exploit an opportunity – 42% compared to EU 49% - suggests that the majority of Bulgarian entrepreneurs go into business for lack of alternatives.

Access to finance for start-ups and SMEs is severly limited in view of weak credit growth due to the need for balance sheet adjustments and the on-going upward trend in non-performing loans. Some timely policy initiatives co-financed by the Structural Funds were launched to tackle some of the weaknesses highlighted. A new funding scheme was adopted in 2012, called the "acceleration and Seed Fund", to support SMEs in their seed and start up phases. According to most recent data in 2010 only 13% of Bulgarian SMEs are innovating in-house (compared to 17% in 2008), which is a direct consequence of the low rate of introduction of new products, processes, marketing or organizational innovations.

Bulgaria is clearly behind the EU average in terms of environmental performance as only a quarter of Bulgarian SMEs introduced environmentally friendly innovations or received public support for their resource efficiency measures.

Figure 4: Bulgaria's distance from EU average in terms of environmental performance



Source: SBA, 2013

Many sectors which constitute the backbone of Bulgaria's economy – such as real estate, construction, and financial services – were negatively impacted by the financial crisis in 2008, resulting in 10%-12% reduction of employment level or 350 000 people lost their jobs (Economic Policy Institute, 2011). However, it is precisely the SMEs that considered the recession as an opportunity to embark on new entrepreneurial ventures. In 2009 there were 315 850 SMEs which made up 99.8% of all Bulgarian enterprises and 90,3% of the SMEs were micro enterprises. In general SMEs provide 76% of the jobs in Bulgaria, while large enterprises account for 24%. During the peak of the crisis in 2008-2009 the SMEs were the source of employment, keeping 5 people on average as personnel. Approximately 56% of all SMEs dealt proactively with the crisis by cutting down costs, while 44% adopted a rather passive attitude.

In the beginning of 2011 over 90% of all SMEs had difficulties in accessing finance, the worst affected being the micro enterprises as well as the service firms, while financing is provided by the company owners themselves. In 80% of the SMEs innovation activity is weak, only 10% of all SMEs have substantial resources to finance innovation and the most innovative are the manufacturing companies. There are three prerequisites for innovation to be implemented in SMEs: new equipment, skilled and qualified workers, good financial status. In general, innovation in Bulgaria is hindered by the lack of appropriate funding, the high number of population with low income and low qualifications as well as the lack of a national innovation system, which would enable some firms to transfer and apply innovations.

Innovations and the role of SMEs for sustainable development

The SMEs have a structural role for the development of a country's economy and they are a main engine for economic growth. The main competitive advantages of the SMEs are their ability to generate new business ideas and to provide employment opportunities even in times of economic crisis. They are easily adaptable to implementing new technologies and innovations, developing entrepreneurial skills and business culture, which in regional aspect contributes to the improvement of the social and regional development and also strengthens competitiveness.

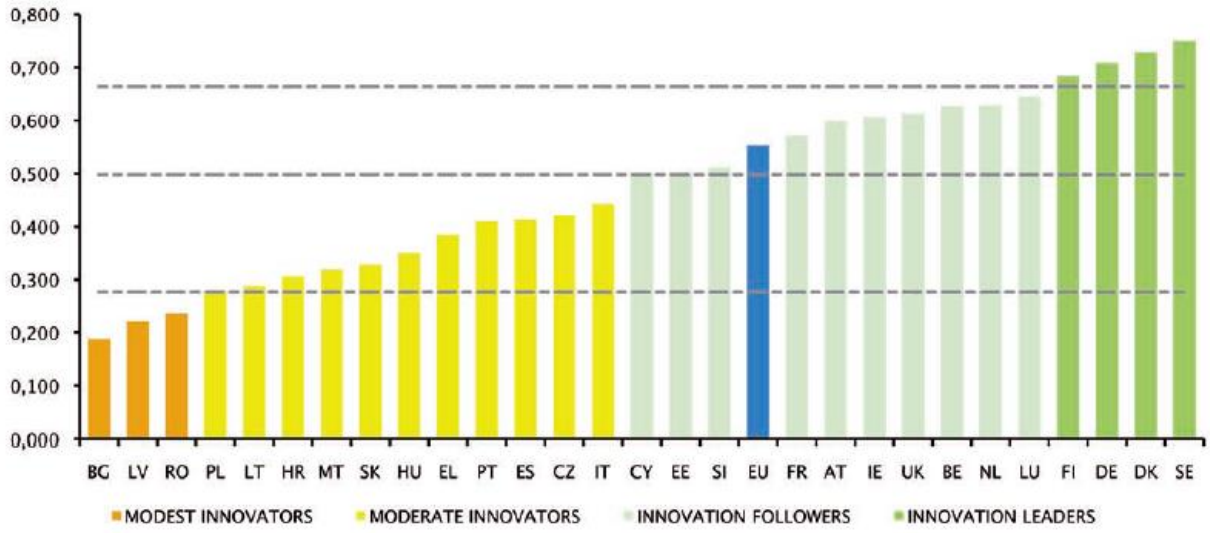
A major contribution of the governmental policies is to ensure the development of entrepreneurial skills through the provision of stimulating and reliable conditions for idea generation, which is the basis for innovation implementation. The role of SMEs and micro enterprises in the innovation process has a significant contribution and the

implementation of specific measures in support of their activity is commensurate with their specific requirements. A driving motivation for innovations in SMEs is the progress of enterprises which deliver new products, services, energy efficiency, a better marketing approach, a better managerial structure or another type of innovation.

The innovation activities are performed by entrepreneurs who use the existing knowledge and technology for developing and spreading new products and practices. An ecosystem which encourages entrepreneurship also creates opportunities for identifying business possibilities and facilitates the access to “raw materials”, necessary for their development. The state interference in this process aims to discourage any actions which might hinder the entrepreneurial activities through providing the adequate stimuli as well as legislative framework. But even with the existing stable institutional framework, innovations are often accompanied by market failures.

Taking into account the unpredictability of the results from innovations, the companies are often reluctant to make sufficient investments in R&D. Especially in Europe, the fear of failure is often a major hindrance for innovations, although knowledge acquired in such manner could have a high social value. Figure 5 clearly shows that Bulgaria is currently the modest innovator among all EU member states. In an environment where failure is unacceptable and also carries high business and social price, the actions of the state to stimulate innovations and entrepreneurship is obligatory.

Figure 5: Innovation in EU member states



Source: Innovation Union Scoreboard, 2014

The formulation of objectives for creating a favorable environment for doing business, encouraging start-ups and stimulating the innovative activity among SMEs is developed in the European Initiative Small Business Act (SBA), which forms the basis of the entire European policy concerning the small and medium enterprises. SBA includes ten key principles and a number of particular activities which are implemented in Bulgaria through the National Strategy for Encouraging the Development of SMEs 2014-2020. The encouragement of the innovative activity of The Bulgarian SMEs is expected to ultimately contribute to the increase in developing local business competitiveness, the improvement of economic performance in comparison with other EU Member States and the setting of prerequisites for implementing knowledge-based economy under the 8th priority of SBA – "Skills and Innovations".

The main principles of "Skills and Innovations" are to encourage the improvement of skills in SMEs, as well as all forms of innovations by stimulating the investment activity in research and development and their participation in R&D programmes, the cross-border research activity, the setting up of clusters and the effective management of intellectual property. Bulgaria takes the last (27th) place in the EU ranking 2014 according to the methodology of the EC. The last place is mainly due to the indicators: **Share of SMEs (without microenterprises) which sell online, Share of SMEs (without microenterprises) which buy online, Participation of the Employees (in microenterprises) in training programmes.**

Table 2: Skills and Innovations - worst indicators

Indicator	EU Average	Bulgaria
Share of SMEs (without microenterprises) which sell online	13%	3%
Share of SMEs (without microenterprises) which buy online	28%	4%
Participation of the Employees (in microenterprises) in training programmes	10.5%	2.5%

Source: own interpretation, based on SBA data

Under the other innovation indicators Bulgaria is positioned from 22nd to 26th place, the most favorable result is only under the indicator – Share of the sales of new products for the company or new products and services for the market – 13th place with a result 14.2% compared to 13.3% average for EU.

Bulgaria is a country in which SMEs invests in R&D, they create on their own or in collaboration and place on the market new or improved products and services and also introduce new or improved organizational and marketing processes. The training programmes as well as the complete professional preparation of employees is a national and company policy and the enterprises do not consider it as difficult to employ and train an employee. The national innovation objectives to be achieved by 2020 are as follows:

Table 2: Operative innovation objectives - 2020

N	Indicator	Objective	Change
1	Share of SMEs with internal innovations	>30%	Additional 45 000 SMEs
2	Share of innovative SMEs which collaborate with other enterprises and organizations	>11%	Additional 26 000 SMEs
3	Share of SMEs, which have introduced innovative products and processes	>34%	Additional 46 000 SMEs
4	Share of SMEs, which have introduced an organizational/marketing innovation	>39%	Additional 76 000 SMEs
5	Share of sales of products/services, which are new for the company or the market	>=14%	Increase/sustaining the current result
6	Number of SMEs, which have participated in R&D, financed by the EU	>23 SMEs	Additional 53 SMEs
7	Share of SMEs (without microenterprises), selling online	13%	Additional 2 400 small and medium enterprises
8	Share of SMEs (without microenterprises), buying online	>28%	Additional 6 700 small and medium enterprises

9	Share of SMEs, which provide training	>58%	Additional 102 000 SMEs
10	Participation of the employees (in microenterprises) in courses and trainings	>10%	Additional 26 000 microenterprises

Source: Ministry of Economy – www.mi.government.bg

The major conclusion which can be drawn on the basis of these observations is that in order to achieve the objectives and support the sustainable development of SMEs, there is a need to observe the following:

1. Implementation of SME specific regulatory provisions
2. Sufficient provision of financial resource
3. Increase of the access of SMEs to the market
4. Strengthen SMEs's role for effective use of resources, development of entrepreneurship and employment opportunities

Conclusion

The analysis in this paper identified the need for innovative mechanisms in transition economies as a measure against the post effects of an unstable political system and the recent financial crisis. Its major focus was on the role of innovations for achieving sustainable development in Bulgaria, particularly in the undertakings of small and medium enterprises.

The analysis provided an overview of the Bulgarian economy over the last 20 years - the dropdown of industrial production, the difficulties in setting up and managing SMEs, and the general decline in the country's economic activity. Furthermore, the paper explored the development impacts of innovations. A comparison was made with innovation levels in EU countries.

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