INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR A PROPOSED LOAN

IN THE AMOUNT OF 149.3 MILLION EURO
(US$200 MILLION EQUIVALENT)

TO THE

REPUBLIC OF BULGARIA

FOR A
THIRD SOCIAL SECTORS INSTITUTIONAL REFORM
DEVELOPMENT POLICY LOAN (SIR DPL 3)

APRIL 20, 2009

Human Development Unit
Central Europe and the Baltic Countries Department
Europe and Central Asia Region

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Republic of Bulgaria - Government Fiscal Year
January 1 – December 31

Currency Equivalents
(Exchange Rate Effective as of 31 March 2009)

Currency Unit       Currency Unit
US$1.00              BGN 1.34035

Weights and Measures
Metric System

Abbreviation and Acronyms

BNB Bulgarian National Bank
BRU Better Regulation Unit
CFAA Country Financial Accountability Assessment
CKOKO Center for Control and Assessment of the Quality of Education
CoM Council of Ministers
CPS Country Partnership Strategy
FDI Foreign Direct Investment
FMIS Financial Management Information System
GDP Gross Domestic Product
GNP Gross National Product
IBRD International Bank for Reconstruction and Development
IFC International Finance Corporation
IMF International Monetary Fund
LDP Letter of Development Policy
MLSP Ministry of Labor and Social Policy
MES Ministry of Education and Science
MOF Ministry of Finance
MOH Ministry of Health
MTHS Multi-Topic Household Survey
NHIF National Health Insurance Fund
NPTI National Principals Training Institute
OPAC Operational Program for Administrative Capacity
OP HRD Operational Program Human Resources Development
PHRD Japan Policy and Human Resources Development Trust Fund
PIRLS Progress in International Reading Literacy Study
PISA Program for International Student Assessment
RIA Regulatory Impact Assessment
SDR Special Drawing Rights
TIMSS Trends in International Mathematics and Science Study

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# LOAN AND PROGRAM SUMMARY

**Republic of Bulgaria**

**Third Social Sectors Institutional Reform Development Policy Loan (SIR DPL 3)**

<table>
<thead>
<tr>
<th>Borrower</th>
<th>Republic of Bulgaria</th>
</tr>
</thead>
<tbody>
<tr>
<td>Implementing Agency</td>
<td>Ministry of Finance, Ministry of Health, Ministry of Labor and Social Policy, Ministry of Education and Science</td>
</tr>
</tbody>
</table>
| Financing Data | IBRD Loan  
Terms: Variable-Spread Loan  
Amount: EURO 149.3 million (US$ 200 million equivalent) |
| Operation Type | Programmatic, third in a series of three |

**Main Policy Areas**

1. Promotion of productive employment;
2. Enhancement of the institutional capacity for education quality assessments;
3. Promotion of the financial sustainability of the national health insurance system;
4. Strengthening of incentives to focus on quality, drop-out and efficiency of spending.

**Key Outcome Indicators**

1. Increase in the employment rate of older workers to at least 40 percent (age 55-64, Eurostat data) from the 2005 baseline of 34.7 percent (intermediate status (2007) of 42.6 percent);
2. Matura examination results are used by Bulgarian universities as credential for admission;
3. Percentage of payments to hospitals channeled through NHIF remains constant or increases. Baseline: 55 percent (January-December 2005); target: 80 percent; value 2008: 86 percent;
4. Increased efficiency as shown by halting the decreasing trend in pupil-teacher ratio in public schools (for grades 1-13) observed since 2002.

**Program Development Objectives and Contribution to CPS**

The DPL series support the Government of Bulgaria (GoB) to meet some of the challenges associated with the convergence in living standards with the rest of the European Union. The DPL series support the adoption and implementation of policies to (i) increase employment and lay the foundations for long-term productivity growth by providing incentives for job creation and labor force participation and improving the quality of education, and (ii) promote fiscal sustainability through efficiency gains in the social sectors. The DPL series support the two of the three priority areas laid out in the CPS, (i) raising productivity and employment in support of private sector-led growth along the lines of the EU’s Lisbon Agenda; (ii) fiscal sustainability and improved capacity for absorption of EU funds, and is consistent with the third priority area, poverty reduction and social inclusion.
### Risks and Risk Mitigation

Three types of risks could affect implementation of policies supported by DPL 3:

**Macroeconomic risks**
Large external imbalances and a rapidly worsening external environment magnify the risks of a sudden stop in capital inflows and a slowdown of growth with potential negative effects on the quality of banks’ portfolio.

**Political risks**
Bulgaria will elect a new parliament in the summer of 2009, and some of the reforms supported by the DPL-series may not be sustained through the pre-election period and political transition to a new government.

**Technical risks**
Capacity in some line ministries for programs monitoring and impact evaluation of policies is limited.

**Mitigation mechanisms** include sustaining Bulgaria’s track record of prudent fiscal policy and coordinated efforts of the Government and the Bulgarian National Bank in maintaining the stability of the financial sector and confidence in the sustainability of the currency board arrangement. The government’s active participation in the coordination of national and EU-wide responses to the global crisis is expected to help maximize Bulgaria specific responses to potential risks. A close monitoring of recent economic developments and risks, in close consultation with the International Monetary Fund would help identify further increase in vulnerabilities and advise on measures to respond to potential risks if they materialize. A close dialogue with officials from all political parties in the coalition would provide support to policies that address possible adverse effects from the expected downturn on employment and that ease pressures on the economy—contributing to efficiency improvements in the social sectors and increases in labor productivity; close cooperation with various departments in the European Commission, and substantial technical assistance and ongoing policy advice to support the strengthening of monitoring and impact evaluation capacity in line ministries.

| Operation ID | P115400 |
I. INTRODUCTION

1. This Program Document describes the third and final phase of three Social Sectors Institutional Reform Development Policy Loans (SIR DPL 3 or simply DPL 3). The series has been designed to support the Government of Bulgaria (GoB) to meet key structural reform and modernization challenges in the wake of EU accession — in the case of DPL 1 — and post-accession —DPL 2 and 3. The DPL series support the adoption and implementation of structural reform policies to (i) increase employment and lay the foundations for long-term productivity growth by providing incentives for job creation and labor force participation as well as by improving quality of education and; (ii) promote fiscal sustainability through efficiency gains in the social sectors. The actions supported by the DPL series are expected to contribute to increased speed of convergence with EU policies and standards, enhanced competitiveness through increased skills of the labor force and a better investment climate, and more efficient health, education, and social assistance systems. Many of the policies are well placed to also improve access to and quality of social services over the medium term, a secondary objective of the program.

2. The completion of the third phase of the SIR DPL series takes place in times of heightened economic risks for Bulgaria resulting from a worsening global economic environment in the wake of the global financial crisis. Bulgaria's economic growth is forecast to decline substantially in 2009 and 2010 compared to 2008, and the Government is focusing on a dual strategy of (i) maintaining a prudent fiscal stance to ensure the continued cushion of a sizable fiscal surplus and (ii) continued structural reforms to increase competitiveness and raise productivity so as to emerge stronger from the economic downturn. The SIR DPL 3 contributes to address both short-term and medium-term aspects of the expected economic slowdown by supporting (i) short-term measures to address the potential adverse employment effect from the economic downturn, (ii) the government's continued reforms to improve, in the short- and medium-term, the efficiency of resource use in health and education, and (iii) measures to raise employment and productivity growth over the medium-term through structural reforms to improve employment activation policies, raise quality of primary and secondary education and to reduce the regulatory burden for the enterprise sector.

3. The structural reform agenda supported by the SIR DPL 3 is at the core of Bulgaria's efforts to comply with the European Union's Lisbon Jobs and Growth Strategy. While health, social protection and education policies are treated as national affairs in the European Union and therefore differ widely among countries, they are increasingly subject to a process of policy exchanges and mutual learning among Member States called the Open Method of Coordination (OMC), first introduced at the 2000 Lisbon European Council and subsequently revised in the Jobs and Growth Program. Social sector reforms as supported by

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1 At the March 2000 European Council in Lisbon the Heads of State launched a "Lisbon Strategy" aimed at making the European Union (EU) a more competitive economy and achieving full employment by 2010. The strategy was revised in 2005 to focus it more on growth and jobs. To achieve these objectives four priority areas were identified: investing in people and modernizing labor markets, unlocking the business potential, investing in knowledge and innovation, and energy and climate change. Using these priority areas and the accompanying economic and
the SIR DPL series are key to the implementation of the EU Lisbon Jobs and Growth Strategy for Bulgaria: First, well-functioning education, health and social protection systems and flexible labor markets are an important input to promoting economic competitiveness, which is among the parameters set by the Lisbon agenda. Second, as indicated by the experience of other new EU Member States, social sector spending may have a large impact on the fiscal outlook of Bulgaria, and efficiency of spending will need to increase to improve services while maintaining the prudent fiscal stance required for eventual entry to the eurozone. Third, policy harmonization and converging to EU standards remains an important goal of the Government. Fourth, improving the functioning of social sectors is part of Bulgaria’s effective participation in the Open Method of Coordination.

4. In line with the Lisbon Jobs and Growth Strategy, the Government remains committed to the goal of convergence to EU policy standards and per capita income levels. The government is convinced that one of the pillars to achieve convergence while maintaining fiscal discipline is a well functioning labor market and more efficient delivery of social services to the entire population. The objectives of the reform strategy supported by the DPL series are to be achieved through the implementation of policies and actions oriented towards

- creating opportunities and incentives for individuals to join the labor market and to move to higher productivity jobs, improving the institutional and regulatory framework —so that it is easier for companies to start new businesses and to hire workers, and for labor to be mobile— and introducing measures to address adverse employment effects triggered by the expected economic downturn in the wake of the financial crisis;
- changing the finance and governance system for primary and secondary education to promote improved quality of education and enhance the efficiency of resource use, and improving the capacity of education authorities to assess quality of education and use information critically to improve the education system;
- revising the financing mechanism in the health sector to make the system financially sustainable and lay the ground for improving its quality; preparing a plan for restructuring the health facilities network; using insurance administrative systems to improve the efficiency of health expenditures; and making purchasing and reimbursement policies for pharmaceuticals more rational; and
- promoting monitoring and evaluation of policies.

5. The program supported by the DPL emphasizes the need for evidence-based policy making, and has succeeded in developing a cross-cutting agenda in this area with the Government. It has been supporting the Government’s efforts to invest in data collection and strategic use and developing monitoring and evaluation capabilities. To this end the program is: (i) supporting the assessment of effectiveness of changes in one of the main social assistance programs; (ii) promoting the collection and the critical use of information on education quality through student assessments, including the national school-leaving examination (Matura); and (iii) building the capacity to evaluate the impact of policy changes and implement household surveys through accompanying technical assistance on impact evaluation linked to the DPL. Some of the policies supported by the DPL series are going to show results only in the medium term, i.e. not until after the three-year DPL-supported reform program. These include an increase in quality of education and access to underserved populations, a decrease in long term unemployment, and an improvement in health outcomes through a more responsive supply of services and improved employment guidelines, EU countries produce a three year National Reform Program (NRP). Implementation of the NRP is reviewed every year on the basis of the monitoring indicators and targets set in the Lisbon strategy.
access to drugs. While it will not be possible to capture and report on these changes at the time of DPL 3, the focus on evidence-based policy-making and establishment of an evidence base for the supported reforms are an essential contribution to monitoring medium-long-term effects of the reform program (including specific DPL actions and complementary policies).

6. The main strategic choices adopted in DPL 1 have been retained throughout the DPL series and in DPL 3. First, the Bank is providing high level policy advice and TA in addition to financial assistance associated with the DPL series. Second, this situation requires a very streamlined approach, focusing on a few very significant policies and concentrating the TA on those policies. Third, the DPL is also aiming at strengthening the implementation capacity of the government to support its strategies and policies. Finally, the program has to remain flexible, in order to respond to emerging needs and requests from the Government. This has allowed, in the process of preparing DPL 3, to provide some technical input into the national policy discussions on reforming vocational education and training, performance-related teacher pay, and dealing with skill shortages in the labor market.

II. COUNTRY CONTEXT

RECENT ECONOMIC DEVELOPMENTS IN BULGARIA

7. In January 2007 Bulgaria became a Member State of the European Union – nine years after the Accession Partnership was decided by the European Council. Over these nine years, a broad reform agenda was implemented, macroeconomic stability was maintained, and economic growth was strong, averaging above 6 percent between 2004 and 2008. Most of the non-infrastructure enterprises and banks were privatized or liquidated, trade and prices were liberalized, energy reforms made important progress, institutional reforms were implemented in a number of areas which improved the effectiveness of public institutions, and first steps were taken in regulatory reform to improve the investment climate. Fiscal consolidation reduced the overall fiscal deficit from 15.2 percent of GDP in 1996 to a balanced budget in 2003 and increasing surpluses after that. Prudent fiscal policy has led to a substantial reduction in total public and publicly guaranteed debt — from over 100 percent of GDP in 1997 to 16.1 for 2008. The markets responded well to Bulgaria’s sustained, solid track record, and its credit risk rating was upgraded to investment grade in mid-2004. Since then, FDI flows have exceeded 15 percent of GDP per annum, contributing to improved productive capacity of Bulgaria’s economy. Sovereign bond spreads declined significantly and borrowing costs for domestic investors were reduced substantially, thus boosting investment and credit growth.

8. While growth continued in 2008, the global financial crisis is making downside risks increasingly relevant. Output growth accelerated to 7 percent in the first three quarters of 2008, driven by strong domestic demand, but decelerated sharply in the fourth quarter. Private consumption growth remained little changed from 2007, with investment being the most important driver of growth. On the production side, growth was concentrated in agriculture, financial services, and construction with the contribution of manufacturing declining sharply. By the third quarter of the year, manufacturing output had stopped increasing and started to decline. Signs of further weakening were already visible by the end of 2008 and into 2009, with industrial sales falling and consumer confidence worsening sharply.

9. Economic growth led to an improved labor market but signs of deteriorating conditions are beginning to emerge. Between 2004 and 2008, employment increased by more than 400,000, with gains in construction, trade, and real estate and business services more than compensating for job losses in the state administration, mainly education, and in state-owned
enterprises. Unemployment declined from 12 percent in 2004 to 5.7 percent in 2008. However, Bulgaria’s labor force participation rate remains one of the lowest among the EU10 countries, while labor shortages in the most dynamic sectors had pushed real wage growth to double digits since the beginning of 2007. While wages are still low compared to Western Europe, this pace of wage growth raises concerns given Bulgaria’s mediocre productivity growth. Signs that the labor market is slackening are beginning to emerge. Registered unemployment is now edging up as layoffs and hiring freezes are being announced.

Table 1: Selected Economic Indicators

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008p</th>
</tr>
</thead>
<tbody>
<tr>
<td>GNI per capita (Atlas method, US$)</td>
<td>1600</td>
<td>1720</td>
<td>1870</td>
<td>2230</td>
<td>2870</td>
<td>3510</td>
<td>3990</td>
<td>4600</td>
<td>5570</td>
</tr>
<tr>
<td>Unemployment rate1, average (LFS)</td>
<td>16.3</td>
<td>19.4</td>
<td>17.6</td>
<td>13.7</td>
<td>12.0</td>
<td>10.1</td>
<td>9.0</td>
<td>6.9</td>
<td>5.7</td>
</tr>
<tr>
<td>Real GDP Growth (% change)</td>
<td>5.4</td>
<td>4.1</td>
<td>4.5</td>
<td>5.0</td>
<td>6.2</td>
<td>6.3</td>
<td>6.2</td>
<td>6.0</td>
<td></td>
</tr>
<tr>
<td>CPI (average, % change)</td>
<td>10.3</td>
<td>7.4</td>
<td>5.8</td>
<td>2.3</td>
<td>6.1</td>
<td>6.0</td>
<td>7.4</td>
<td>7.6</td>
<td>12.0</td>
</tr>
<tr>
<td>Total revenues and grants2 (% of GDP)</td>
<td>38.5</td>
<td>38.6</td>
<td>38.3</td>
<td>39.9</td>
<td>40.3</td>
<td>41.1</td>
<td>40.0</td>
<td>41.3</td>
<td>40.9</td>
</tr>
<tr>
<td>Total expenditures2 (% of GDP)</td>
<td>38.5</td>
<td>38.4</td>
<td>38.9</td>
<td>39.9</td>
<td>38.6</td>
<td>38.0</td>
<td>37.5</td>
<td>37.5</td>
<td>37.9</td>
</tr>
<tr>
<td>Overall Fiscal Balance2 (% of GDP)</td>
<td>-0.6</td>
<td>0.2</td>
<td>-0.6</td>
<td>0.0</td>
<td>1.7</td>
<td>3.1</td>
<td>3.5</td>
<td>3.5</td>
<td>3.0</td>
</tr>
<tr>
<td>Current Account Balance (% of GDP)</td>
<td>-5.6</td>
<td>-5.6</td>
<td>-2.4</td>
<td>-5.5</td>
<td>-6.6</td>
<td>-12.4</td>
<td>-18.4</td>
<td>-25.1</td>
<td>-25.3</td>
</tr>
<tr>
<td>Net FDI (% of GDP)</td>
<td>8.0</td>
<td>5.9</td>
<td>5.7</td>
<td>10.3</td>
<td>11.3</td>
<td>14.7</td>
<td>23.9</td>
<td>28.7</td>
<td>16.7</td>
</tr>
<tr>
<td>Gross External Debt (% of GDP)</td>
<td>86.9</td>
<td>78.6</td>
<td>65.0</td>
<td>60.1</td>
<td>63.8</td>
<td>70.9</td>
<td>81.9</td>
<td>100.2</td>
<td>107.7</td>
</tr>
<tr>
<td>Non-performing loans (% of total gross loans)</td>
<td>3.4</td>
<td>2.7</td>
<td>1.8</td>
<td>2.5</td>
<td>2.0</td>
<td>2.2</td>
<td>2.2</td>
<td>2.1</td>
<td>2.4</td>
</tr>
</tbody>
</table>


1 Preliminary data.
2 Refers to unemployed persons aged 15-64.

10. **Relatively high inflation in recent years is now slowing down.** Fuelled by surging global commodity prices and demand pressures, inflation rose through the first half of 2008. However, price increases started decelerating significantly in the second half of the year. Year-on-year inflation was 15 percent in June 2008 but was down to 7.2 percent by December.

11. **External imbalances continued to widen through most of 2008, but signs of a correction are beginning to appear.** In 2008, the current account deficit reached 25 percent of GDP following further widening of the trade gap. The earlier surge in prices for imported oil and strong imports of investment goods had been behind the worsened merchandise trade deficit. With prices of oil declining from their peak in the summer months and slowing of capital inflows that had led to a boom in domestic demand, import growth slowed in the last quarter of 2008 and is expected to drop significantly in 2009.

12. **The financing of the expanding current account has shifted from FDI to debt-creating funding sources during 2008.** Over the last several years Bulgaria enjoyed sizable FDI inflows reflecting the improved business environment as well as EU accession. However, in

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2 Harmonized Index of Consumer Prices, NSI, Eurostat
2008, net FDI fell to 16.7 percent of GDP, well down from 28.7 percent in 2007. Net FDI flows in 2008 financed close to 66 percent of the current account deficit compared to over 100 percent over the last several years.\(^4\)

13. **Other capital flows almost doubled in 2008, especially deposits by non-residents, but uncertainty about future capital inflows has increased in recent months.** Deposits by non-residents, mostly short-term and from parent banks, have financed the strong credit growth in Bulgaria, attracted by high bank profits. Short-term borrowing from abroad by banks more than doubled in 2008 compared to 2007 and together with short-term deposits account for close to 77 percent of banks’ external debt. Short-term debt of firms accounts for close to 53 percent of total debt of firms (excluding FDI-related), little changed from 2007. Despite a substantial reduction in external public debt, strong private borrowing from abroad kept the gross external debt increasing to 107.7 percent of GDP in 2008 from almost 100 percent of GDP at the end of 2007. Private borrowing from abroad, however, is likely to slow down significantly in 2009 with some of the parent banks experiencing liquidity or capital adequacy issues at home and bank lending to firms tightening globally.

14. **Thus far, net capital inflows have exceeded the current account shortfall, boosting foreign exchange reserves. That this will continue cannot be taken for granted.** Foreign exchange reserves grew by close to €2.4 billion between end-2007 and November 2008 to €14.3 billion, or 6 months’ cover of imports of goods and services, higher than in the last several years. However, intensified end-of-year government spending and changes to bank regulations brought down the foreign exchange reserves by €2.2 billion between January 2009 and November 2008.

15. **Generally prudent fiscal and income policies have been the main cushions against growing external vulnerabilities.** Fiscal surpluses of 3.5 percent of GDP have been achieved since 2006, supported by strong revenue performance and contained public spending. This led to the accumulation of a large fiscal reserve account of 13 percent of GDP by December 2008. Public and publicly guaranteed debt further declined to 16.1 percent of GDP in 2008 compared to 40.1 percent at end-2004. Preliminary data show that the 2008 fiscal surplus reached the target of 3 percent of GDP despite the slowdown in revenues in Q4 2008 and the supplemental budget spending approved by Parliament in September 2008 for an amount of 1.8 percent of GDP.\(^5\)

16. **Credit growth decelerated in 2008 in response to increased borrowing costs and changes to bank regulation and is likely to further decelerate in 2009 with the expected reduction in foreign financing.** Late in 2007 the Bulgarian National Bank (BNB) raised the minimum reserve requirements to 12 percent to contain rapid expansion of credit. Credit growth to the private sector slowed sharply to 32 percent year-on-year in the end of 2008 from 63 percent a year earlier, with new lending squeezed significantly and lending terms tightened since October 2008. Credit growth was stronger in the corporate segment—mainly lending to the most dynamic sectors of the economy—construction, trade, real estate, and manufacturing. Banks remained profitable and well capitalized despite the worsening external environment. The capital adequacy ratio in 2008 stood at 14.9 percent, higher than in 2007, and higher than the

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\(^3\) FDI data are usually subject to substantial upward revisions when data from non-financial companies become available.

\(^4\) Net FDI flows in 2008 were affected by a significant investment abroad made by a Bulgarian branch of a multinational company which contributed to a more than tripling of investments abroad (to €403 million in the first ten months of 2008).

\(^5\) The latter included (i) additional social assistance programs to the poor to help mitigate the negative effects of sharp increases in food and energy prices earlier in the year, and (ii) appropriations for new investment projects in the light of the disappointing performance of the existing pipeline (until August 2008, the execution of the capital budget was only 35 percent of the annual plan).
required ratio of 12 percent. Loan portfolios of banks remain of good quality, with non-
performing loans representing only 2.4 percent of loans in 2008, slightly higher than in 2007 –
reflecting, however, an increasing share of new lending. The strong banking supervision and
more stringent regulations on provisioning (higher than the level of impairment based on
IAS/IFRS and stronger treatment of non-performing loans), capital adequacy (including higher
capital requirement for mortgages) and liquidity in Bulgaria than in other EU countries. The anti-
cyclical policy of BNB has created buffers that are expected to help mitigate the negative impacts
of the financial turmoil on the Bulgaria’s banking sector.

17. In response to the global financial crisis, the Bulgarian Government in
coordination with the BNB has announced and introduced a number of policy actions
aimed at addressing negative impacts from the ongoing financial turmoil on the stability
of the banking system and on the real economy. In line with agreements between the EU
members states reached in October, the guarantee on bank deposits was raised to €50,000 from
the €20,000 and in 2009 it might be increased further to €100,000 per depositor per bank. To
help improve access to short-term liquidity, the BNB made amendments to reserve requirements
regulation with immediate positive effects on the interbank market late in 2008. Further easing
of regulation is in effect from January 1, 2009. Reserve requirements were reduced from 12
percent to 10 percent with no reserves required on government deposits and 5 percent only
required for attracted funds from abroad. Under the Currency Board Arrangement, the BNB has
limited instruments to provide emergency liquidity to banks. According to the law, BNB’s lender
of last resort facility is limited up to the deposit of the Banking Department which is currently
close to €1.4 billion. The government has a fiscal reserve account at its disposal to provide
liquidity, if needed, but only within limits preserving the minimum level of the fiscal reserve
account set by law. The fiscal reserve account stood at close to €4.2 billion in the end of 2008.
No Bulgarian bank appears to suffer liquidity or solvency problems at the moment requiring
BNB or state intervention. Further changes in legislation or bank regulations might be needed in
case pressures on financial markets intensify.

MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

18. Increased tensions on financial markets are changing rapidly the external
environment for 2009 and 2010, with significant downward adjustments to growth
prospects. Weakened investor confidence and recession in most of Europe and elsewhere are
affecting negatively Bulgaria’s growth outlook, with growth projected to slow to about 1 percent
in 2009. However, large investments already in the pipeline are expected to mitigate somewhat
the adjustment to growth in 2009. Planned upgrades in infrastructure, financed almost
exclusively with EU post-accession funds, are likely to keep investment-to-GDP ratios relatively
high, although declining. In the following two years growth is expected to recover. The
slowdown of private consumption that has been in place over the last three years is expected to
continue on the back of worsened growth outlook and credit squeeze. Slowing domestic
demand, expected lower FDI inflows, slowing domestic credit and downward corrections to oil
and food prices would contribute to substantial narrowing of the trade gap in the medium term.
The slowdown in economic growth is also likely to have an effect on household incomes. In
particular, given that economic growth in recent years has been pro-poor, the poor and
vulnerable could suffer disproportionately during 2009.
Table 2: Macroeconomic Framework

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</thead>
<tbody>
<tr>
<td><strong>National accounts and prices</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Real GDP growth (%)</td>
<td>6.2</td>
<td>6.3</td>
<td>6.2</td>
<td>6.0</td>
<td>1.0</td>
<td>1.5</td>
<td>3.0</td>
</tr>
<tr>
<td>CPI, annual average (%)</td>
<td>6.0</td>
<td>7.4</td>
<td>7.6</td>
<td>12.0</td>
<td>4.7</td>
<td>2.5</td>
<td>3.0</td>
</tr>
<tr>
<td>GDP deflator (%)</td>
<td>3.8</td>
<td>8.5</td>
<td>7.9</td>
<td>9.9</td>
<td>3.1</td>
<td>2.8</td>
<td>3.4</td>
</tr>
<tr>
<td>Real effective exchange rate (CPI based)</td>
<td>-0.1</td>
<td>5.3</td>
<td>8.8</td>
<td>7.2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment (% of GDP)</td>
<td>28.0</td>
<td>31.7</td>
<td>36.8</td>
<td>38.3</td>
<td>27.8</td>
<td>21.9</td>
<td>22.0</td>
</tr>
<tr>
<td>Public investment (% of GDP)</td>
<td>4.8</td>
<td>4.7</td>
<td>6.3</td>
<td>6.4</td>
<td>6.8</td>
<td>5.9</td>
<td>6.0</td>
</tr>
<tr>
<td>Private investment (% of GDP)</td>
<td>23.2</td>
<td>27.0</td>
<td>30.5</td>
<td>31.9</td>
<td>21.0</td>
<td>16.0</td>
<td>16.0</td>
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<td><strong>Monetary indicators</strong></td>
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<tr>
<td>Broad money (annual percentage change)</td>
<td>23.9</td>
<td>26.9</td>
<td>31.2</td>
<td>31.0</td>
<td>2.7</td>
<td>2.2</td>
<td>4.9</td>
</tr>
<tr>
<td>Domestic credit (annual percentage change)</td>
<td>32.4</td>
<td>24.6</td>
<td>62.5</td>
<td>31.6</td>
<td>5.0</td>
<td>6.0</td>
<td>7.0</td>
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<tr>
<td><strong>Fiscal Policy</strong></td>
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<tr>
<td>Revenue (% of GDP)</td>
<td>39.8</td>
<td>38.8</td>
<td>40.7</td>
<td>30.9</td>
<td>41.3</td>
<td>39.3</td>
<td>39.0</td>
</tr>
<tr>
<td>Expenditure (% of GDP)</td>
<td>37.5</td>
<td>35.3</td>
<td>37.2</td>
<td>37.9</td>
<td>39.9</td>
<td>37.8</td>
<td>37.7</td>
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<tr>
<td>Overall fiscal balance</td>
<td>2.3</td>
<td>3.5</td>
<td>3.5</td>
<td>3.0</td>
<td>1.4</td>
<td>1.5</td>
<td>1.3</td>
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<tr>
<td>Gross Public and Publicly Guaranteed debt/GDP (%)</td>
<td>31.3</td>
<td>24.7</td>
<td>19.8</td>
<td>16.1</td>
<td>18.7</td>
<td>19.4</td>
<td>19.7</td>
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<td><strong>Balance of payments</strong></td>
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<tr>
<td>Current account balance (% of GDP)</td>
<td>-12.4</td>
<td>-18.4</td>
<td>-25.1</td>
<td>-25.3</td>
<td>-15.3</td>
<td>-8.4</td>
<td>-6.4</td>
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<tr>
<td>Foreign direct investment, net (% of GDP)</td>
<td>14.7</td>
<td>23.9</td>
<td>28.7</td>
<td>16.7</td>
<td>7.9</td>
<td>4.9</td>
<td>5.3</td>
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<tr>
<td>Merchandise Terms of Trade (percent change)</td>
<td>-2.5</td>
<td>3.5</td>
<td>0.3</td>
<td>-7.3</td>
<td>-3.5</td>
<td>0.5</td>
<td>0.4</td>
</tr>
<tr>
<td>Export volume (percent change)</td>
<td>10.5</td>
<td>11.3</td>
<td>10.2</td>
<td>12.4</td>
<td>-4.8</td>
<td>6.9</td>
<td>7.7</td>
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<tr>
<td>Import volume (percent change)</td>
<td>15.3</td>
<td>15</td>
<td>17.3</td>
<td>9.5</td>
<td>-10.3</td>
<td>-5.7</td>
<td>3.8</td>
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<td><strong>Debt Management</strong></td>
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<tr>
<td>Gross external debt (% of GDP)</td>
<td>70.9</td>
<td>81.9</td>
<td>100.2</td>
<td>107.7</td>
<td>106.8</td>
<td>108.1</td>
<td>105.7</td>
</tr>
<tr>
<td>Short term external debt (% of GDP)</td>
<td>18.0</td>
<td>24.7</td>
<td>32.7</td>
<td>38.9</td>
<td>36.2</td>
<td>35.4</td>
<td>34.5</td>
</tr>
</tbody>
</table>

Sources: NSI, MOF, BNB, IMF6, and staff estimates

1 To Non-Government.

19. **Inflation is projected to decline to single digits in 2009** to an annual average of 4.7 percent and gradually decline thereafter to converge to levels in the eurozone. The projections for inflation are based on the following assumptions: (i) improved agricultural production following substantial investments financed by EU funds and a strong recovery of agricultural output already in place after the sharp contraction in 2007; (ii) stabilization of global commodity prices; and (iii) moderation of wage growth as output growth weakens leading to a narrowing of the output gap.

20. **The ongoing financial turmoil and expected slowdown of growth is likely to support a substantial narrowing of the external current account deficit in 2009**—from 25 percent of GDP in 2008 to 15 percent in 2009 but to remain high, reflecting catch-up effects. The importance of FDI inflows as the primary source of balance of payments financing is expected to diminish substantially in 2009 as investments in real estate decline and intercompany borrowing decelerates. Other capital inflows are also expected to decline compared to 2008. Current and capital transfers from the EU are expected, however, to increase as absorption of EU funds accelerates. In case of prolonged financial turbulence, however, Bulgaria’s current account deficit may see a sharp downward adjustment with negative effects on growth.

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6 Based on *Staff Report for the 2008 Article IV Consultation*, IMF, February 13, 2009
21. Fiscal policy for 2009 is expected to remain prudent and flexible to respond to the worsening of the external environment and slowdown of growth in Bulgaria. Consistent with the Government’s Convergence Program for 2009-2011, the 2009 budget envisages maintaining a fiscal surplus of 3 percent of GDP and a ceiling in public expenditure of 40 percent of GDP (net of the contribution to the EC budget). Maintaining a continued high fiscal surplus will require a significant slowing of expenditure growth in 2009, as the budget is based on an optimistic macroeconomic scenario assuming an output growth of 4.7 percent in 2009. To achieve the fiscal target, non-interest spending was restricted to 90 percent of the budgeted amount to counteract the effect of lower revenue growth (the “10 percent rule”). Despite the flexibility provided by this buffer, estimated at 2.4 percent of GDP, risks to achieving the planned fiscal surplus remain on account of larger than expected revenue shortfall. Thus, fiscal surplus is projected to reach at least 2 percent of GDP with Bulgaria being one of the few countries in the EU projected to end 2009 with a surplus. Planned investment of 7 percent of GDP is expected to support growth and investment and mitigate the impact of lower private capital inflows from abroad. The success of implementation of the investment program however will hinge on further improvements in the governance structures and mechanisms for management of EU post-accession funds.

22. While further cuts in tax rates were not introduced with the 2009 budget, the social insurance contribution burden for employers was reduced by 2 percentage points. Since 2009 the Government has become a third contributor together with employers and employees (with the Government covering 12 percent of the contribution and employers and employees covering 10 and 8 percent respectively). Until 2009 social contributions were paid by employers and employees, each paying 60 and 40 percent of the contribution respectively, while the Government covered the deficit of the pension fund. Further cuts in the tax burden were not introduced, as both personal and income tax rates (at 10 percent currently) are among the lowest in the EU. A low tax burden, planned improvements in regulation of businesses, as well as improvements in the efficiency and effectiveness of state administration are expected to help sustain foreign and domestic investment.

23. The main fiscal challenge in the medium term will be to improve the efficiency and effectiveness of public spending, especially in health, education and social protection. Structural reforms in these sectors are expected to ensure that almost half of public sector resources are spent more effectively. To improve the efficiency and effectiveness of public administration and remove bottlenecks to absorption of EU funds, the Government is undertaking a Government-wide functional review. While recent efforts to optimize the number of public administration staff led to a downsizing of 17,000 employees (close to half of them unfilled positions), the focus in the future should be on improving the capacity of state administration to select, manage, and implement large investment projects.

24. Ensuring sustainability of the pension and health insurance funds is very important in view of Bulgaria’s unfavorable demographic situation and given the tightening fiscal position in the short-term. Recently approved legislation envisages the establishment of a fund to guarantee the stability of the public pension system. The “Silver Fund” would be financed by revenues from privatization, concessions, and from the fiscal surplus to address the negative effects from population aging which are expected to turn acute in 10-15 years. The proposed start-up capital of the fund is around €350 million. The 2009 budget of the National Health Insurance Fund (NHIIF) introduced an increase in the health contribution rate to 8 percent from 6 percent currently which will be maintained as reserves on the budget account of the NHIIF.
25. **Heightened medium-term risks of sharp adjustments to growth amidst a rapidly worsening external environment weigh heavily on the fiscal stance and advancement of productivity-enhancing structural reforms.** In the context of the domestic environment there are risks of a loss of momentum in the implementation of structural reforms and a weakening of fiscal discipline in the run-up to Parliamentary elections planned in mid-2009. Reforms to improve the management of EU funds as well as the effectiveness of judiciary and law enforcement are crucial to ensure implementation of projects and programs financed from EU funds. Pressures to increase spending for pre-election purposes are increasing but uncertainty about the implications of the ongoing financial turmoil are reducing the flexibility of the budget and helping the political economy for reforms. Achieving sizable revenue over-performance, as in the past several years, is not likely to continue. Potential need to support the stability of the banking system would create a significant burden on the fiscal reserve account. Planned high public investment spending would require substantial restructuring of the current spending to achieve medium-term fiscal policy objectives.

26. **Downside risks to the baseline scenario have therefore increased substantially over the last couple of months.** Financial systems around the world are under stress, with governments providing liquidity support to increasing numbers of banks, including to the parent banks of subsidiaries and branches of Bulgarian banks. Financial stress has spilled over quickly to the real economy. Growth projections for the region and the world have been scaled back a number of times since the onset of the crisis, suggesting there is substantial uncertainty about the implications of the global financial turmoil on the real economy. There is uncertainty also about the second-round effects of the worsening of real economy on the financial sector. Further worsening of growth prospects of Bulgaria’s main trade partners increases the risk for Bulgaria of experiencing sharper adjustment to growth and entering even into a mild recession in 2009. There is also uncertainty about the effects of the measures put in place in the EU and globally aimed at supporting the financial sectors in these countries. Whether these measures would be effective in quickly restoring confidence and increasing lending to the real economy is yet to be seen. The measures would have key implications for capital flows in Bulgaria, coming both from parent banks and from private investors.

27. **The short- and medium term macro framework is sustainable under the current projections, but growing downside risks need to be managed carefully.** Under the current growth projections, the macro framework would continue to be sustainable provided government expenditure is restricted to 90 percent of budgeted amount, as announced, and access to capital markets allow a 100 percent rollover of short-term external debt. However, the short-term outlook will continue to be revised as new data and information become available. If the current global financial turmoil is not contained and there is a shortfall in the rollover of short term external debt, adjustments to growth in Bulgaria would be significant. Lower output growth and a worsened external environment would result in a sharp narrowing of the external current account deficit, but could slow the EU convergence process. The accumulated fiscal reserves would provide an important buffer if the external conditions were to deteriorate further.

28. **Independent of the extent of a cyclical downturn, achieving Bulgaria’s aim of income convergence over the medium term will depend on increases in employment and, more importantly, substantial increases in productivity.** Bulgaria’s convergence effort is complicated by its projected significant demographic decline over the next two decades. Bulgaria is projected to lose about 1.5m people between 2000 and 2025 - the largest decline among the new EU Member States in percentage terms, at 18 percent. The policy implications of this are

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two-fold: (i) promoting employment, by activating those currently not in the labor force, and (ii) raising productivity by improving human capital and labor mobility from low to high productive sectors. Increasing employment has been making a strong contribution to economic growth in the past years. Yet further labor market activation of the working age population will not be sufficient to generate the high economic growth necessary for Bulgaria’s longer-term convergence. Rather, convergence will require substantial increases in skills and productivity of the current and future labor force and delays in addressing the skills issue would have negative long-term implications on growth.

III. THE GOVERNMENT'S PROGRAM

29. In its updated National Reform Program 2008-2010 – a key requirement under the EU Lisbon Jobs and Growth Strategy – Bulgaria has committed itself to continued fiscal and structural reforms. The Bulgarian Government recognizes that achieving sustained high rates of economic growth for convergence with Bulgaria’s EU partners will require actions in the field of fiscal policy and structural reforms. With this in mind, the Government’s updated National Reform Program in 2008 sets out a number of strategic measures aimed at:

- Improving the administrative capacity, particularly in key areas of government in relation to implementing policies in the field of the labor market, program budgeting, market regulation, and the EU Structural Fund absorption;
- Limiting the current account deficit and the high inflation rate through implementing measures in the field of fiscal policy, market and competition functioning, consumer protection and income policy;
- Further improving the business environment and applying the principles of better regulation through implementing the measures of the Better Regulation Program and increasing the share of the electronic registrations in the Trade Register;
- Increasing the labor supply, improving the quality of the workforce and raising the employment level;
- Ensuring the long-term sustainability of public finances in particular in relation to the potential risks related to the adequacy and sustainability of pension expenditures;
- Developing an integrated policy approach of the public sector in the field of research and development (R&D) and innovation with the aim to reform the public R&D system, transition from publicly financed R&D (based on a total value of R&D expenses to GDP by 2010) to a more competitive financing focused on key priorities;
- Taking measures against hidden employment through strengthening the institutional capacity for conducting inspections and ensuring law enforcement; and
- Encouraging lifelong learning.


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8 Republic of Bulgaria (2008), National Reform Program 2008-2010, which updates the National Reform Program 2006-2008.
### Table 3: Key objectives of sectoral reform strategies in Bulgaria

<table>
<thead>
<tr>
<th>Sectoral area</th>
<th>DPL 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Employment</strong></td>
<td></td>
</tr>
<tr>
<td>Adopting macroeconomic policies for economic growth and job creation</td>
<td>X</td>
</tr>
<tr>
<td>Activation of discouraged and inactive persons and effective integration into the labor market</td>
<td>X</td>
</tr>
<tr>
<td>Ensuring flexibility and security in the labor market (&quot;flexicurity&quot;) and implementation of the lifecycle approach to work</td>
<td>X</td>
</tr>
<tr>
<td>Education and training in support of the transition to a knowledge-based economy</td>
<td>X</td>
</tr>
<tr>
<td><strong>Education</strong></td>
<td></td>
</tr>
<tr>
<td>Orienting school education towards the stimulation of thinking and independence, towards the formation of practical skills and towards personality building</td>
<td></td>
</tr>
<tr>
<td>Establishing an efficient internal assessment system through the wide-scale use of tests and introduction of a system for national standardized external assessment</td>
<td>X</td>
</tr>
<tr>
<td>Decreasing the number of drop-outs and increase enrollment rates for children in the compulsory schooling age</td>
<td>X</td>
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<tr>
<td>Strengthen the authority and improving the social status of the teacher</td>
<td></td>
</tr>
<tr>
<td>Decentralizing the school network through the gradual introduction of delegated budgets for all schools and providing more flexibility to municipalities to appoint school directors; and</td>
<td>X</td>
</tr>
<tr>
<td>Optimizing the school network by introducing a single standard (per capita) financing formula and putting in place a system of financial incentives for the closure of ineffective schools</td>
<td>X</td>
</tr>
<tr>
<td><strong>Health</strong></td>
<td></td>
</tr>
<tr>
<td>Delivering high-quality and guaranteed healthcare services, by improving the accreditation system and increasing access to healthcare services</td>
<td></td>
</tr>
<tr>
<td>Emphasizing the role of primary outpatient care, by refining the payment mechanisms and clearly defining the division of the responsibilities between the primary and the outpatient specialized medical services</td>
<td>X</td>
</tr>
<tr>
<td>Optimizing the network of the health care providers, by improving the links between outpatient and inpatient care, devising a master plan and implementation strategy for achieving a more efficient hospital network; strengthening hospital management, and revising the prospective payment system for hospitals</td>
<td>X</td>
</tr>
<tr>
<td>Implementing a transparent and fair pharmaceutical policy, by increasing the awareness of patients, controlling prices and rationalizing the drug prescription practices</td>
<td>X</td>
</tr>
<tr>
<td>Securing the financial stability and sustainability of the system in the long-term, by promoting the rational use of pharmaceutical products, creating an efficient and effective drug reimbursement policy, refining the models of primary and specialized outpatient healthcare and the restructuring of inpatient care, improving compliance for health insurance contributions, improving the negotiation process for the National Framework Contract, increasing the monitoring and enforcement capacity of the NHIF, improving the prospective payment system, developing a voluntary health insurance, and introducing regulated co-payments</td>
<td>X</td>
</tr>
</tbody>
</table>

31. Bulgaria’s continued focus on structural reforms in education, the labor market, business environment and health also follows the philosophy of the European Union’s Economic Recovery Plan. In December 2008, the Council of the European Union has adopted a European Economic Recovery Plan in response to the economic downturn affecting many EU
Member States in the wake of the global financial crisis. While this plan includes a pillar focusing on boosting purchasing power across Member States where needed, a second pillar highlights the need for short-term action to (i) reduce the human cost of the economic downturn and its effect on the most vulnerable by stemming job losses and help people return quickly to the labor market and to (ii) raise Europe’s competitiveness in the long-term by investing in skills, facilitating labor market transitions and reducing the regulatory and administrative burdens on enterprises – in line with the Lisbon Jobs and Growth Strategy.

IV. BANK SUPPORT TO THE GOVERNMENT’S PROGRAM

LINK TO THE COUNTRY PARTNERSHIP STRATEGY

32. The DPL series is consistent with the three priority areas laid out in the Country Partnership Strategy (CPS):

a. **Raising productivity and employment in support of private sector-led growth along the lines of the EU’s Lisbon Agenda.** The DPL series have supported the productivity and employment agenda by focusing on: (i) the reform of the labor framework and social protection system to increase employment by lowering payroll taxes, reducing social assistance dependency, and increasing formal employment through more flexible work arrangements and better incentives to participate in the formal economy; (ii) the reforms in the education sector to strengthen the institutional capacity to monitor and improve quality and increase accountability, laying the foundation for long-term productivity growth; and (iii) improving the investment climate by improving the quality of regulation and reducing the burden that regulation imposes on firms to increase productivity and encourage firm growth.

b. **Fiscal sustainability and improved capacity for absorption of EU funds.** The DPL series focus on improving the efficiency of the health, education, and social protection systems to support their financial sustainability and effectiveness. In health, the focus has been on improving financial sustainability of the NHIF as well as improved efficiency of the hospital and pharmaceutical sectors. In education, the DPL series have supported finance and governance reforms that would help improve both the quality of education, and the efficient utilization of resources available for education. In social protection, the restructuring of active labor market policies would help increase the employment prospects of long term unemployed. The reforms in these sectors will also open windows of opportunity to utilize EU funds as new programs are being created or old programs reformed.

c. **Poverty reduction and social inclusion.** Even though social inclusion and poverty reduction are not explicit themes of the DPL, the policies supported by the program are well placed to have a positive impact on the poor. For example the increased focus on active labor market policies and emphasis on capturing the long term unemployed and other vulnerable groups should help address skill gaps and enhance employment prospects for individuals in low quality subsidized jobs. The actions supported in the health sector are expected to increase access to basic care, as the reimbursement policies for basic drugs that are now preventing some groups from obtaining them at affordable prices will be thoroughly revised. Reforms in the health sector should promote access by (i) shifting the focus from inpatient to outpatient care, and (ii) using the resources from efficiency savings to improve

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quality in lagging areas. The DPL is also increasing awareness of the Bulgarian Government about the impact of policies on vulnerable groups. It is a success of the policy dialogue under the DPL series to have supported a mitigating "package of measures and incentives" so that municipalities consolidating schools could provide additional services to at-risk groups, something that the Government had not originally planned. The same applies to the assessment of the effectiveness of changes in social welfare policies.

COLLABORATION WITH THE IMF AND OTHER DONORS

33. The IMF completed an Article IV consultation in December 2008 the result of which was discussed by its Board in March 2009. Mission discussions focused on the effect on Bulgaria’s economy of the changing economic conditions worldwide and in Europe. While noting that projections are subject to an unusually high degree of uncertainty, the Fund mission presented a forecast for GDP growth to slow to about 2 percent in 2009, the current account deficit to shrink to 15 percent of GDP, and inflation to decline to 4½ percent at the end of 2009. The Government is in agreement with the revised growth figures, evident in the decision to apply a “10 percent rule” to the execution of the 2009 budget – which adjusts expenditures to a revenue envelope consistent with a 2.1 percent growth forecast. Given the challenges, the mission recommended, inter alia, (i) policies to maintain confidence in the currency board and the financial sector, (ii) continued fiscal prudence and structural policy reform to maintain a large fiscal surplus, including through a significant slowing of expenditure growth, (iii) policies to curb wage growth and moderate unit labor cost increases.

34. In addition to the IMF, the World Bank DPL team has been coordinating closely with the European Commission throughout the DPL series on Bulgaria’s macro situation and the reform agendas in education, health and social protection and labor, through the European Commission Secretariat-General, DG Economic and Financial Affairs (DG ECFIN) and DG Employment, Social Affairs and Equal Opportunities (DG EMPL). The DPL series are fully consistent with Bulgaria’s commitments to the European Commission in the framework of the National Reform Programs 2006-2008 and 2008-2010, the National Strategic Reference Program and related Operational Programs. With Bulgaria having acceded to the EU, the Bank-EC relationship related to Bulgaria has evolved over the lifetime of the DPL series from a formal cooperation of donors to an informal dialogue about structural policy reforms and information-sharing.

RELATIONSHIP TO OTHER BANK OPERATIONS

35. The DPL series is complementary to existing and recent Bank operations in the social sectors, and has been the pillar around which future investments and policy dialogue in these sectors will be structured. The recently closed Health Sector Reform Project included a component on hospital restructuring in selected municipalities and technical assistance to develop the hospital master-plan as well as the introduction of a new integrated information system for NHIF. In addition one of its main activities is the strengthening of the management and administrative capacity of the NHIF, an essential condition to improve financial sustainability and efficiency in health care provision. The recently approved Social Inclusion Project is designed to promote the long-term social inclusion of marginalized groups by raising the school readiness of children below the age of 7. The project builds on strategic EU goals of promoting inter-generational social inclusion and focusing on early childhood interventions and will contribute to the strategic utilization of financing from the European Social Fund for social inclusion policy through the Operational Program Human Resources Development (OP HRD). This operation will complement the DPL series in its objective to develop an agenda to improve
the delivery of social welfare services and promote access to quality education. Lastly, an Institutional Development Fund Grant is supporting the capacity building in the Ministry of Education and Science through the strengthening of the national Center for Control and Assessment of the Quality of Education (CKOKO), the National Principals Training Institute (NPTI) and the MES department serving as an Intermediate Body for the OP HRD.

36. **The DPL series also interact with parallel World Bank technical assistance TA** to build Government capacity on (i) impact evaluation and (ii) performance-based budgeting and public investment management (both FY09 tasks).

### LESSONS LEARNED

37. **The preparation and implementation of the Bulgaria PAL series (2003-2005) and the DPL 1 and DPL 2 have provided useful lessons** that have been taken into account in the preparation of the DPL series including DPL 3:

- **Focusing on fewer actions:** The Bulgaria PAL Implementation Completion Report (April 20, 2006) discusses the large number of benchmarks and triggers throughout the series. Even though that PAL program was highly successful, a more streamlined approach focusing on fewer actions facilitates coordination within the Government, and focus the attention of authorities on fewer issues.

- **Maintaining a flexible approach to adjust to changing environment and demands.** The DPL series define triggers in broad terms in order to accommodate changes in government’s requests for assistance in specific areas or to allow for time to define specific actions.

- **Accompanying reform program with technical assistance.** This has proven essential to the success of the program, as it has been used to both define details of policy changes and also to strengthen the capabilities of counterparts to implement policy reforms. The preparation of DPL 3 as the concluding phase of the program has benefited from prior and ongoing technical assistance through the DPL 2 PHRD and Bank-financed work.

- **Allowing time for sustainable reform.** The programmatic approach has also been extremely useful as the reforms in many areas have built upon changes in previous years.

### ANALYTICAL UNDERPINNINGS

38. **The DPL series have been well integrated with, and benefited from, the World Bank’s recent analytical and advisory work in Bulgaria.** As part of the preparation activities for the DPL 1 the Bank team produced (in December 2005) policy notes in health, education, and social protection providing a comprehensive overview of the three sectors, highlighting the main problems, and identifying key areas where Bank intervention would be needed. The DPL 2 was complemented by a PHRD grant supporting a number of pieces of analytical work to inform the DPL-supported reform agenda, and the DPL 3 has benefited from this input. In addition, the DPL team prepared brief technical notes on hospital restructuring, the pharmaceutical sector, education financing, assessment of quality of education, labor market and unemployment, disability cost containment, social assistance and social services delivery. More recently the Bank completed two short reports on health sector policies, one regarding the National Framework Contract and another assessing the Clinical Care Pathways mechanism to set prices of hospital services. The Bank also produced a policy note on skills shortages in the labor market at the joint request of the Minister of Labor and Social Policy and the Confederation of Bulgarian Employers and Industrialists. Box 1 summarizes recent background reports prepared in the framework of the DPL series.
39. The DPL-supported education finance and governance reforms have benefited from particularly in-depth and hands-on Bank analytical work. As part of the preparation of the DPL 1, the World Bank education team has worked closely with the MES and MOF on compiling a school level expenditure data base and investigating the drivers of costs in education. This database has continued to serve as the basis for developing the system of per-capita financing in primary and secondary schools. In addition, the World Bank's 2007 report “Accelerating Bulgaria’s Convergence: The Challenge of Raising Productivity” laid out in detail the necessary reform steps in financing and governing schools and have informed policy reform design.

<table>
<thead>
<tr>
<th>Box 1: List of background reports prepared during the preparation of the DPL series</th>
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<tbody>
<tr>
<td>1. Implementation of unified standard per capita finance formula in basic education</td>
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<td>2. VET in Bulgaria and best practice in Europe</td>
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<tr>
<td>3. Assessment of proposal for differentiating payment for teachers</td>
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<td>4. Assessing Bulgaria’s performance in 2006’s PISA and PIRLS</td>
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<tr>
<td>5. Bulgaria Living Conditions Assessment Report</td>
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<tr>
<td>6. Assessment of administrative costs of social assistance programs in Bulgaria</td>
</tr>
<tr>
<td>7. Revision of the National Framework Contract (NFC) for publicly financed health services</td>
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<tr>
<td>8. Resource Allocation for Hospitals: Assessment and Recommendations</td>
</tr>
<tr>
<td>9. Competitive Social Health Insurance in Bulgaria: Assessment of a Proposed Model</td>
</tr>
<tr>
<td>10. Options for Improving GP Referral and Hospital Admissions Practices</td>
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<tr>
<td>11. Evaluation of National Programs on ICT in the Education Sector</td>
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<tr>
<td>12. Policy Framework for Teacher Qualification and Career Development</td>
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<tr>
<td>13. Using of National Assessment Data for Quality Improvement at the School and Classroom Level</td>
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<tr>
<td>14. Student Loan Scheme in Bulgaria</td>
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<tr>
<td>15. Survey of the profile of social assistance (GMI) beneficiaries affected by limiting the maximum duration of GMI eligibility</td>
</tr>
</tbody>
</table>

40. Recent steps in regulatory reform in Bulgaria supported by the DPL 3 have benefited from prior in-depth Bank analytical work. Two World Bank reports on regulatory reform, which were presented at the Council for Economic Policy in October 2007 (2007a, 2007b) contributed to the development of a Better Regulation Program, while the Investment Climate Assessment (2008), which was presented to Government and discussed in the framework of the Council for the Promotion of SMEs in September 2008, has contributed to further the reform momentum in the area of business environment and regulatory issues.

41. The World Bank will continue analytical work in education, social protection and employment and health beyond the SIR DPL series, through a series of policy notes to be prepared in the summer of 2009 and aimed at informing the next generation of reforms in the social sectors.


Box 2: Initial results of the program supported by the DPL series

With support of DPL 1 and DPL 2 the government reform program has achieved significant initial accomplishments in the labor market and the education and health sector.

In the labor market reforms supported by the DPL series to reduce the social insurance burden and to make active labor market programs more effective have contributed to increases in the employment rate of youth and older workers – traditionally more disadvantaged in the labor market compared to their peers elsewhere in the EU and compared to prime age workers – from 21.6 percent in 2005 to 24.5 percent in 2007 and from 34.7 percent in 2005 to 42.6 percent in 2007 respectively. Moreover, reforms in active labor market policies have contributed to an increase in the relative share of beneficiaries enrolled in training programs from 19.4 percent in 2005 to 26.5 percent in 2007. DPL 1 and DPL 2 have contributed to counteracting to social welfare-related disincentives for job search through supporting job search incentives for welfare beneficiaries and encouraging the authorities to study the profile of the social assistance beneficiaries, start developing individual activation plans and design active labor market programs for those who cannot find jobs on the primary labor market.

In the education sector, Bulgaria has significantly improved its information base on education and the capacity of the Center for Control and Assessment of the Quality of Education to manage national and international student assessments has been raised. Supported by the DPL series, Bulgaria participated in the international student assessments PISA 2006, PIRLS 2006 and TIMSS 2007 – creating a solid baseline for the Government’s education reform program – and has conducted a new national placement test for 7th graders and a new census based test for 4th graders. There is now full readiness for the nationwide implementation of the Matura, a National Education Portal is fully operational and all school directors have been trained through the Institute of School Directors. Meanwhile, the financing and governance system for primary and secondary education has been completely revamped, resulting in substantial efficiency improvements. The introduction of a per-capita unified financing standard and package of measures and incentives, supported by the DPL series, has triggered substantial consolidation of the previously oversized school network and efficiency increases evident in increasing pupil-teacher ratios (see Figure 2 below). Moreover, delegated budgets to schools have been introduced, raising the percent of municipal education budget delegated to schools to a minimum of 80 percent.

In the health sector, the rationalization of the hospital payment mechanism and the introduction of service volume ceilings, initiated under DPL 1 and sustained under DPL 2, have contributed to substantial progress towards the stabilization of hospital financing. The share of hospital payments passing through NHIF has jumped from 55 percent in 2005 to 86 percent in 2008. Together with the introduction of budget ceilings, this measure has sent a strong signal to hospitals that the previous approach to reimbursement -- which was both fragmented and open-ended -- would no longer be supported. The positive outcomes associated with these measures include a reduction in the stock of hospital arrears from 60.8m BGN to 19.6m BGN between 2006 and 2008, and a reduction in the annual rate of growth of hospitalizations from 22 percent to 7 percent over the same period. Improvements in other hospital indicators, such as average length of stay, have also been recorded. Furthermore, the pharmaceutical policy reforms supported by DPL 1 and DPL 2 have made an additional contribution to ensuring the sustainability of health spending. The growth rate of pharmaceutical spending has fallen each year since 2005-06, and remains within the targeted range relative to GDP growth. Completion of the positive drug list should help consolidate these gains.
V. THE PROPOSED BULGARIA SIR DPL3

OPERATION DESCRIPTION

42. Prepared in times of heightened economic risks and an expected slowdown in growth in Bulgaria in 2009, the third phase of the DPL series continues to focus on structural reforms in the social sectors and measures to lay the ground for future strong economic growth and convergence. Living standards in Bulgaria continue to lag EU averages, requiring decisive action to promote productivity and raising employment and the efficiency of public spending over the coming decade. At the same time, Bulgaria joins its EU partners in facing a period of economic downturn and considerable uncertainty triggered by the turmoil in the global financial markets, raising the need for adequate measures to cushion the negative employment and social impacts and to ensure a prudent fiscal stance. The Government has requested that the third phase of the DPL series maintain its primary focus on the social sectors, and emphasizes actions to contribute to improving productivity and skills of the labor force as well as efforts to improve fiscal sustainability and the efficient use of public funds in the social sectors. The DPL series perform many functions: (i) they anchor the Bank’s work in the social sectors as well as regulatory reform, which includes various investment operations, analytical and advisory activities, and technical assistance; (ii) they provide a framework for implementation of the government’s strategies; (iii) they commit the highest levels of Government, and particularly the Ministry of Finance, to work together with the social sector ministries; and (iv) they provide a timeframe for reforms and outside monitoring to measure success and determine corrective actions.

POLICY AREAS

43. Marking the completion of the DPL series, the DPL 3 continues to support some of the overarching objectives stated in the CPS. These are: (i) Increase employment and lay the foundations for long-term productivity growth by providing incentives for job creation and improving quality of education and; (ii) Promote fiscal sustainability through efficiency gains in social sectors. However, it also takes account of the worsening economic prospects following the global financial crisis. All prior actions, summarized in Box 3 and discussed in the sections below, have been completed:

**Box 3. Prior Actions for the Bulgaria SIR DPL 3**

2. The Government has (i) raised unemployment benefit replacement rates and changed the payment schedule to incentivize job search and (ii) introduced targeted active labor market programs and job subsidies for newly laid-off workers in order to address expected negative effects of the slowdown in economic growth projected for 2009 on employment.
3. Amendments to the Employment Promotion Act and the Vocational Education Act have been enacted to open opportunities for second chance education and training for early school leavers, low skilled and people without education.
4. In order to improve the investment climate and promote job creation the Government has approved and begun implementation of the Better Regulation Program 2008-2010 as a
The following section provides a detailed description of the measures, organized around the themes and original challenges as identified at the time of DPL 1 in 2006/7, and documents the linkages to previous reforms supported by DPL 1 and DPL 2.

I. Increase employment and lay the foundations for long-term productivity growth by providing incentives for job creation and improving quality of education

I.1. Original Problem: Low employment, relatively high unemployment rates, high percentage of long term unemployed and high rates of informality in the labor market

Main sector issues and recent developments

45. At the outset of the Government’s reform program Bulgaria faced a situation of low employment, low labor force participation and low labor productivity. While it had already been picking up from its low pre-2000 levels, Bulgaria’s employment rate for the 15-64 population in 2005 was 55.8 percent – a significant gap towards the EU Lisbon employment target of 70 percent by 2010. The employment rates in 2005 for youth (21.6 percent for 15-24 year olds) and older workers (34.7 percent for 55-64 year olds) were particularly low. Long-term unemployment was rife and there were increasing signs of particular barriers to further activation and employment growth, including related to skills and welfare dependency. Lastly, in addition to low employment Bulgaria’s labor productivity in 2004 was low, accounting for only 33 percent of the EU 15 average. The overarching objective of the DPL series at the outset was, therefore, to support Bulgaria’s efforts to increase employment and lay the foundations for long-term productivity growth by providing incentives for job creation and improving the quality of education.

46. Thanks to an improving policy environment Bulgaria has seen remarkable improvements in the labor market over the last few years, with falling unemployment and rising employment, although the recent worsening of the external environment will put...
on hold further improvements or may even reverse some of them. Unemployment rates have fallen from above 15 percent in 2000 to 6.9 percent in 2007 and further to 5.7 percent in 2008. Over the last five years, Bulgarian businesses have created more than 400,000 jobs; however many of which were in low-skill sectors such as construction. A substantial reduction in social security contributions by 6 percentage points in early 2006, supported under DPL 1, has contributed to this job creation, as have improvements in the business environment. However, the economic slowdown in the wake of the global financial crisis in the second half of 2008 has already triggered closures of several industrial enterprises and in construction and related industries. As a result, unemployment is expected to increase in 2009. Most of the sectors of the economy will be affected due to reduced inflow of investments, domestic sales and exports, and tightened access to capital. The section of the workforce with no or little transferable skills and key competencies, those without professional experience (first job seekers) and those with limited mobility are expected to be affected most.

Figure 1: Bulgaria’s labor market outcomes are on par with the EU 15 for workers aged 25-54, but there are major lags for young workers, while inactivity looms large among the low-skilled

Source: Eurostat

47. However, even with the surge in employment in recent years, labor has remained underutilized in Bulgaria, driven primarily by low participation among youth and older workers. While unemployment rates have fallen and job creation has been strong, employment rates remain low in Bulgaria – relative to the EU 15 and to the Lisbon target of 70 percent by 2010. The same is true for activity rates. While the employment and activity rates for the prime age adult population (25-54) are on par with EU averages – a remarkable achievement – Bulgaria has large underutilized pools of labor among the youth (Figure 1, left panel) and, to a recently lessening extent, among older workers. Two characteristics of labor market barriers stand out:

- **Low skills**: Despite the recent high labor demand in low-skill sectors, unemployment rates among workers with initial education (4th grade) and below remain highest, and inactivity is highest among the least skilled (Figure 1, right panel). This suggests that the workers with initial education (4th grade) and below may be considered insufficiently qualified even by employers in predominantly low skill sectors. At the same time, unemployment has remained largely of a long-term nature with the share of long-term unemployed in total unemployed close to 60 percent.

- **Youth**: According to both recent data from the 2007 Multi-Topic Household Survey (MTHS) and Eurostat, around 20 to 25 percent of young Bulgarians are inactive but not in school (“NEET” – neither in employment nor education or training), and most of those are low-skilled and with lower secondary education at best. Thus many young Bulgarians drop out early from education without being employable and enter a vicious
circle of labor market exclusion: Once out of the formal education system, a lack of second chance alternatives and a lack of flexibility in the qualifications framework to recognize qualifications earned outside the formal education system in effect leave the doors firmly closed.  

48. **Disadvantaged workers such as youth and the low-skilled are also likely to be most affected by the economic downturn.** Reduced labor demand with fewer job openings is likely to disproportionately affect younger workers who lack specific skills and work experience. Like unskilled workers, they are also likely to be first in line for lay-offs because they are often in less stable employment.

49. **Meanwhile, productivity growth has been above EU averages for the last three years but needs to increase further to accelerate Bulgaria’s convergence.** In 2004, Bulgaria’s labor productivity per person employed accounted for 33.7 percent of labor productivity in the EU27. In 2007, this figure had risen to 34.9 percent. The productivity of labor is hampered by the educational level and skills of the labor force but also by a slower than desired rate of technological change in companies and by the quality of regulations for businesses. Recent Bank analysis has shown that mobility of labor as well as capital has been low in recent years, and productivity gains were achieved almost exclusively at the intra-sector level. Sustained higher rates of productivity growth can only be achieved if labor becomes more mobile across sectors.

50. **In response to the labor market challenges in recent years, the Ministry of Labor and Social Policy (MLSP) has continued to restructure active labor market programs (ALMP) to improve their targeting, foster private provision of employment services and improve their quality of the programs rendered by private providers, strengthen their focus on on-the-job qualification and on linking training to private sector skill needs.** Supported by DPL 2, the National Action Plan for Employment (NAPE) for 2008 continued the 2006-2007 trends in restructuring of active labor market policies to make them more demand-driven and focused on specific vulnerable groups. In 2008 Bulgaria’s ALMPs targeted with priority unemployed young people, older unemployed, unemployed with low education and qualification and inactive and discouraged persons. More incentives have been provided to employers to open new jobs for these groups, including through internships and counseling for career development, to offer part-time and flexible work time arrangements and to invest in the qualification of those who are in employment. ALMPs have become more open to life-long learning, creation of sustainable jobs and wider participation of the private sector (instead of municipalities) as providers and financiers, and less prone to locking able-bodied people, who could find employment in the open labor market, in low-quality subsidized jobs. Bulgaria is also in the process of harmonizing its policy framework with the European Union’s ‘flexicurity’ principle which highlights increased labor mobility as one of its key features. Bulgaria has recently also adopted a lifelong learning strategy which guides investment in training outside the formal education system.

51. **Job creation and investment in skills upgrading in enterprises has been hampered by continued regulatory burdens.** Bulgaria has made considerable progress in reducing the burden of regulation in recent years, ranking among the top 10 reformers in the World Bank’s Doing Business report in 2006/07. Despite this, regulation remains a serious constraint to enterprise operations and growth. In the World Bank’s 2007 Enterprise Survey, senior managers in Bulgaria reported spending 17 percent of their time dealing with requirements imposed by

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13 For a more detailed discussion see World Bank(2008), Bulgaria: Raising employment and human capital for growth and convergence, Washington, DC

14 GDP in Purchasing Power Standards (PPS) per person employed relative to EU27 (data from Eurostat)

Government regulations such as taxes, customs, labor regulations, licensing and registration. This is very high compared to other middle-income economies\footnote{World Bank (2008), Bulgaria: Investment Climate Assessment (in three volumes). Washington: DC}. Over 70 percent of firm managers are also concerned that laws and regulations in Bulgaria are interpreted and enforced unpredictably and inconsistently. This is higher than in the other EU entrants and is higher than in 2005. Bulgarian legislation currently provides for 54 licensing regimes, which are all administered by the central administration, 58 registration regimes, 280 permission regimes and no existing concerted regimes. However, a recent report by the Bulgarian Industrial Association (BIA) found that over 1,900 regulatory regimes are administered illegally in Bulgaria, most of them by municipal authorities.

\textit{DPL3 program}

52. The DPL3 supports further reform steps by the Government to promote productive employment and address adverse employment effects from the expected economic downturn. Consistent with the EU Lisbon Growth and Jobs Strategy and the European Economic Recovery Plan, it specifically focuses on the adoption of a new employment strategy, measures to promote second chance education, adjustments to active and passive labor market programs to cushion the effect of job losses related to the economic downturn projected for 2009 and measures to reduce the regulatory burden on enterprises. The following section presents the DPL 3 prior actions and discusses their implementation.

<table>
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<th>Prior Action 1</th>
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<tr>
<td>The Council of Ministers has approved the updated National Employment Strategy 2008-2015 to guide future employment and labor market policy</td>
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53. The updated National Employment Strategy 2008-2015 was approved by the Council of Ministers in April 2008 and will provide new guidance to Bulgaria's policy in the labor market at a time of rapid change. A key requirement under the National Reform Program 2006-2008, the strategy was updated based on an interim assessment of the objectives of the 2004-2010 strategy in the complicated context of improving business climate, increasing economic growth and demand for labor in 2004-2007, combined with demographic decline, low real productivity growth which does not contribute to swift convergence of the productivity in Bulgaria to the EU 15 average and real wage growth that surpasses productivity growth. The strategy ‘translates’ into national policies the EU Lisbon Jobs and Growth Strategy and the EU Integrated Guidelines for Growth and Employment, and has multiple objectives as (i) to foster the tailored and individual approach to activation; (ii) to increase the role of employment intermediation and improve the quality of labor intermediation services; (iii) to lessen the scope of informal employment; (iv) to ensure work-life balance; (v) to encourage entrepreneurship among the unemployed; (vi) to foster lifelong learning and develop the institutions for it; (vii) to ensure smooth transition from school to work; (viii) to ensure equal opportunities and access to the labor market for different social groups, especially Roma and people with disabilities, but also first time job seekers and older workers, through opportunities for second chance education, on-the-job training and subsidies at hiring. It sets key monitoring indicators linked to the EU Lisbon Jobs and Growth Strategy.
54. **Amendments to the Employment Promotion Act** approved in March 2008 contained measures to open the possibility for sustainable and demand-driven life-long learning through subsidizing training and on-the-job qualification for those who are already employed and for enabling the use of budget resources to this effect. Before that, subsidies and incentives were in place only for the training and re-training of unemployed. The importance of this policy measure is increasing in the context of overcoming the economic slowdown with structural changes in production and employment.

55. **Consistent with the focus of the DPL series on structural reforms to strengthen active labor market programs,** the DPL 3 is proposed to support adjustments to passive and active labor market programs required by a worsening labor market outlook for 2009. The original trigger 2 was mainly driven by a highly tightened labor market and limited evidence of firm-based training to raise productivity of the currently employed work force. While this agenda remains important, the economic slowdown in 2009 in the wake of the global financial crisis is likely to lead to a slackening of the previously tight labor market. A range of instruments may be needed to weather the effect of the slowdown on the labor market, including those in stable employment and those at risk of losing their job. The prior action has therefore been revised to take account of the broader effort by the government to support employment creation and raise productivity in times of economic difficulties.

56. **The Government has adopted a package of measures consisting of interventions to prevent job losses and incentivize a quick return to jobs for those laid off due to the economic downturn, while ensuring sufficient financing for unemployment benefits.**

Consistent with the focus of the DPL series on structural reforms to strengthen active labor market programs, the DPL 3 program supports the following elements of the Government’s package:

- **Unemployment compensation (passive labor market programs):** The Law on the Social Insurance Budget for 2009 raises the minimum and maximum levels of unemployment benefit from BGN 100 to 120 and from 200 to 240 (the level of the minimum wage) respectively.

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17 The package of “Measures in the sphere of social policy aimed at overcoming the negative consequences from the financial and economic crisis” foresees (i) new and revised active labor market programs under the 2009 National Employment Action Plan, (ii) public works programs under the “Beautiful Bulgaria” Project and the Social Investment Fund, (iii) training and employment programs funded through the OP HRD, (iv) amendments to labor and employment legislation to introduce reduced working hours, (v) adjustments to unemployment benefit eligibility and (vi) increases to the financial support of families with children.
Moreover, amendments to the Social Insurance Code\(^{18}\) have changed the schedule of unemployment benefit receipt – from a flat monthly rate to a two-step declining compensation: 130 percent of the monthly amount is going to be paid in the first half of the eligibility period, followed by 70 percent of the monthly amount in the second half of the period. The objectives are two-fold: (i) to ensure a more meaningful monthly compensation immediately after the job loss and (ii) to create incentives for more intensive job search and quicker resuming of employment.

- **Employment promotion policies (active labor market programs):** The National Employment Action Plan (NEAP) for 2009 – approved by the COM on January 15, 2009 – contains new measures aimed at countering possible negative employment effects resulting from the economic slowdown, including (i) the launch of a new active labor market program targeted at the newly unemployed as a result of job cuts targeting a caseload of up to initially 3,000 program beneficiaries and encompassing subsidized employment, labor market intermediation, counseling services and training and re-training; (ii) more flexible reallocation of NEAP resources amounting to BGN 190 million for 2009 across programs and measures; (iii) temporary wage subsidies for up to 3 months to compensate workers placed on short working hours as a result of the economic slowdown, targeting a caseload of up to 18,700 workers. In addition, the 2009 NEAP envisages sharpening the regional focus of the “From Social Assistance to Employment” Program – which will be further downsized by 30 percent relative to 2008 to an average of 18,000 participants per month in continuation of the reforms supported under DPL 2 – to municipalities which are expected to be most adversely affected by the economic slowdown. The “From Social Assistance to Employment” Program will continue to absorb with priority new participants to avoid longer-term ‘locking’ of unemployed in low-quality jobs. Lastly, the Employment Promotion Act was amended to expand the opportunities for in-work training and to incentivize in-work training to facilitate company restructuring (original DPL 3 trigger 2).

<table>
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<th>Prior Action 3</th>
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<tr>
<td>Amendments to the Employment Promotion Act and the Vocational Education Act have been enacted to open opportunities for second chance education and training for early school leavers, low skilled and people without education</td>
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57. **Second chance education and training opportunities for low-skilled individuals to facilitate their entry into the formal labor market have been introduced with the amendments to the Employment Promotion Act\(^{19}\) and the Vocational Education Act which were approved in February 2008.** The provisions apply to individuals who dropped out early of the education system and do not comply with the entry requirements (accomplished minimum six grades of education) for receiving formal ‘complete, or full’ vocational qualification for a certain profession. The provisions allow individuals who complete at least grade 4 equivalent the formal access to further vocational qualification. They also de-link the educational programs for adults (for grades from 1 to 6) from the curriculum and the delivery methods applied for children. In a first step, a state educational standard for grade 4 has been developed by MLSP with the assistance from specialists and has already been applied for adult literacy

\(^{18}\) See the transitory and final regulations of the Law on the Social Insurance Budget for 2009

\(^{19}\) The provisions on second chance education were introduced in the same set of amendments to the Employment Promotion Act as those referred to in original trigger 2, but are capturing a separate policy area.
programs whose successful completion now results in a grade 4 equivalent qualification. The provisions also includes flexible opportunities for the acquisition of primary and initial secondary education and introducing more flexible ways of confirmation and legalization of literacy and qualifications and skills acquired outside the formal education system, and for recognition of ‘partial’ vocational qualification.

58. The new provisions will allow expanding programs targeted at adults facing functional literacy problems. According to the last census in 2001 there are around 200,000 illiterate people in the country, while the Employment Agency has been providing literacy courses for not more than 1,500 people per year since 2007 under the National Program for Literacy Training and Qualification of Roma of the 2008 National Employment Action Plan. The NEAP 2009 foresees a substantial expansion of literacy programs with up to 8,000 beneficiaries as well as 1,200 under a program targeted at unemployed Roma.

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<th>Prior Action 4</th>
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<tr>
<td>In order to improve investment climate and promote job creation the Government has approved and begun implementation of the Better Regulation Program 2008-2010 as a national policy to institutionalize regulatory impact assessments.</td>
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59. The Council of Ministers (CoM) adopted a Better Regulation Program 2008-2010 in April 2008 which was drafted by an inter-ministerial group based on World Bank analytical work and advice. In line with the program, a Better Regulation Unit (BRU) was established under the auspices of the Council of Ministers within the Council of Minister’s Directorate of Strategic Planning and Governance. The BRU manages, monitors and controls the implementation of the program, in particular related to measures to institutionalize Regulatory Impact Assessments (RIAs). There are currently five people working in the BRU – five junior experts – headed by the Director of the Strategic Planning and Governance Directorate in the CoM. The unit’s work-plan for 2009, including regulatory reform measures, was adopted at the end of 2008.

Expected results

60. By the end of the DPL series, the expected results are:

- An increase in the employment rate of younger workers to at least 23 percent (age 15-24, Eurostat data) from the 2005 baseline of 21.6 percent, with intermediate status (2007) of 24.5 percent;
- An increase in the employment rate of older workers to at least 40 percent (age 55-64, Eurostat data) from the 2005 baseline of 34.7 percent (intermediate status (2007) of 42.6 percent);
- As an intermediate output that would result in a decrease in long term unemployment the relative share of individuals benefiting from training out of the total number of beneficiaries of active labor market programs increases, from the 2005 baseline of 19.4%

Some of the expected outcomes have been surpassed prior to the completion of the program. However, the expected outcomes are not proposed to be raised, because (i) they reflect government targets, (ii) the economic slowdown is likely to trigger a worsening in labor market prospects for youth and older workers in particular; it is, therefore, not certain whether more ambitious targets can realistically be met. Moreover, the results indicator target on youth employment (15-24 year olds) was lowered compared to the target set at the time of DPL2 (25 percent) to 23 percent in recognition of the expected effect of the economic downturn on young workers. While the employment rates for 15-24 year olds in Q3 and Q4 of 2008 were 27.5 and 26.1 percent respectively, with the expected slowdown in the labor market the originally set 25 percent are unlikely to be met.
percent to 30 percent, with intermediate value of 26.5 percent (December 2007), as well as an increase in absolute numbers of beneficiaries of training programs;

- Increase in contribution compliance in 2006 (as a proxy for the incentive to job creation and reducing informality associated with the reduction in social security contribution rate by 6 percentage points in January 2006), evident in a lower actual decrease in contribution revenue (94.1 percent in 2006, 2005=100) compared to that implied by the rate cut (79.3 percent, 2005=100) (linked to DPL I action).

- Reduction in the percentage of senior managers in private enterprises stating that the interpretations of laws and regulations by public officials is unpredictable and inconsistent, from the 2007 baseline of 75 percent (2007 Enterprise Survey)\(^21\).

I.2. **Original Problem: Social welfare program design creates disincentives for job searching**

**Main sector issues and recent developments**

61. **Aiming to promote employment activation of those furthest from the labor market, the Government has tightened eligibility of social assistance for working age individuals who are capable to work.** As of 1 July, 2006, the maximum duration of eligibility for Guaranteed Minimum Income (GMI)\(^22\) for able-bodied working age beneficiaries was limited to a maximum period 18 months. While they are eligible to enroll in remunerated employment and training programs upon losing GMI benefit eligibility, affected beneficiaries cannot re-apply for the benefit until after 12 months of break in benefit receipt. The policy measure has been enforced since January 1, 2008, and the duration of GMI receipt was further reduced to 12 months as of July 1, 2008. The original rationale for the measure was that the buoyant labor market created an opportunity to remove employment disincentives in the social assistance system and to move people off benefits and into work. In addition, the measure was linked to plans to review and adjust the targeting of the GMI and force those receiving GMI support while working in the informal sector to enter into formal employment.

62. **Prior to the measure’s effectiveness the Social Assistance Agency (SAA) and Employment Agency (EA) reviewed the structure and profiles of beneficiaries and developed individual activation action plans for affected beneficiaries.** This ex-ante assessment of the beneficiaries was supported by DPL 2 and sought to identify particular barriers and disadvantages of beneficiaries in particular with respect to their skill levels. This review allowed the Employment Agency, through its branch offices, to draw up individual activation action plans for affected beneficiaries. This involved setting up individual interviews with the beneficiaries to inform them of the measure and the options for enrollment on training and employment programs, including subsidized employment.

**DPL3 program**

63. **The DPL3-related policy dialogue includes the further implementation of the Government’s measures to promote employment activation of social welfare beneficiaries.** It specifically focuses on the strengthening of monitoring and analysis capacities related to the tightening of benefit eligibility for social assistance so as to adjust policy if needed.

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\(^{21}\) A further enterprise survey will be conducted in 2009 to assess progress on this results indicator.

\(^{22}\) The Guaranteed Minimum Income benefit refers to the monthly social assistance benefit.
64. **The Government has conducted an assessment of the implications of the GMI eligibility tightening for the social assistance beneficiaries who were affected by it.** The assessment was done on the basis of a targeted survey of GMI beneficiaries who lost benefit eligibility after 18 months. The survey was conducted by the National Statistical Institute in March/April 2008 – three months after eligibility had lapsed. It covered inter alia the following aspects of the beneficiaries’ personal and family/household welfare situation: (i) how the welfare status of the family or household changes with the stoppage of the GMI benefit for the following 12 months; (ii) what kind of coping strategies have been applied by the affected individuals and households, such as activation (joining the labor market), going into the informal economy, opting for disability pension, continuing to rely on social assistance, reliance on intra-household or extended family transfers; (iii) to what extent those affected by this policy measure have been able to benefit from employment activation, literacy and training programs, counseling and motivation for job search, intermediation for job placement, etc.; (iv) what kind of barriers emerged to effective activation; (v) to what extent the policy measure achieved its objectives; (vi) what kind of design improvements should be introduced in the policy measure to reduce the risk of leaving without a last resort safety net people who are not able to find jobs independently; (vii) what are the reasons why the affected GMI recipients do not enter the labor market – like a high reservation wage, disincentives to work related to the level of the benefit, the level of wage, taxation, the lack of adequate skills and qualification, the lost working habits, and other reasons which make the person unemployable.

65. **The survey updated the picture of the particular vulnerabilities of the GMI beneficiaries which is useful for the authorities at times of expected worsening economic conditions.** It confirmed a highly vulnerable profile of affected beneficiaries: Almost 60 percent of the affected beneficiaries are with primary education (4 grades), less than 4 grades of education or illiterate. Moreover, close to two thirds of the affected are young, between 21 and 40 years of age, while one third is aged between 41 and 60 years of age. Close to two thirds of the surveyed population reside in rural areas, where the demand for labor is limited. The majority of affected beneficiaries are Roma (63 percent), regionally concentrated in Plovdiv/Pazardjik and Vidin regions.

66. **The survey revealed barriers in moving people off welfare and into work and limitations to the effectiveness of the measure.** Around 70 percent of the surveyed beneficiaries reported to have remained unemployed 3 months after the stoppage of the GMI support – in a situation of high demand for labor. More than half of the remaining 30 percent work as formally employed, while the rest work in the informal sector, as self-employed, or in temporary employment. About a quarter (27 percent) of the affected stated that they have not looked for jobs after the stoppage of the GMI support. They point at several reasons - lack of qualification, low pay offered/higher reservation wage, family reasons (nobody to look after children), long distance/travel of the offered job to the place of residence. Not looking for a job does not seem to be driven by the receipt other forms of social benefits. Barriers also include apparent insufficient activation support by the Employment Offices (EO): Despite early identification of beneficiaries and the preparation of individual action plans, many former beneficiaries reported that were left to search for jobs on their own; however, this proved not to be successful as a result of their low employability, with low qualification, literacy, and loss of
work habits. Another reason for low activation rate is the low share of those who were offered participation in program for subsidized employment or training: only around 12 percent of the respondents declared that they have been given such options and only two thirds of them have accepted to participate.

67. The survey results will inform further adjustments to the social assistance system in order to balance employment activation incentives while ensuring protection of the vulnerable. While the original decision to introduce time limits to the eligibility for GMI was motivated by the recent strong labor demand and more favorable employment opportunities even for disadvantaged workers, the slow-down in economic growth and expected worsening of conditions in the labor market are likely to substantially limit such opportunities in the near future. The survey has improved the knowledge base of the Ministry of Labor and Social Policy on the effectiveness of the measure and can serve as important input into further policy planning. In view of the changing challenges in the labor market, the trigger was not included within the list of prior actions which aim to highlight the most important elements of the Government’s reform program.

I.3 Original Problem: Quality of education has been declining and the institutional capacity for quality assessment is lacking

68. When the government started out its education reform program in 2006 Bulgaria was facing severe concerns about education quality and a near-total lack of knowledge about quality status and change. First, Bulgaria had not participated in any international student assessments in years and had no system of external evaluation. Second, despite this lack of data, there was a sense that quality was low and declining. Indeed, subsequent data from the 2006/2007 Program for International Student Assessment (PISA) confirmed that Bulgarian students substantially lag their EU peers in skills and learning results.

Main sector issues and recent developments

69. Supported by the DPL series, Bulgaria has conducted a range of national external assessments and has participated in all relevant international student assessments since 2006. Set at the beginning of the implementation of the Government’s education reform program, they can serve as baselines for the reform. This included (i) the piloting of a new placement test at the end of 7th grade which has the potential to radically overhaul current patterns of student access to upper secondary school; (ii) new census-based tests, at grade 4 and 5 which can be used strictly as system-wide evaluation of education quality; (iii) a National Matura examination in all subjects for the purpose of university entrance but also with the potential of becoming the national standard for secondary graduation, and (iv) Bulgaria’s participation in international achievement tests such as PISA, Trends in International Mathematics and Science Study (TIMSS) and the Progress in International Reading Literacy Study (PIRLS).

70. Data from national and international assessments have been made available to the public (with the exception of the 4th grade national assessment test administered in 2007), and the reports on the international tests have been widely disseminated, while further analytical work on their results is ongoing. Moreover, the newly restructured national Center for Control and Assessment of the Quality of Education (CKOKO) has provided individualized feedback to all participating schools in PISA and PIRLS, in the 4th grade national assessment held in 2007 and 2008 and in the 5th grade testing of 2008. In the ongoing academic year 2008/2009 CKOKO is arranging technical seminars, subject by subject, with specialist teachers from all over the country to discuss specific improvement implications of the assessment results. Moreover, the Matura examination was administered for the first time nationally in June 2008, one year in advance of
what was originally envisaged at the time of preparing DPL 1. In parallel, the National School Principals Training Institute (NPTI) is providing up to 11 different training programs to prospective and in-service school principals, having already covered to some extent all schools in the country. The Institute has also supported the MES in the training of Regional Education Inspectorate experts. These courses are highlighting the role of student assessment data in the management and governance of the school system.

71. **Substantial progress has also been made in terms of building up the institutional capacity for system-wide assessment of education quality.** In the context of the implementation of the three-year plan for CKOKO, the most important recent breakthrough has been the increased financial resources for CKOKO from the EU Structural Funds (US$ 2 million to be spent in 2009 and 2010). New technical staff continues to be hired for CKOKO, including experts in psychometrics and item analysis, a new coordinator for TIMSS, and other support staff. These developments reflect that Bulgaria is well into the process of consolidating the capacity for the monitoring of student achievement and the evaluation of the impact of education reforms on the quality of education in the country.

72. **This extraordinary wealth of student assessment data provides a much-needed opportunity for Bulgaria to effectively use the evidence to improve the quality of its schools and classrooms.** Already in 2008, the MES launched the “Caring about every student” program, allowing schools with a certain number of low performing students in the national tests to apply for extra funds to finance support classes for those students. In order to continue the effective use of assessment data, the analytical, reporting and communication capabilities of CKOKO are essential; and it will also be crucial that CKOKO work in close cooperation with other key agencies, namely, the Institute of Directors, the National Pedagogical Center (in charge of in-service teacher training) and the Regional Inspectorate. Furthermore, considering the increased effort that the MES is making in terms of student assessment, it is important that the integrity of data is stored in a place where there is real capacity to analyze and report expeditiously. In this regard, it will be critical for the General Education Directorate of MES and CKOKO to increase their cooperation.

73. **The results from national and international assessment of student performance have been sobering and underline the need to continue the reforms in the school education system.** PISA and PIRLS results were made public in early December 2007. While Bulgaria has fared very well in PIRLS (reading literacy of 4th grade students), PISA results in all three areas (Science, Math and Reading) are less than encouraging. The results in reading literacy are particularly worrying as it could be interpreted that there has been a steep decline from those obtained by 15-year old Bulgarians back in 2001. The MES has expressed its preoccupation about this discrepancy between primary and secondary students in terms of reading literacy, and has decided to further intensify monitoring and evaluation of student achievement. Thus, in 2008, and in addition to the 4th grade test, there was another census-based national test of 5th grade students, i.e. the same cohort of students who were tested in the fourth grade were again assessed. In fact, the MES plans to continue the assessment of this same generation of students until they reach the 8th grade four years from now (the 6th grade test will take place in May 2009). Incidentally, this is also the first generation to study the new curriculum, including foreign languages and IT from the 2nd grade.

**DPL3 program**

74. **The DPL3 supports the further implementation of the Government’s education reform program,** focusing on the further introduction and strengthening of external student assessment to contribute to the development of better quality education services. The following section presents the DPL 3 prior actions and discusses their implementation.
Prior Action 5:  
The Matura examination (national secondary school-leaving certification test) in all subjects is implemented nationally  

Status: Completed

75. **The new Matura examination was implemented for the first time nationally in June 2008.** Complementing the introduction of external assessment in grade 4 and 5 as well as Bulgaria’s participation in international studies of student achievement, the introduction of the Matura is a major breakthrough in Bulgaria’s education reform, and one which has required firm political will and sustained technical and logistical efforts. The implementation of the first nationwide Matura was made possible by the amendment to the Education Act, passed in Parliament in February of 2008, to establish the Matura as one of the pillars of the quality-assurance system in education.

76. **The introduction of the Matura has been accompanied by prior outreach to ensure recognition for university admission and subsequent dissemination of results.** A major achievement has been the consensus among most Bulgarian universities to accept the results of the Matura as one of the criteria for their admission decisions, and therefore to replace the previous system based exclusively on institution-based specific admissions exams. As for the technical and logistical dimensions of the examination, the MES is investing a lot of time and effort in disseminating the particulars of the new Matura – including a website which is being intensively used by students and their families to get answers to their doubts, a national media campaign, and also efforts to make sure that students with disabilities will not have constraints to take the examination. At this point, the introduction of the Matura can be considered as irreversible for at least two reasons: (i) wide consensus of support among all political parties represented in Parliament and (ii) generalized support of the higher education sector when it comes to the use of Matura results for university entrance purposes.

77. **In addition to its university-entrance function, the Matura will provide a national benchmark of student achievement** for every secondary curriculum subject just at the critical point of secondary graduation. This will allow the MES to identify high and low performance secondary schools and to come up with measures and programs to promote good practices and improve such performance.

*Expected results*

78. **By the end of the DPL series, the expected results of reforms to strengthen education quality and raise external assessment capacity are:**

- Capacity for quality assessment is in place and enhanced as shown by the new Reports on National and International Student Achievement testing programs prepared by CKOKO and made available to the public. (increase from a baseline of 0 to a target of 5);
- Matura examination results are increasingly used as a credential for admission to Bulgarian universities;
- The Ministry of Education is using the results of national assessment testing programs to formulate quality improvement-oriented policies, as shown by the number of programs financed which rely on the 4th and 5th grade national tests’ results (from a baseline of 0 in 2007 to a target of 2);

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23 Previous attempts by previous Governments to introduce the Matura had failed due to strong public resistance.
• The percentage of principals reporting that student assessment data (regional and school-level, respectively) are being used as one of the key factors to identify training needs and decide on training and innovation programs increases (from a baseline of 0 in 2005 to a target of 60 percent).

II Promote fiscal sustainability through efficiency gains in social sectors

II.1 Original Problem: health service provision is inefficient and the financial sustainability of the National Health Insurance system is threatened

The expected economic slowdown in the wake of the global financial crisis has reinforced the continued importance of achieving greater efficiency in health sector spending – an agenda supported by the SIR DPL series. With substantial increases in the health budget unlikely to materialize as the current economic cycle unfolds, it will be important to continue with recent efficiency reforms in order to achieve greater value for money from those resources already in the sector, and to provide some room for new programs and initiatives.24 As discussed below, the program supported by DPL3 is likely to contribute to significant fiscal savings in 2009 as well as over the medium term. Persisting with the reform agenda will also ensure that the sector emerges from the downturn well prepared to embark on the next generation of reforms, and deserving of additional investment when additional funds become available.

Main sector issues and recent developments

80. The main focus of the DPL 3 relates to continued efforts to improve the financial sustainability of the National Health Insurance Fund (NHIF). Established in 1998, the NHIF accounts for about 70 percent of total public health spending but is still an evolving institution. In recent years it has faced several key threats to its financial sustainability, including: (i) an ineffective allocation of resources to hospitals and payment to physicians, using a mechanism that set no limit in the volume of services and therefore resulted in significant growth in hospital spending; (ii) a large hospital infrastructure that continues to grow (both public and private), is not based on needs assessment, and puts pressure on NHIF spending since it is mandated to sign contracts with all hospitals; and (iii) rapid expenditure growth on pharmaceuticals, which are also responsible for a large share of out-of-pocket spending by the poor.

81. Supported by the DPL series, important progress has been made with respect to containing the growth of hospital spending. Since 2006, with the support of DPL 1, the NHIF has become the primary payer of hospital services as the role of the MoH in hospital financing has been limited to certain special programs and drugs; business recovery plans were signed with major hospitals to prevent the accumulation of debt; and the ability of NHIF to limit expenditure growth through volume ceilings and price changes was enhanced. Most significantly, in the 2008 NHIF Budget Act and with the support of DPL 2, the previous fee-for-service, open-ended payment mechanism was replaced with a new allocation formula that distributed

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24 The approved 2009 Budget includes a significant increase in the health insurance contribution rate from 6 to 8 percent for the active contributors. As a result, it is estimated that about 500m BGN additional revenues will be collected due to the increase. Due to the uncertain impact of the financial and economic crisis on revenue collection and the fiscal position, the approved 2009 NHIF Budget maintains an expenditure plan of 2.07 billion BGN. The additional revenues will be collected and maintained as reserves on the budget account of the NHIF. The government makes insurance contributions on behalf of those outside the formal wage sector, so losing a job does not mean losing coverage.
resources to Regional Health Insurance Funds (RHIF) on a per-capita basis, and the RHIFs in turn signed contracts with providers that included financial limits. Reserves were also maintained at the national and regional levels to help manage spending fluctuations. The overall objective was to allocate funding based on population needs, but subject to limits. As a result of these measures, after a 22 percent increase in hospitalizations observed in 2007, the increase in 2008 is estimated to be only 7 percent. The 2009 Budget Act aims to consolidate these gains (see below).

82. The government has taken the first steps towards rationalizing the hospital network, but implementation will not take place during the current government mandate. A National Health Map was created which takes stock of the existing hospital infrastructure at all levels, and the government subsequently commissioned the development of a hospital master-plan, which was completed in November 2008. It makes concrete recommendations to optimize the hospital network, reducing the number of acute care beds and closing down underperforming wards (mostly in municipal hospitals). This effort was supported by DPL 2. However, implementing a master-plan is a difficult political process that requires significant effort to build consensus among the public and key stakeholders. As such, it is unlikely that a full endorsement and launch of implementation measures will be carried out during the current government mandate. Still, the substantive technical work required to move towards hospital optimization is now complete, and this will provide a valuable starting point for when the political environment is more conducive to implementation.

83. Progress towards a fully rationalized pharmaceutical pricing system continues, albeit at a slow pace. New drug legislation was approved in December 2006 under DPL1 to address a range of topics including registration, manufacturing, licensing, and pricing. In 2007, with DPL2 support, new by-laws were passed to introduce reference pricing for prescription drugs, and to create a Positive Drug List (PDL) that identifies medicines to be reimbursed under the public benefit package and their prices. The process of developing a PDL began in early 2008, and involves a three-step procedure including registration (market authorization), pricing, and inclusion in the PDL. Progress has been slow, as several thousand applications have been received, the approval process is often hampered by problems with the submitted documentation, and the commission responsible for approval only works on a part-time basis. The current drug list expires on January 31st, 2009, and some temporary arrangements will be necessary if, as is likely, the new PDL is not completed by then. Once finalized, the new pharmaceutical policy environment should enable significant cost savings for Bulgaria’s health sector.

DPL3 program

84. The DPL3 supports the further implementation of the Government’s health sector reform. It primarily focuses on the measures to strengthen the National Health Insurance Fund and promote fiscal sustainability in the health sector. The following section presents the DPL 3 prior actions and discusses their implementation.

<table>
<thead>
<tr>
<th>Prior Action 6:</th>
</tr>
</thead>
<tbody>
<tr>
<td>The government is implementing measures to improve incentives for more efficient use of hospital resources by further strengthening the role of NHIF as the primary payer of hospitals and refining the contracting and payment system to hospitals.</td>
</tr>
</tbody>
</table>

| Status: Completed |
85. **The approved 2009 NHIF budget consolidates and improves upon last year’s hospital financing reforms.** The NHIF confirmed that about 77 percent of hospitals’ spending was financed by NHIF during 2008. Table 4 shows the increasing share of NHIF financing for health services (the majority of which are hospital services). Budget projections for 2009 foresee this percentage increasing to over 80 percent. In addition, as negotiations with the Bulgarian Medical Association on a new National Framework Contract will not take place this year, NHIF is preparing a draft Budget Act for 2009 that includes the same cost-containing mechanism to allocate resources to hospitals described above, with improvements in the formula to better reflect health needs. For example, regional variation in health status and the provision of highly-specialized services will be additional factors taken into account during budget allocation in 2009. Although this action largely reflects a continuation of measures originally undertaken as part of DPL1 and DPL2, it remains part of the DPL3 program because (i) it must be re-enacted annually through the NHIF Budget Act in order to take effect; and (ii) the fiscal implications of not doing so are potentially large and thus continued commitment to the action deserves to be highlighted.

| Table 4: NHIF expenditures as a share of total government health spending, percent |
|---------------------------------|--------|--------|--------|--------|
|                                 | 2005   | 2006   | 2007   | 2008 (forecast) |
| NHIF                            | 55.3   | 67.9   | 67.2   | 70.2   |
| Ministry of Health              | 40.0   | 24.3   | 25.1   | 22.8   |
| Source: NHIF                    |        |        |        |        |

**Original Trigger 8:**

The government is implementing structural reforms to improve the efficiency of the hospital sector, for example consolidating hospitals according to the master plan

*Status: Unlikely to be fully implemented*

86. **While the hospital master plan has been completed, hospital restructuring based on the plan is unlikely to get under way during the current Government mandate.** The master plan has been completed and can inform hospital restructuring decisions. Due to the proximity of the end of the current Government’s mandate, substantial measures to implement the master plan’s provisions are unlikely to take place in early 2009. However, the plan is available to inform future decision-making in the health sector. As in other countries in the region, master plan implementation may occur over time through the adoption of selective contracting rather than as a result of an administrative decision.

87. **In view of the unlikely implementation of structural reforms based on the hospital master plan, it is being proposed to include as a replacement action in the DPL 3 program a major step forward in hospital spending efficiency embodied by the NHIF's new integrated information technology (IT) system.** An ordinance has been signed to make official the planned launch of the system on January 1st, 2009. Previously, the rules governing hospital claims were applied unevenly across regions through the NHIF’s deconcentrated branches (RHIFs). Ineligible claims were frequently submitted and subsequently resolved on an ad hoc and variable basis at the regional level, and the NHIF had few options for ensuring the legitimacy of claims prior to reimbursement. It was also not possible to monitor and evaluate services provided to a specific patient across different levels of care.
Revised Prior Action 7:
The NHIF is implementing a new integrated IT system for medical claim processing in order to achieve greater control and efficiency in health expenditures.

Status: Completed

88. The new IT system opens the door for significant efficiency improvements in health spending as an instrument to support both audit and policy functions. The system has been operated in parallel to the previous system since September 2008. Early results suggest that substantial improvements are attainable with regard to reducing the volume of ineligible claims reimbursed. The system will no longer allow hospitals to make an electronic submission of a claim form unless the services fully adhere to all NHIF business rules as coded in the software, implying stronger ex-ante control of spending. In addition, the IT system will also allow NHIF to exercise closer monitoring of inefficient practices such as over-referral from primary care to hospitals, excessive cross-regional referrals, over-prescribing of medicines, or inappropriate re-hospitalization. Early signs of resistance by hospitals and doctors to the new system are perhaps the best indication of its potential to reduce wasteful spending.

Original trigger 9:
The stock of arrears in hospitals has decreased at least 10 percent relative to the 2006 level.

Status: Partially completed

89. Hospital arrears have decreased substantially in recent years. Table 5 below shows hospital arrears data from 2005-2008. Data available as of October 2008 indicate a decline of well over 10 percent relative to both 2005 and 2007, but not 2006. However, it was determined that the 2006 stock of arrears is not an appropriate baseline because the government provided significant cash infusions to hospitals that year to help pay off arrears – importantly, this was the last year of direct budget support to hospitals for the payment of arrears. Thus, it is likely that this action will be substantively implemented. This improved trend in hospital arrears is a result of earlier steps taken by NHIF to impose budget ceilings on hospitals, and thus create incentives for sound hospital financial management.

<table>
<thead>
<tr>
<th>Year</th>
<th>Hospital arrears</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>60.8</td>
</tr>
<tr>
<td>2006</td>
<td>6.3</td>
</tr>
<tr>
<td>2007</td>
<td>35.3</td>
</tr>
<tr>
<td>2008 (October)</td>
<td>19.6</td>
</tr>
</tbody>
</table>

Source: NHIF

90. In view of the fact that the trigger reflects an outcome, it was removed from the program and included in the list of outcome indicators (see below). Instead, the program includes measures to strengthen primary health care in a new prior action.
Revised Prior Action 8:
The Government is implementing measures to strengthen the primary health care system by: (i) allowing for an increase in the relative share of primary care expenditure; (ii) promoting primary prevention by raising reimbursement prices and expanding the eligible population; (iii) changing regulative standards to increase number of diagnoses under responsibility of general practitioners.

Status: Competed

91. The adoption of a package of measures to boost primary health care is an additional action proposed to be added in order to strengthen the health program further. As indicated in Table 6, Bulgaria spends the highest share of total health expenditure on inpatient care in the region, reflecting an underdeveloped primary health care system. Following significant investments in 2000-2001, the primary health care sector in Bulgaria has endured several years of relative neglect as successive budgets have favored hospitals. In 2008, primary care accounted for less than 10 percent of NHIF’s expenditures. As a result, general practitioners often serve as little more than administrative clerks, referring patients to out-patient specialists or hospitals or prescribing medicines on the instructions of providers at higher levels. Thus, many services that could be provided at the primary level are instead delivered (at much greater expense to the public budget) by out-patient specialists or hospitals. A reduction of hospitalizations is a clear potential benefit from improved primary care.

92. In recognition of the scope for achieving greater value for money through measures that promote primary care as opposed to inpatient care, the Government is proposing a significantly larger budget and additional measures intended to benefit general practitioners. The draft 2009 NHIF budget provides for a 17 percent increase in primary care spending (compared to a decrease in the proposed hospital budget). In addition, specific ordinances have been drafted that will raise provide additional incentives for GPs to carry out preventive exams for cardiovascular disease and cancer screening, and to expand eligibility for these interventions from about 30 to 40 percent of the population. Lastly, there is a draft ordinance to change regulative standards in order to increase the number of diagnoses under the responsibility of GPs. Currently there are certain services that are predominantly delivered by out-patient specialists that could be provided more cheaply at the primary level, thus freeing specialists to focus more on their areas of expertise.

Table 6: Inpatient spending as percent of total health expenditure, latest available year

<table>
<thead>
<tr>
<th>Country</th>
<th>Inpatient Spending</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>59</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>35</td>
</tr>
<tr>
<td>Estonia</td>
<td>36</td>
</tr>
<tr>
<td>Hungary</td>
<td>28</td>
</tr>
<tr>
<td>Latvia</td>
<td>45</td>
</tr>
<tr>
<td>Lithuania</td>
<td>n.a.</td>
</tr>
<tr>
<td>Poland</td>
<td>30</td>
</tr>
<tr>
<td>Romania</td>
<td>53</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>27</td>
</tr>
<tr>
<td>Slovenia</td>
<td>47</td>
</tr>
<tr>
<td>EU-10 average</td>
<td>40</td>
</tr>
</tbody>
</table>

Source: WHO Health For All database
93. Overall, the revised policy matrix for health represents a stronger series of measures, while sustaining the focus on improving the efficiency of sectoral spending. Against the backdrop of the economic downturn, the approved 2009 NHIF budget foresees an increase in operational costs (excluding reserves) of less than 2 percent relative to the executed 2008 budget. Nevertheless, there is scope within this relatively flat budget for expanded services and new initiatives in light of the anticipated improvements in the allocation formula, the reduction of ineligible claims through application of the new IT system, and measures to boost primary care.

Fiscal impacts of the DPL-supported program

94. Government health spending in Bulgaria as a share of GDP has been on a slight downward trend in recent years, as indicated in Table 7. Moreover, at about 4 percent it is low by EU standards (where the average is about 7.4 percent or 4.6 percent among the new Member States)25.

<table>
<thead>
<tr>
<th>Table 7: Government health spending in Bulgaria, percent of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
</tr>
<tr>
<td>Government health spending, percent of GDP</td>
</tr>
</tbody>
</table>

Source: NHIF

95. At the same time, Bulgaria has the highest share of out-of-pocket spending in the EU 10. As indicated in Table 8, relatively low public spending on health is one reason why Bulgaria has the highest ratio of out of pocket spending to total health expenditure among new EU Member States. This suggests that efficiency gains should be used to reallocate funding to other health programs to dampen the magnitude of out-of-pocket spending, rather than to achieve outright cuts in health spending.

<table>
<thead>
<tr>
<th>Table 8: Out of pocket spending as percent of total health expenditure, latest available data</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
</tr>
<tr>
<td>38</td>
</tr>
</tbody>
</table>

Source: WHO Health For All database

96. Fiscal savings achieved through the DPL-supported health program, although difficult to estimate with precision, are likely to be significant. The following savings avenues can be identified:

25 Additional background context on Bulgaria’s health sector can be found in the documents listed under the earlier section on analytical underpinnings of the SIR DPL operation.
• First, as noted, the annual rate of increase of hospitalizations has fallen from about 22 to 7 percent between 2006 and 2008, in large part due to the introduction of ceilings on hospital budgets supported under DPL 1. A rough estimate would suggest that by avoiding this unrestrained growth path, the health budget may grow by an annual amount of about BGN 100m less than otherwise in the years to come.

• Second, the introduction of the new NHIF IT system is expected to yield a one-off saving of a potentially similar amount by reducing the number of illegitimate claims (based on a conservative estimate drawn from preliminary simulations).

• Third, Bulgaria allocates a higher share of total health expenditure to the in-patient sector than any other country in Central and Eastern Europe and the Baltics, and the measures to strengthen primary care should help bring it closer in line with regional averages (see Table 6) and generate fiscal savings, although this may take some time to bear fruit.

• Fourth, the earlier steps taken to rationalize pharmaceutical spending (for example, by adopting a reference pricing approach) supported under DPL 1 and 2 can also be expected to make a contribution to the creation of fiscal space, although an estimate of the magnitude will have to await the completion of the ongoing PDL pricing exercise.

**Expected results**

97. **By the end of the DPL series, the expected results of the health sector reforms are**

- The stock of arrears in hospitals has decreased at least 10 percent relative to the 2006 baseline level (BGN 60.8m, October 2008: BGN 19.6m).

- Percentage of payments to hospitals channeled through NHIF remains constant or increases. Baseline: 55 percent (January-December 2005); target: 80 percent; value 2008: 86 percent;

- Increase in efficiency through changes in payment mechanisms to hospitals, as reflected in a decrease in average length of stay over time. In 2006: 6.59; in 2007: 6.32; in 2008: 6.3.

- NHIF data showing that pharmaceutical spending is growing at a rate not higher than 10 percent annually in 2008-09 (2005-06: 11 percent; 2006-07: 10.3 percent; 2007-08: 5 percent);

- The number and value of rejected provider claims as a result of inconsistency with agreed business rules is tracked and is significant. (Baseline: no IT capability to monitor this).

**II.2 Original Problem: Current governance and financing system for schools provide only weak incentives to focus on quality, drop-out rates, and efficiency of spending.**

**Main sector issues and recent developments**

98. **The government started out its education reform program in 2006 facing substantial challenges in terms of quality, drop-out and efficiency of spending.** For example, as discussed above, there was evidence that quality was low and declining. Moreover, while Bulgaria is experiencing a demographic transition, with the school-age population shrinking

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26 This formulation modifies the previous outcome target used in DPL 1 and DPL 2, which aimed for an increase in pharmaceutical spending not higher than twice GDP growth. That target was achieved each year between 2006 and 2008, but due to the projected impact of the global economic crisis on Bulgaria’s GDP growth in 2009, this is no longer considered to be an appropriate formulation.
substantially, a generous education infrastructure had remained since before the transition. Student numbers had declined by more than 25 percent in the period 1992 to 2005, and while some municipalities had been closing down schools in response to this decline, there had not been a systematic plan to adapt to this demographic transition. As a result, student-teacher ratios declined, driving up per student costs (see Figure 2 below). Apart from low average student-teacher ratios, there were other signs of inefficiencies: in 2006, about 31 percent of municipal schools operated with ratios below 11 —both in rural and urban areas. At the core of the problem were the facts that (i) the regulation of staffing numbers in the education system did not necessarily follow cost-effectiveness considerations — nor were they visible linked to considerations related to the quality of learning; and, more broadly, (ii) the financing mechanism in place until the end of 2006 —where local authorities’ freedom to adjust human and capital resources is limited and resource allocation to schools is determined exclusively at the central level— failed to create incentives for an efficient management of resources.

99. In the area of governance and finance, the government’s response consisted of a three-stage introduction of a new financing and governance system: (i) per capita financing to municipalities with a unified standard for wage and non-wage recurrent expenditure, (ii) delegated budgets to schools and (iii) school-based management, evident in greater decision-making at the school level and freedom of resource use by the school principals. In short, the three-stage reform package was aimed at moving the school system from a highly centralized system with little school autonomy to a system of self-managing schools operating within a framework of centrally determined learning standards.

100. The school year 2007/08 was the first under per-capita financing and one of the most tumultuous school years in recent memory in Bulgaria. First, the start of the school year was delayed by a six-week strike of teachers (demanding higher wages and worried about aspects of the government’s plans to introduce performance-based pay). Second, just as the strike came to an end, mayoral campaigning intensified and municipal elections dominated politics. Third, municipal education teams were still learning how to operate within the new funding system introduced on January 1, 2007 (i.e. the per capita “unified standard” system): The new system provided more flexibility to re-allocate funds from staff to non-staff expenditure and from one school to another; however, the new system – for the first time – placed the onus to optimize resources on municipalities. Fourth, as planned (and a trigger for DPL2), the 2008 Budget Act mandated municipalities to set up school accounts and introduce “delegated budgets”: transparent rules to determine how the education grant from the center is disbursed amongst the schools located within the municipality. This, in turn, required municipal education teams to consider which formula best suited their schools, consult with principals, and try to simulate the likely impact the formula would have on their schools.

101. In the budget year 2008, the Ministry of Finance and Ministry of Education and Science introduced strong incentives to speed up the process of rationalizing the municipal school network, consisting of “sticks” and “carrots” as incentives to schools and municipal education teams and compounding the incentives resulting from the per capita financing system. The “stick” worked by intentionally setting low “unified standard” amounts (relative to estimates of underlying costs for the year), essentially forcing a large number of.

27 Each of the three steps are described in more details in “Accelerating Bulgaria’s Convergence: The Challenge of Raising Productivity” (World Bank, 2007).

28 A well known definition of this system by Caldwell (2002: p. 35) is: “A self-managing school is a school in a system of education to which there has been delegated a significant amount of authority to make decisions related to the allocation of resources [resources defined broadly to include knowledge, technology, power, material, people, time, assessment, information, and finance] within a centrally determined framework of goals, policies, standards and accountabilities.”
municipalities and schools to rationalize to bring costs in line with the education grant received from the center. The “carrot” was in the form of large national programs to support the rationalization process: (i) a scheme to purchase and/or supply busses to transport students from merged or closed-down schools; (ii) a scheme to support refurbishing of consolidated schools; and (iii) a scheme to pay severance payments to laid-off teachers. To access this “carrot” financing, municipalities had to present detailed plans on how students in the closed-down schools would be transported to and accommodated within remaining schools, to ensure that school closures were carefully planned and discussed within communities.

Figure 2: Teacher and student numbers and student teacher ratio in grades 1-12 (estimates for 2008/09)

Source: World Bank staff calculations

The changes introduced during the 2007/08 school year resulted in the largest consolidation of the Bulgarian school system in recent history. The number of municipal school closures totaled 293 (up from around 130 in 2007, and less than 50, on average, between 2004 and 2006). This, in turn, resulted in a large adjustment in the number of teachers and non-teaching staff. In fact, an estimated 30 percent of school personnel have been laid off since the beginning of the program supported by the DPL series. As a result, the student-teacher ratio in 2008/09 improved significantly for the first time in more than a decade (see Figure 2). These new student-teacher ratios are comparable to the OECD average at 16.3 in primary schools and 13.5 in secondary schools (World Bank, Edstat, 2004).

DPL3 Program

The DPL3 supports the further implementation of the Government’s finance and governance reform. It focuses on the strengthening of school-based management and on measures to promote and help manage responsibly the further consolidation of the school network.

According to World Bank estimates presented at a joint MES/WB workshop in February 2008, the low unified standard amounts implied that half of Bulgaria’s municipalities would be in financial distress unless they undertook steps to rationalize their school network.
104. **School-based management** has been further strengthened in a number of ways, completing the implementation of the three core ingredients of the finance and governance reform supported by the DPL series – the unified per capita financing standard (DPL 1), delegated budgets (DPL 2) and school-based management (DPL 3). The strengthening of school-based management consists of the following measures: First, with the full introduction of delegated budgets in 2008, all schools will now prepare budgets for 2009 using delegated budgets, and they have the right to carry over the balance from 2008 to 2009. Second, powers of principals have been significantly expanded to include (i) managing all funds allocated to the school; (ii) deciding on teachers’ workload and the number of students in each class (within minimum and maximum norms which were widened in 2007), and, most importantly, (iii) determining individual teachers’ remuneration. The fact that principals now determine individual teachers’ salaries is a very important change towards creating self-managing schools: As of 2008, the pay of school education system employees is no longer determined centrally. Rather, the new ordinance on salaries of employees in the units within the public education system sets out only the general salary structure rules and minimum salaries by position levels. The mechanisms applied to determine the individual teacher salaries are determined by the school principal.

105. Prior action 11 combines the original triggers 11 and 12 into a single prior action for presentational purposes.

106. **For the third year in a row, the government will in 2009 maintain a package of measures to support the process of school consolidation.** As discussed above, the government’s package of measures and incentives to support the implementation of the unified standard and school consolidation (i.e. the “carrots”) appears to have played an important role in advancing school consolidation. In particular, the following programs are included in the 2009 budget: (i) support transportation of children to merged schools (in 2008, 95 motor vehicles were
purchased and distributed to municipalities); (ii) additional finances to municipalities that merge or close schools (in 2008, this program supported the closure of 296 schools, up from 74 schools supported under the program in 2007); (iii) support a new component (in the national program on consolidating schools) which pays paying severance payments to laid off teachers; and (iv) finance a list of “protected schools”: schools whose closure would impair access to education. The list has been widely discussed amongst stakeholders and has been approved by the Council of Ministers.

107. **The process of consolidating state schools – mostly vocational schools – and transferring them to municipal management has continued in 2008**, with 8 schools restructured or merged, 12 closed and 26 transferred to municipalities (out of 386 remaining state schools). In addition to continuing to consolidate the state school network, the government has taken a move to help rationalize resource-use within the remaining schools. In particular, the government has introduced per student “unified standards” – at somewhat higher rates than in municipal schools, reflecting the fact that more state schools are vocational schools with higher unit costs – to finance education in these schools. In addition to providing better incentives to optimize resource-use, this move will provide better incentives for principals to attract and retain students (since their financing will be directly linked to the number of students in the school), and will help make more visible the schools which are not financially viable.

*Fiscal impacts of the DPL-supported program*

108. **The fiscal impact of the finance and governance reforms so far has been and will continue to be substantial.** Since the government has kept overall spending on education roughly constant in recent years – at around 4-4.2 percent of GDP – the fiscal impact of the reforms has not been in terms of fiscal savings but rather in terms of a more desirable re-allocation of resources from wage to non-wage spending within the education sector. World Bank staff estimates that this re-allocation will amount to more than 0.3 percent of GDP in municipal schools alone, or around BGN 215m in 2009 – and even more in 2010. At the core of this re-allocation is a shift from spending on wages to non-wage spending in municipal schools, including spending to refurbish schools, supply schools with computers, and pay for free provision of textbooks and free snacks and milk. To estimate the size of this re-allocation, Figure 3 (left hand panel) compares actual spending on personnel compensation and an estimate of actual municipal spending on maintenance in municipal schools to a “counterfactual” – the likely path personnel compensation and maintenance spending would have taken without the reforms. Figure 3 (right hand panel) shows the shift in the composition of spending in municipal schools between 2005 and 2009. In 2005, more than 70 percent of spending on municipal schools was spent on wages. By 2009, this percentage is likely to drop to around 50 percent.

109. **The re-allocation of resources from wage to non-wage spending is likely to be desirable for educational outcomes.** There is compelling reason to believe that the pre-reform wage bill was excessive: First, Bulgarian schools had more teachers per students than was likely necessary from an educational perspective: it is likely that the same quality (and quantity) of education could be provided with fewer teachers. Second – and partly the reason for the large number of teachers – Bulgaria had a larger number of schools than what was needed to provide access to its declining number of students. Third, the many teachers and large number of schools was the result of a lack of incentives to “right-size” the system as opposed to deliberate choices.

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30 The counterfactual was calculated by assuming that personnel numbers and school numbers kept declining at the same rate that they had been declining during the period 2000-2005 (and assuming the same average wages and the same estimate of the fixed (or “overhead”) cost per school as in the actual scenario).
aimed at improving the quality of education. With per capita financing following the reforms supported by the DPL series, municipal education departments and principals have the ability to shift resources from wage to non-wage expenditure, to retain savings from one year to the next, and to decide to close one school and move the savings to a consolidated school.

Figure 3: **Education finance and governance reforms in primary and secondary education have triggered substantial changes in the composition of spending**

<table>
<thead>
<tr>
<th>Year</th>
<th>Compensation, actual (w/reforms)</th>
<th>Non-compensation</th>
<th>Compensation, counter-factual (no reforms, trend growth in personnel and no. of schools)</th>
<th>Non-compensation</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>52%</td>
<td>48%</td>
<td>71%</td>
<td>29%</td>
</tr>
<tr>
<td>2009</td>
<td>52%</td>
<td>48%</td>
<td>71%</td>
<td>29%</td>
</tr>
</tbody>
</table>

Source: World Bank staff calculations

110. **Taking a more long-term perspective, there is a compelling reason why the re-allocation within the education sector is desirable: spending on education has become more flexible.** With less resources being tied up in salaries and costs related to maintaining buildings, policy makers start each fiscal year with more room to target resources to where they are likely to have the biggest impact. Increased flexibility per se will not automatically lead to better educational outcomes. However, combined with a rigorous approach to analyzing weaknesses in the learning process, and evaluating existing programs, such flexibility could lead to better learning outcomes. Moreover, while teachers undoubtedly remain the most important input the learning process, policy makers now have more freedom to consider what the best way to heighten the quality of the remaining teachers, by (i) raising overall salaries for everyone, (ii) letting additional spending on teachers be related to high-performing teachers, (iii) invest in more and better training (of, now, fewer teachers), or (iv) provide them with better learning material in the classrooms.

*Expected results*

111. **By the end of the DPL series, the expected results of the education finance and governance reforms are:**

- Increased efficiency as shown by halting the decreasing trend in pupil-teacher ratio in public schools (for grades 1-13) observed since 2002.31 Already, the preliminary results for 2008/09 show that this trend has been reversed (see Figure 2).
- Increased efficiency as shown by reductions in average drop-outs as a percent of total enrolments in small mountainous municipalities (proxies for regions that struggle with largest declines in population) (from baseline of 3.7, 5.1 and 4.2 percent for grades 1-4, 5-8 and 9-13, respectively, in 2005)

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31 Pupil-teacher ratios in public schools declined continuously from 14.2 in 2002 to 13.1 in 2006 according to NSI school-based data.
• Percent of municipal schools’ core financing financed through unified standard increases (from baseline of 0 to target of 100 percent; value 2007/2008 and budgeted value for 2008/09: 100 percent)

Table 9 compares the original triggers for DPL 3 and the final prior actions.

Box 4. Efforts to address the risk of drop-out in Bulgarian schools

Addressing student drop-out, in particular in the context of rapid school consolidation, remains an issue and is subject to increased monitoring and vigilance. Clearly, the finance and governance reforms have improved spending per enrolled student – as proxied by student-teacher ratios – but the key question is whether there are adequate measures in place to ensure that drop-outs do not increase – especially of the most vulnerable – as a result of the school closures. A Poverty and Social Impact Analysis undertaken as part of DPL 2 reviewed the measures currently in place to prevent such rise, and examined six years of historical data on school closures and drop-out in Bulgaria – a period in which 200 general education schools were closed. The analysis concluded that the country is well-equipped to handle an accelerated pace of school closures and mergers (see section VI. below).

A number of additional measures are currently under implementation to help reduce drop-out, focusing on better monitoring and the effective use of mitigating instruments.

1. Bulgaria has an advanced education management information system (EMIS) that serves as the main vehicle for the monitoring of the education system and allows the MES to track the enrollment of individual students.

2. A separate database with a geographical mapping of settlements and schools across the entire country was developed and actively used. In particular, government officials used the database to determine which schools are too far away from their settlement to ask pupils to commute. This type of analysis was the basis of the first list of “protected schools” which was proposed — i.e. schools whose closure would impede access to education.

3. Inter-ministerial cooperation between the Ministry of Education and Science (MES) and Ministry of Finance (MOF) has been strong, especially in the area of training stakeholders in their new roles and responsibilities. Spearheaded by the National Principals Training Institute, the MOF and MES have continued to train municipal education teams and principals in their new roles and responsibilities.

4. With support from the World Bank under a Technical Assistance task linked with the DPL series, the Council of Ministers has created an inter-ministerial task force on impact evaluation, tasked, inter alia, with helping MES analyze the impact of school closures on drop-outs.

5. The MES has launched a new OP HRD-funded program to, inter alia, enhance capacity of the EMIS system to track drop-out, pilot a program to improve access to preschool education to children aged 5-6 in municipalities with a high risk of drop out, improve communication with parents, provide additional hours of schooling to children with problems in learning and in Bulgarian language and award priority project financing to schools with high risk of drop out.
<table>
<thead>
<tr>
<th>Original challenges and issues</th>
<th>Triggers DPL3 at time of DPL2</th>
<th>Prior Actions DPL3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Overarching objective 1: Increase employment and lay the foundations for long-term productivity growth by providing incentives for job creation and improving quality of education</strong></td>
<td>Maintenance of a satisfactory macroeconomic policy framework</td>
<td>Maintenance of a satisfactory macroeconomic policy framework</td>
</tr>
<tr>
<td>Low employment, high percentage of long term unemployed, and high rates of informality in the labor market</td>
<td>[REPLACED] The Government has enacted amendments to the Employment Promotion Act to raise the skills and competitiveness of the employed through incentivizing adult education and on the job qualification and training.</td>
<td>[NEW] The Government has (i) raised unemployment benefit replacement rates and changed the payment schedule to incentivize job search and (ii) introduced targeted active labor market programs and job subsidies for newly laid-off workers in order to address expected negative effects of the slowdown in economic growth projected for 2009 on employment.</td>
</tr>
<tr>
<td>Social welfare program design creates disincentives for job searching</td>
<td>[DROPPED] The Government has conducted an assessment of the effectiveness of employment activation incentives in the social assistance system.</td>
<td></td>
</tr>
<tr>
<td>Quality of education has been declining and the institutional capacity for quality assessment is lacking</td>
<td>The Matura examination (national secondary school-leaving certification test) in all subjects is implemented nationally.</td>
<td>The Matura examination (national secondary school-leaving certification test) in all subjects is implemented nationally.</td>
</tr>
</tbody>
</table>

**Overarching objective 2: Promote fiscal sustainability through efficiency gains in social sectors**
<table>
<thead>
<tr>
<th><strong>Health service provision is inefficient and the financial sustainability in the National Health Insurance system is threatened</strong></th>
<th>The role of the NHIF as a primary payer of hospitals is maintained and the contracting and payment system to hospitals supports more efficient use of resources.</th>
<th><strong>[EDIT]</strong> The Government is implementing measures to improve incentives for more efficient use of hospital resources by further strengthening the role of NHIF as the primary payer of hospitals and refining the contracting and payment system to hospitals.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>[REPLACED]</strong> The government is implementing structural reforms to improve the efficiency of the hospital sector, for example consolidating hospitals according to the master plan.</td>
<td><strong>[NEW]</strong> The NHIF is implementing a new integrated information system for medical claim processing in order to achieve greater control and efficiency in health expenditures.</td>
<td><strong>[REPLACED]</strong> As a result of earlier measures to improve hospital efficiency, the stock of arrears in hospitals has decreased at least 10 percent relative to the 2006 level.</td>
</tr>
<tr>
<td><strong>Current governance and financing system for schools provide only weak incentives to focus on quality, drop-out rates, and efficiency of spending.</strong></td>
<td>Process of consolidating state schools and transferring them to municipalities continues.</td>
<td><strong>[CONSOLIDATED WITH SUBSEQUENT TRIGGER]</strong></td>
</tr>
<tr>
<td>School-based management is further strengthened.</td>
<td><strong>[EDIT]</strong> School-based management is further strengthened, with school principals having increased discretion over school budgeting, including over staff salaries, and over staffing for the budget year of 2009.</td>
<td></td>
</tr>
<tr>
<td>Government maintains the package of measures and incentives to support the implementation of the unified standard and school consolidation.</td>
<td><strong>[EDIT]</strong> The Government has maintained the package of measures and incentives to support the implementation of the unified standard per student, and has closed down and transferred state schools to municipalities.</td>
<td></td>
</tr>
</tbody>
</table>
VI. OPERATION IMPLEMENTATION

POVERTY AND SOCIAL IMPACTS

Recent trends in poverty and living standards

113. **Bulgaria achieved impressive poverty reduction in recent years owing to significant positive economic growth** attributable to a series of structural reforms, macroeconomic stability and improved business climate for private sector to create jobs. Analysis using the 2003 and 2007 MTHS data shows that between 2003 and 2007, household consumption per adult equivalent increased from BGN 339 in 2003 to BGN 410 in 2007 (in 2007 prices), a 21 percent increase in 4 years. As a result, the headcount poverty declined from about 20 percent in 2003 to 10.2 percent in 2007—using an absolute poverty line of BGN 185 per month per adult equivalent—essentially halving the incidence of absolute poverty (see Figure 4, left panel). The data suggest extreme poverty declined even faster, with only 4.5 percent of the total population consuming less than BGN 145 per adult equivalent, compared to 11 percent in 2003. The evidence from the household survey data points towards a strong positive correlation between economic growth and poverty reduction: Over 75 percent of the reduction in poverty between 2003 and 2007 was attributable to growth in per capita consumption. The decline in the unemployment rate and a low share of the working poor due to real wage increases also contributed to poverty reduction.

Figure 4: **Poverty has fallen substantially between 2003 and 2007, and growth has been pro-poor**

Source: World Bank (forthcoming), Bulgaria: Living standards before and after EU accession, World Bank

114. **Moreover, inequality fell appreciably between 2003 and 2007** with the Gini coefficient of consumption expenditures falling from 0.31 in 2003 to 0.28 in 2007 – a nearly 10 percent reduction in 4 years. Much of the improvement in inequality took place in urban areas where inequality declined by close to 11 percent. The key reason for the observed improvement

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32 The PSIA analysis is based on information provided by the Multi-Topic Household Survey (MTHS) 2003 and 2007 and additional administrative data.
33 World Bank (forthcoming), Bulgaria: Living conditions before and after EU accession, World Bank: Washington DC
in inequality has been the largely pro-poor economic growth, with the poor having captured a slightly greater relative share of the growth, particularly in urban areas (see Figure 4, right panel).

115. **However, Bulgaria still faces some challenges to achieving a more inclusive and sustainable development.** First, while Bulgaria appears to have successfully avoided the phenomenon of the working poor, the unemployed face more than three times the national average risk of poverty and eight times that of the working individuals. The unemployed, despite representing only about one in ten of the work force, account for nearly half of the poverty among all labor market participants. Second, children (ages below 6) face a headcount poverty rate of over 16 percent, 6 percentage points higher than the national average. People in the youngest and oldest age groups together comprise 24 percent of the population, yet account for over 37 percent of the poor. The key contributing factor for worsening distribution of child poverty is high poverty among the Roma children. In 2007, despite accounting for less than 15 percent of the Bulgaria’s children, the Roma children contributed about 68 percent of total child poverty, significantly higher than their contribution of about 43 percent in 2003. Third, individuals with less than secondary education represent only 37 percent of the population 18 and above, but make up nearly 80 percent of the poor. The poverty rate for individuals with less than secondary education is double the national average and seven times the poverty rate of individuals with a secondary or higher education. Primary and secondary school attendance rate among children from poor households was considerably lower than for those in non poor households. Therefore, despite considerable improvement in welfare nationwide, some groups have benefited more than others from the robust growth experience and, as a result, large and significant disparities still persist.

*Possible poverty and social effects from the economic downturn*

116. **The effects of the global economic and financial crisis on Bulgaria pose serious challenges for further poverty reduction.** After a period of strong economic growth through 2008, the outlook for 2009 is that growth will slow down to 1 percent in the wake of the global economic and financial crisis; and sharper slowdowns are not ruled out. This slowdown, which is coming on the heels of the food and fuel price increases in 2007 and the early part of 2008, could potentially have a wide-ranging impact on the poor and vulnerable. Due primarily to its effect on trade (via declining demand for exports) and investment (as financial markets contract), the impact of the global financial crisis on poverty could be felt through contraction in the labor market and slowdown in wage growth in response. Remittances from abroad, which are significant contributor to consumption of nearly 5 percent of the Bulgarian population, are likely to slow down in 2009. The loss of income and employment opportunities would lead to declining current consumption and ability to smooth consumption and further depletion of productive assets.

117. **Given a pro-poor nature of growth, the poor and vulnerable could suffer disproportionately during the economic downturn.** The effect of the economic downturn is likely to be felt through (i) a slowdown in poverty reduction, leaving in poverty individuals who would have been lifted out of poverty by continued strong economic growth, and (ii) an increase in poverty among certain groups, for example those employed in sectors that experience negative growth. Between 2003 and 2007, the analysis of the elasticity of poverty to GDP shows that for each percentage point of growth recorded, the overall poverty incidence would decline by 0.54 percentage points. Consequently, with real GDP growth revised downwards from the projection underlying the 2009 Budget of 4.6 percent to 1 percent in 2009, Bulgaria would lose the opportunity to further reduce national poverty by 2 percentage points. That means that an estimated 143 thousand currently poor, who would otherwise have been lifted out of poverty, would remain poor due to the slowdown in economic growth alone. Moreover, the expected
negative growth in certain economic sectors such as construction and export oriented industries is projected to increase poverty incidence in 2009. A simulation of poverty based on sectoral growth projections for 2008 and 2009 suggest that poverty would likely inch up by about 0.3 percentage points from a projected 9.2 percent in 2008 to 9.5 percent in 2009. In other words, over 20 thousand Bulgarians who were non-poor in 2008 will likely fall into poverty in 2009 if current sectoral growth projections hold. A further worsening of growth prospects for 2009, particularly for construction and export sectors, could trigger even a larger reversal of the recent impressive poverty reduction trend.

118. According to household survey data of 2007 remittances account for 47 percent of consumption expenditure for the 5 percent of the population who reported receiving remittances. Thus, with remittances accounting for a significant share of the household consumption, the effect of financial crisis could be significant poverty impact for those relying on remittances. If remittances were to decline by 25 percent, poverty rates among recipients of remittances would double from 7 percent to about 14 percent. Poverty gap and severity would increase by over 150 and 200 percent, respectively. The increase in extreme poverty would be more pronounced as it more than doubles from 2.5 percent to 6.2 percent. Even worse, the extreme poverty gap and severity would skyrocket in multiples of their pre-shock levels. When looking at the regional levels, the urban areas stand to lose the most from declining remittances.

Possible effects of the DPL-supported program

119. With support under the DPL 3, the Government has adopted a package of measures to address adverse effects on the labor market from the economic downturn and relies on active and passive labor market measures as the primary social safety net. The package of “Measures in the sphere of social policy aimed at overcoming the negative consequences from the financial and economic crisis” foresees (i) new and revised active labor market programs under the 2009 National Employment Action Plan (NEAP), (ii) public works programs under the “Beautiful Bulgaria” Project and the Bulgaria Social Investment Fund, (iii) training and employment programs funded through the OP HRD, (iv) amendments to labor and employment legislation to introduce reduced working hours as well as the introduction of wage subsidies to cover remuneration losses resulting from short working hours, (v) adjustments to unemployment benefit eligibility, including increased replacement rates, and (vi) increases to the financial support of families with children. Within the NEAP, the Ministry of Labor and Social Policy now also has increased flexibility for reallocation of financing between different programs to more quickly respond to short term needs. Items (i), (iv) and (v) are supported by the DPL 3.

120. Looking at DPL 3-supported measures beyond those related to addressing the effects of the economic downturn, prior analysis shows that they do not result in direct negative poverty or other social consequences. A detailed assessment of the poverty and social impact of the overall DPL-supported program was conducted at the time of DPL 2, and the DPL 2 program document contains a detailed discussion. Since DPL 3 marks the continuation of a reform process spanning all three loans – and with few exceptions supports the further implementation steps of the same reform program – no new fully fledged assessment was done for DPL 3. Instead, the sections below summarize and update the findings of the PSIA conducted at the time of DPL 2. The earlier PSIA concluded that the DPL-supported policies do not result in significant direct negative poverty or other social consequences, while many of the policies could actually contribute to improving the situation of vulnerable groups.

121. There are few direct poverty and social impact risks associated with the Government’s health reform program supported by DPL3. Improving sectoral efficiency (e.g., by maintaining NHIF as the primary payer for health services and refining the budget ceiling payment mechanism, and introducing the new IT system) implicitly means that there will
not be a rapid rise in the public budget to help address the long-standing issue of high out-of-pocket payments for health. However, efficiency gains mandated by short-term fiscal tightening will help set the stage for a more systemic approach to this problem over the medium-term. Furthermore, the strengthening of the primary care sector supported by DPL3 should be beneficial for the poor since they have better access to this level of care than to hospitals.

122. **The main poverty and social impact risks related to the education sector reforms are related to the process of school consolidation.** First, drop outs of disadvantaged students could increase as a result of school closures. Historical data suggests that municipalities with a higher rate of school closures have not experienced a large increase in dropouts. The analysis found that ethnicity (drop-out has been highly concentrated among Roma children) and poverty are likely more important underlying factors for children dropping out of school in Bulgaria than a school closure – although school closure can compound these factors. However, Bulgaria is relying on experience in municipalities across the country in dealing with the problem after more than a decade of declining student numbers. In some instances, municipalities had to close down more than half of their schools during the past decade, and officials both at the central and municipal level gained important experience in the process. Reflecting these experiences, the process of closing down a school is fairly elaborate and a number of safeguard measures are built into the process. For instance, a school closure proposal has to include a discussion of how transportation of students affected will be addressed. In addition the Government has put in place a series of policies to prevent an increase in dropouts in municipalities where school closings are taking place (see also Box 4).  

123. **The main poverty and social impact risk in the Government's social protection reform program stems from the employment activation measures** which include a tightening of eligibility for Guaranteed Minimum Income (GMI), with a cancellation of eligibility for able bodied working age individuals after 12 months of benefit receipt, associated with ineligibility for the following 12 months. The DPL series are not supporting the policy change, but an assessment of its effectiveness in getting GMI beneficiaries into work, as a prior action in DPL 3. Analysis based on the 2007 MTHS as well as a targeted survey of affected GMI beneficiaries suggests that (i) the majority of GMI beneficiaries are poor and highly vulnerable, (ii) most are young (below the age of 40) with very low levels of education, residing predominantly in rural areas and very often from the Roma minority; (iii) unless replaced by remuneration from employment or training programs, the loss of the GMI benefit is likely to substantially deepen the already deep poverty among beneficiaries, but likely adds relatively little to the poverty headcount.

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34 For example, Bulgaria benefits from many years of experience with school desegregation programs across several municipalities in Bulgaria which have focused on moving Roma children from segregated Roma schools into mainstream schools, typically involving parent outreach, after-class activities and busing. In 2008 the MES has directed European Social Fund financing from the OP HRD to such activities.
124. The targeted survey of affected beneficiaries supported by DPL 3 has shown that the activation measures as initially implemented have faced effectiveness barriers and have triggered adjustments to the system. Around 70 percent of the surveyed beneficiaries report to have remained unemployed 3 months after the stoppage of the GMI support. More than half of the remaining 30 percent work as formally employed, while the rest work in the informal sector, as self-employed, or in temporary employment. About a quarter (27 percent) of the affected stated that they have not looked for jobs after the stoppage of the GMI support. The survey also confirms that the chances for finding formal employment increase with the increase in the level of education, signaling that investment in literacy, training and retraining may be much more cost-effective than just paying social assistance. However, the survey identifies barriers related to apparent insufficient activation support by the Employment Offices. While an early identification of beneficiaries and the preparation of individual action plans has been part of the formal system, many former beneficiaries reported that were left to search for jobs on their own. Another reason for low activation rate is the low share of those who were offered participation in program for subsidized employment or training: only around 12 percent of the respondents declared that they have been given such options and only two thirds of them have accepted to participate. The Government has adopted a number of changes to the system to make it more effective in placing highly disadvantaged long-term unemployed welfare recipients into jobs (described in detail in Section V. of this document).

IMPLEMENTATION, MONITORING AND EVALUATION

125. The responsibility for implementation of the Program lies with the Council for Economic Policy (CEP) under the Council of Ministers, chaired by the Minister of Economy. The CEP undertakes the overall management and coordination of the Government program and assures representation of all the Sectoral Ministries involved in the reform (i.e. Health, Education, and Labor and Social Policy) and the involvement of the Ministry of Finance and Ministry of Economy in the discussion of the reform program. The program’s coordination is officially managed by the Directorate for Coordination of EU Affairs and International Financial Institutions (IFIs) of the Council of Ministers. A report monitoring the status of the actions included in the Policy Matrix, indicating progress achieved and highlighting any particular difficulties in their implementation, is regularly (i.e. usually every 2-3 months) prepared and reviewed jointly by the Bank and the Government.

126. The outcome indicators for monitoring of the outcomes of the program rely mainly (but not exclusively) on administrative data that are already being collected by the information systems of the respective Government agencies. In order to prevent false attribution of outcomes to the policies included in the DPL, the Program Document explains where needed that some complementary actions and an enabling environment have to accompany the DPL supported policies in order for certain outcomes to be achieved. In addition, some outcomes will only be achieved after the implementation of the reform program supported by the DPL series, due to their long term nature. However, the contribution of the DPL to achieving such outcomes is noted where appropriate.

127. With regards to evaluation of specific policy interventions, the reform program supported by the DPL series emphasizes the need for evidence-based policy making, and has succeeded in developing a cross-cutting agenda in this area with the Government. It is supporting the Government’s efforts to invest in information gathering and developing monitoring and evaluation capabilities. To this end the program is: (i) promoting the collection and the critical use of information on education quality through student assessments, (ii)
supporting the gathering of new data through a targeted survey of beneficiaries of Guaranteed Minimum Income who were affected by benefit eligibility tightening, and (iii) building the capacity to evaluate the impact of policy changes and implement household surveys through accompanying technical assistance associated with the DPL. Specifically, the Bank is providing technical assistance to the Government, including the newly formed Government task force on impact evaluation, to raise capacity for conducting routine impact evaluations of strategic policies. The DPL-supported reforms in education governance and financing serves as one of the pilot case studies in the context of the technical assistance.

128. **In agreement with the Government, the Bank has conduct jointly with the Open Society Institute Bulgaria (OSI) an independent multi-topic household survey (MTHS) in 2007.** The survey is representative for consumption, incomes and non-monetary aspects of poverty at national and regional (28) level and will include boosters to allow assessing the income, educational, health and labor market status of the Roma and Turkish ethnic minority groups and comparing them with the country averages. The multi-topic household survey is part of the programmatic work on poverty and living standards currently being conducted by the Bank, and the data became available in December 2007. The survey is already providing baselines for many social indicators and basic data to assess the impact of some of the reforms supported under the DPL series. Finally, the DPL 3 incorporates as a prior action the assessment of the effectiveness of employment activation incentives in the social assistance system in promoting employment through a targeted survey of beneficiaries.

129. **The participation of stakeholders in the program design has been assured through the support of the Government’s strategies.** The health and education actions in the policy matrix are based on the strategies prepared by the MOH and MES respectively. While, the preparation of the strategies was conducted in a highly participatory manner, regular consultations between line Ministries and stakeholders are ongoing. For example, the introduction of the unified per capita financing standard in education which triggered substantial consolidation of the school network is subject to ongoing consultations and analysis involving the MES, the National Association of Municipalities, the teacher trade unions, policy think tanks and NGOs. In addition, the Bank DPL team has been maintaining an ongoing dialogue with the main stakeholders on the reform process – the line Ministries, Ministry of Finance and Ministry of Economy; members of Parliament and Parliamentary commissions for health and education; associations of employers, teacher unions, general trade unions, and Bulgarian Medical Association and Bulgarian Nurses Association; health consumer groups and NGOs. In both education and health, field visits were organized during preparation and main components of the program benefited from discussions in the field. Finally, the education reform was also discussed with the National Association of Municipalities which has endorsed it publicly.

**FIDUCIARY ASPECTS**

**Public Financial Management**

130. The Bank has extensive knowledge of the country’s Public Financial Management (PFM) system. A Country Financial Management Assessment (CFAA) was prepared in 2003. The CFAA highlighted strong features of or significant achievements in Public Finance Management (PFM), including: (i) a well developed PFM system relying heavily on IT, (ii) sound legislation and well functioning external oversight institutions (namely the National Audit Office and the Parliament); (iii) comprehensive budget process covering also a number of previous extra-budgetary funds, (iv) well-developed Treasury Single Account (TSA) to service all budgetary institutions; (v) adequate realism of budget estimates, (vi) closely monitored cash management system, (vii) and an adequate internal control framework.
131. While the overall financial management risk to Bank funds was deemed low, the CFAA made recommendations that the Government implemented, including under PAL-2 and PAL-3, and with continued technical assistance from other development partners. An update of recent reform activities and their impact has been carried out in the first half of 2007 as part of the continuous dialogue with Bulgaria. Progress and challenges since the 2003 CFAA are detailed below:

132. Steady progress has been made in the development of systems and institutions of public financial management. The Government has made considerable progress in the development of the medium-term budget framework and program budgeting has been progressively rolled out in line ministries. Budgetary control has improved and all major budget institutions and agencies are now incorporated within the treasury system. The Government has implemented a modern financial management information system (FMIS). The complexity of the project was initially under-estimated and in the end a less ambitious approach has been undertaken to set more realistic goals for the achievement of which adequate resources and staff have been ensured. Further to that and in view of continuing changes in the legal framework in the course of the strategy implementation a decision was made to initially introduce the project in the whole system of the Ministry of Finance and those line ministries, that have relation to the accounting information, related to the management of EU financial instruments. As a result the FMIS as an internet/intranet based system was introduced in MoF, all second level spending units to the Minister of Finance, all EU PHARE and ISPA Implementing Agencies, all Managing Authorities of the Operational Programmes under the EU Structural Funds and Cohesion Fund, as well as all territorial offices of the National Revenue Agency. The elements of a modern public sector audit function (both internal and external audit) have continued to develop in accordance with best EU and international practice and coordination between internal and external audit has improved. As a result of these efforts, the quality of public financial control and supervision in the country has improved substantially.

133. Some public financial management challenges remain. Program budgeting has been introduced and rolled out across all ministries and some agencies. However, the effectiveness of program budgeting needs to be strengthened and the use of performance information enhanced. The Government also needs to build a more comprehensive picture of fiscal risks into budget documents. Finally, while the main building blocks of an internal control and internal audit function are in place considerable work is needed to ensure managers understand the basic concepts of internal control and internal audit function and a sufficient number of certified internal auditors are in place to implement these reforms. Additional details on the fiduciary aspects associated with DPL 3 are presented in Annex 4.

Disbursement and Auditing

134. The proposed SIR DPL 3 amounts to US$200 million (equivalent in Euro). The borrower is the GOB, represented by the MOF. The proposed DPL 3 is the third of a series of three development policy loans totaling up to US$500 million equivalent as provided for in the CPS, which was presented to the Board on June 13th, 2006. The proposed DPL 3 follows the implementation of the SIR DPL 1 and DPL 2 loans which were fully disbursed in June 2007 and [March 2009] respectively. Disbursement of funds will be triggered by implementation of agreed policies as described in the Policy Matrix (Annex 2).

135. The proposed loan will follow the Bank’s disbursement procedures for development policy lending. Disbursements will not be linked to specific purchases, thus evidence will not be

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35 These are detailed in the DPL 1 Program Document.
needed to support disbursements, nor will procurement requirements be necessary. The government will submit a withdrawal application to the IBRD. At the request of the MOF, the IBRD will deposit the proceeds of the loan into a foreign exchange deposit account (deposit account) designated by the government that form part of the general reserves of the country and acceptable to the Bank, such account to be held at the Bulgarian National Bank (BNB). The deposit account is available for budget financing and will be managed by and subject to the control of the MOF. The government shall ensure that upon deposit of the net proceeds of the loan into said account, an equivalent amount will be credited in the Borrower’s budget management system, in a manner acceptable to the IBRD.

136. If after the loan proceeds are deposited in the BNB account, the proceeds are used for ineligible purposes as defined in the loan agreement, IBRD will require the borrower to refund the amount directly to IBRD.

137. The administration and accounting of the loan proceeds will be responsibility of the Ministry of Finance. The standard country rules will be followed by treasury for administration and accounting. The government will maintain accounts and records, or ensure that such items are maintained, showing that loan disbursements were in accordance with provisions of the Loan Agreement. Such accounts and records will be maintained in a form acceptable to the Bank. The proceeds of Loan deposited at the treasury account with BNB will be used to cover budget expenditures. The MOF will be responsible for the Operation’s administration and for preparing the withdrawal application, maintaining the deposit account as required. The MOF, with the assistance of the BNB, will maintain records of all transactions under the Operation in accordance with sound accounting practices. The government will report to the IBRD on the amounts deposited in the foreign currency account and credited to the budget management system within 30 days of receiving such fund.

ENVIRONMENTAL ASPECTS

138. The DPL 3 is not likely to have any significant positive or negative effects on the environment. The reforms supported by the program are related to the adoption of policies and only a few could have a future environmental impact. Specifically, reforms in the education sector are expected to result in consolidation of schools, and this will in turn require changes in some schools infrastructure (e.g. school rehabilitation). Meanwhile the reforms in the health sector are expected to lay the ground for future changes in the hospital sector, including consolidation, conversion of some facilities, and therefore are likely to trigger investments in hospital infrastructure in the future. The rehabilitation of education and health infrastructure would require compliance with the national environmental and construction codes which are now in line with EU standards. Lastly, Regulatory impact Assessments routinely review whether regulations result in potential adverse environmental or social effects.
# RISKS AND RISK MITIGATION

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<th>Risks</th>
<th>Mitigating Factors</th>
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<td><strong>Political</strong>&lt;br&gt;Bulgaria will elect a new parliament in summer 2009, and some of the reforms supported by the DPL-series may not be sustained through the pre-election period and political transition to a new government.</td>
<td>1. DPL 3 marks the end of the DPL series, all prior actions have been met, and the program [has been] negotiated well in advance of the election. 2. Reforms supported by the DPL series have enjoyed strong support by all coalition parties. 3. Bank team has been reaching out to stakeholders across political parties currently in government and the opposition as well as the teacher trade unions, Bulgarian Medical Association, and National Association of Municipalities.</td>
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<td><strong>Macro</strong>&lt;br&gt;Large external imbalances and a rapidly worsening external environment magnify the risks of a sudden stop in capital inflows and a slowdown of growth with potential negative effects on the quality of banks’ portfolio and the health of the financial system.</td>
<td>1. With slowing capital inflows and downward adjustments to global prices already in place, import growth is expected to drop significantly in 2009, bringing down the current account deficit to about 15 percent of GDP from estimated 25 percent in 2008. Inflation is expected to decline as pressures from global prices and wage increases subside on the back of slowdown in the economy. 2. Substantial fiscal and foreign exchange reserves were accumulated during times of strong growth. The fiscal accounts have been in surplus since 2003, with fiscal surpluses exceeding 3 percent per year in 2005-2008. This has made possible accumulation of fiscal reserve amounting 13 percent of GDP in 2008. In 2009 the Government plans a fiscal surplus of around 2 percent, with central government spending restrained to 90 percent of the planned allocations to ensure flexibility of the budget in case of shortfall in planned revenues. DPL-supported reforms have contributed to enhanced fiscal sustainability and efficiency in spending in the education and health sectors. Gross official reserves increased by more than €5 billion between 2005 and 2008 and reached 37 percent of GDP in 2008. 3. To maintain confidence in the financial sector and the currency board, the Government and the Bulgarian National Bank (BNB) raised the deposit guarantee threshold and eased reserve requirements for banks to</td>
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provide access to more liquidity to banks. BNB has intensified monitoring of banks, strengthened its stress testing capabilities, and advised banks to reinvest all the profits accumulated in 2008.

4. The Government is aiming at entering the ERM2, and subsequently the eurozone as soon as possible.

5. Government’s active participation in the coordination of national and EU-wide responses to the global crisis is expected to help maximize Bulgaria specific responses to potential risks.

6. A close monitoring of recent economic developments and risks, in close consultation with the International Monetary Fund would help identify further increase in vulnerabilities and advise on measures to respond to potential risks if they materialize.

<table>
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<tr>
<th>Technical</th>
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<tr>
<td>Capacity in some line ministries for programs monitoring and impact evaluation of policies is limited.</td>
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</table>

1. The DPL series have been supporting data generation (social assistance, student assessment) and critical use of data (ongoing evaluation of school consolidation on drop-out). Ongoing TA on impact evaluation capacity building (working with the newly formed Government Task Force on Impact Evaluation) and TA on performance-based budgeting as well as the Bank’s living standards monitoring work complement DPL-supported reforms.

139. Finally, the DPL 3 is fully consistent with the good practice principles on conditionality, as described in Box 5.
Box 5  Good Practice Principles on Conditionality

Principle 1: Reinforce Ownership

The DPL series support the implementation of the Government’s strategies in health, education, and labor and social protection. It fully reflects the Government’s social sectors and productivity agenda as stated in the Convergence Programme, one of the strategic documents required by the EU. The Bank and the Government worked together in defining concrete actions consistent with the various strategies.

Principle 2: Agree up front with the government and other financial partners on a coordinated accountability framework

The Bank and the Government have agreed on a set of policy actions included in a streamlined policy matrix to measure progress in implementing the program. The development partners’ community in Bulgaria is small and therefore no coordination is required. The Bank shares and exchanges information on various policy matters related to the DPL series with the European Commission.

Principle 3: Customize the accountability framework and modalities of Bank support to country circumstances

The policies supported by the DPL 3 have been discussed and agreed among various stakeholders (line Ministries, MoF, party coalition members, trade unions). The reform program has benefited from substantial technical analysis that the Government has undertaken jointly with the Bank. The DPL 3 benefits from technical assistance and analytical work funded by a PHRD grant for DPL 2 in addition to regular preparation and technical assistance activities.

Principle 4: Choose only actions critical for achieving results as conditions for disbursement

The policy matrix is very streamlined. It contains only 11 triggers and no benchmarks. The DPL series entail three phase single tranche operations. The policy matrix focuses on critical actions for achieving the objectives of the program, for example changes in financing mechanisms for schools and hospitals, and restructuring of labor market programs, many of which have been approved by the National Assembly.

Principle 5: Conduct transparent progress reviews conducive to predictable and performance-based financial support

The reform program supported by the DPL series emphasizes the need for evidence based policy making, and has succeeded in developing a cross-cutting agenda in this area with the Government. Some policy actions included in the matrix directly points towards evaluating the impact of policy reforms, while others require collecting information and using it critically. The Government and the Bank are also working together in the context of the DPL series to measure a number of outcome indicators through administrative and survey data. The support is aligned with the budget cycle and reflected in the budget.
ANNEX 1: LETTER OF DEVELOPMENT POLICY

BULGARIA: SECOND SOCIAL SECTORS INSTITUTIONAL REFORM
DEVELOPMENT POLICY LOAN (SIR DPL III)
LETTER OF DEVELOPMENT POLICY

April 9, 2009

Mr. Robert Zoellick
President
International Bank for Reconstruction and Development
Washington D.C.

Dear Mr. Zoellick:

We appreciate this opportunity to continue our close collaboration with the World Bank in the implementation of our medium-term structural reform agenda and, on behalf of the Government of Bulgaria, we request a Third Development Policy Loan (SIR DPL III) for US $200 million equivalent in Euro to continue the series of three development policy loans in support of this reform agenda. We believe that this series of development policy loans continues to provide the appropriate vehicle for Bank support in addressing our medium term policy and institutional reform agenda in the labor market and the social sectors.

Following the completion of the measures from SIR DPL I and DPL II, we are continuing to use the support of the Bank for advancing the reforms in the social sectors, and SIR DPL III maintains this focus. The program is consistent with the Country Partnership Strategy (CPS) between the World Bank and the Republic of Bulgaria, approved by the World Bank Board on June 13th, 2006, and its strategic areas, (i) Raising productivity and employment in support of private sector-led growth along the lines of the EU’s Lisbon Agenda, and (ii) Fiscal sustainability and improved capacity for absorption of EU funds. Poverty reduction and social inclusion are not explicitly addressed in the DPL program but many of its policies are expected to have an impact on reducing poverty.

We expect that at the end of the DPL series a number of positive outcomes will be achieved, including (i) an increase in the employment rate of younger workers (15 to 24) to at least 24 percent and older workers (55 to 64) to at least 40 percent, although we recognize that the effects of the global economic crisis on Bulgaria will have a dampening effect on the labor market, (ii) a sustainable spending level for hospitals, (iii) a basic package of drugs available to the majority of the population and a faster process to introduce new pharmaceutical products; and (iv) a more efficient school financing mechanism.
In times of a deepening global economic crisis, we have maintained macroeconomic stability as a precondition for the effectiveness and sustainability of the above program, building on a strong track record of sound macroeconomic policies over the last decade. We will maintain the Currency Board Arrangement (CBA) until accession to the Eurozone. The CBA has served Bulgaria well, providing a stable monetary environment, contributing to low inflation, and boosting confidence. We are fully committed to take all of the necessary steps to support it. Furthermore, we will continue to implement a prudent and tight fiscal policy, which is a key to safeguarding external viability under the CBA. In spite of the economic slow-down we aim for a fiscal surplus in 2009 and 2010, following the practice of the last several years, and remain prepared to adjust our fiscal policy in reflection of the economic developments in the short-term. In response to the global economic crisis, the Bulgarian Government in coordination with the Bulgarian National Bank has announced and introduced a number of policy actions aimed at addressing negative impacts from the ongoing financial turmoil on the stability of the banking system and on the real economy. Lastly, the structural reform program supported by the SIR DPL III is an important contribution to our goal of raising medium-term growth and to converge with our partners in the European Union.

This Letter of Development Policy summarizes the elements of the structural reform program supported by SIR DPL III, while the reform program outcomes and the critical steps taken to achieve those outcomes are summarized in the accompanying Matrix of Performance Benchmarks and Desired Outcomes.

In relation to the overarching objective 1 of the program - increasing employment and laying the foundations for long-term productivity growth by providing incentives for job creation and improving quality of education – we have addressed the following key challenges:

**First, we have taken further measures to promote employment and address the high percentage of long-term unemployed and high rates of informality in the labor market.** Our Government has taken steps to promote productive employment and address adverse employment effects from the expected economic downturn. Consistent with the EU Lisbon Growth and Jobs Strategy and the European Economic Recovery Plan, it specifically focuses on the adoption of a new employment strategy, measures to promote second chance education, adjustments to active and passive labor market programs to cushion the effect of job losses related to the economic downturn projected for 2009 and measures to reduce the regulatory burden on enterprises. First, the updated National Employment Strategy 2008-2015 was approved by the Council of Ministers in April 2008 and will provide new guidance to Bulgaria’s policy in the labor market at a time of rapid change. Second, we have introduced adjustments to passive and active labor market programs required by a worsening labor market outlook for 2009.
Our Government has also adopted a package of measures consisting of interventions to prevent job losses and incentivize a quick return to jobs for those laid off due to the economic downturn, while ensuring sufficient financing for unemployment benefits. Third, we have introduced second chance education opportunities for the low-skilled to facilitate their entry into the formal labor market — we have done this through the amendments to the Employment Promotion Act and the Vocational Education Act which were enacted by Parliament in February 2008. The new provisions will allow expanding programs targeted at adults facing functional literacy problems. Lastly, our Government has adopted and is implementing the Better Regulation Program 2008-2010 adopted by the Council of Ministers (CoM) in April 2008, in order to promote regulatory reform.

Second, we have accelerated our efforts to address the problem of a declining quality of education and inadequate institutional capacity for quality assessment. Following earlier steps to introduce national external student testing and our participation in international student assessments, our Government has introduced the first-nationwide Matura school-leaving exam, which not only adds another critical external test to our system to assess and monitor learning outcomes, but also now serves as one of the entrance requirements for most Bulgarian universities.

In relation to the overarching objective 2 of the program — promoting fiscal sustainability through efficiency gains in social sectors — we have addressed the following two key challenges:

First, we have addressed inefficiencies in health service provision and less than universal access to care, as well as threats to the financial sustainability in the National Health Insurance system Our Government’s health sector reform agenda is still open. It primarily focuses on the measures to strengthen the National Health Insurance Fund and promote fiscal sustainability in the health sector. The approved 2009 NHIF budget consolidates and improves upon last year’s hospital financing reforms. While the hospital master plan has been completed, hospital restructuring based on the plan is unlikely to get under way during the current Government mandate. While the implementation of structural reforms based on the hospital master plan are seeing a slight delay, we have made another major step forward in hospital spending efficiency — the implementation of the NHIF’s new integrated information technology (IT) system. An ordinance has been signed to make official the planned launch of the system on January 1st, 2009. The new IT system opens the door for significant efficiency improvements in health spending as an instrument to support both audit and policy functions. The adoption of a package of measures to boost primary health care is an additional action that we took to strengthen the health system further. In recognition of the scope for achieving greater value for money through measures that promote primary care as opposed to inpatient care, the Government is proposing a significantly larger budget and additional measures intended to benefit general practitioners.

Second, we have changed the governance and financing system for schools to strengthen incentives to focus on quality, reduce drop-out rates, and promote efficiency of spending. With the measures supported by DPL III the Government has continued its finance and governance reform for primary and secondary schools. First, following the introduction of the unified per capita financing standard (DPL I) and delegated budgets (DPL II), school-based management has been further strengthened in a number of ways. Second, for the third year in a row, our Government in 2009 maintains a package of measures to support the process of school consolidation. The process of consolidating state schools — mostly vocational schools — and transferring them to municipal management has continued in 2008. In addition to continuing to
To consolidate the state school network, we have taken a move to help rationalize resource-use within the remaining schools. The fiscal impact of the finance and governance reforms so far has been and will continue to be substantial, and the restructuring of spending will contribute to improving educational outcomes which is of key importance to our medium-term growth and convergence agenda.

We would like to reiterate that the Bulgarian Government is committed to continuing reforms and, in particular, to sustaining and continuing the reform agenda needed to promote medium-term economic growth and convergence with our European Union partners. We look forward to the World Bank’s support to Bulgaria in its reform program including through the DPL III.

Sincerely yours,

[Signatures]

Petar Dimitrov
Minister of Economy and Energy

Plamen Oresharski
Minister of Finance

Sofia, Bulgaria
April 9, 2009
## ANNEX 2: BULGARIA SOCIAL SECTORS INSTITUTIONAL REFORM DPL POLICY MATRIX

<table>
<thead>
<tr>
<th>Issues/problems</th>
<th>Actions DPL I</th>
<th>Prior Actions DPL II</th>
<th>Prior Actions third phase</th>
<th>Desired outcomes 2009</th>
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<tr>
<td>Overarching objective 1: increase employment and lay the foundations for long-term productivity growth by providing incentives for job creation and improving quality of education</td>
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<tr>
<td><strong>Macroeconomic stability is necessary for sustained growth</strong></td>
<td>Maintenance of a satisfactory macroeconomic policy framework</td>
<td>Maintenance of a satisfactory macroeconomic policy framework</td>
<td>Maintenance of a satisfactory macroeconomic policy framework</td>
<td>A stable macroeconomic framework which would provide the necessary conditions for achievement of identified outcomes in the social sectors</td>
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<td>Low employment; high percentage of long term unemployed, and high rates of informality in the labor market</td>
<td>The Government has enacted amendments to the labor code to increase flexibility of working time and fixed term and part-time contracts</td>
<td>The Government has enacted amendments to the social insurance code to lower the contribution rate for pension insurance by 6 percentage points from 29 to 23 percent</td>
<td>The Government has enacted amendments to the employment promotion act to introduce a monthly bonus for unemployed recipients of social assistance who find employment at their own initiative</td>
<td>An increase in the employment rate of younger workers to at least 23 percent (age 15-24, Eurostat data) from the 2005 baseline of 21.6 percent, with intermediate status (2007) of 24.5 percent; An increase in the employment rate of older workers to at least 40 percent (age 55-64, Eurostat data) from the 2005 baseline of 34.7 percent, with intermediate status (2007) of 42.6 percent; As an intermediate output that would result in a decrease in long term unemployment the relative share of individuals benefiting from training out of the total number of beneficiaries of active labor market programs increases, from the 2005 baseline of 19.4 percent, as well as an increase in absolute numbers of beneficiaries of training programs; Progress to date: 26.5</td>
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<td></td>
<td>The Government has enacted amendments to the social insurance code to lower the contribution rate for pension insurance by 6 percentage points from 29 to 23 percent</td>
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<td>The Government has enacted amendments to the employment promotion act to introduce a monthly bonus for unemployed recipients of social assistance who find employment at their own initiative</td>
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<td></td>
<td>The Ministry of labor and Social Policy (MLSP) has restructured active labor market programs as per the Employment Action Plans 2007 and 2008 to strengthen on the job qualification and professional training programs and service delivery linked to private sector skill needs</td>
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<td>The Council of Ministers has approved the updated National Employment Strategy 2008-2015 to guide future employment and labor market policy. The Government has (i) raised unemployment benefit replacement rates and changed the payment schedule to incentivize job search and (ii) introduced targeted active labor market programs and job subsidies for newly laid-off workers in order to address expected negative effects of the slowdown in economic growth projected for 2009 on employment. Amendments to the Vocational Education Act and the Employment Promotion Act have been enacted to open opportunities for second chance education and training for early school leavers, low skilled and people without education In order to improve investment climate and promote job creation the Government has approved and begun implementation of the Better Regulations Program as a national policy to institutionalize Regulatory Impact Assessments.</td>
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<td>Social welfare program design creates disincentives for job searching</td>
<td>The Government has developed and piloted one new project and scaled up one national program and two encouragement measures stipulated in the employment promotion act to encourage labor market integration of people with disabilities</td>
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<td>The Government has prepared an ex ante assessment of the impact of measures to strengthen work incentives in the social assistance system, and based on its conclusions has developed an employment activation program including individual action plans for social assistance beneficiaries</td>
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<th>Issues/problems</th>
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<th>Prior Actions third phase</th>
<th>Desired outcomes 2009</th>
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<td>Quality of education has been declining and the institutional capacity for quality assessment is lacking</td>
<td>The Ministry of Education and Science (MES) has approved the 2007-2009 program of activities to be implemented by CRKOKO and CRKOKO has implemented a pilot sample-based national assessment of student performance in grade 7.</td>
<td>Bulgaria has taken part in international assessment tests, like PISA 2006, PIRLS 2006, and TIMSS 2007. In addition, MES has administered sample testing of Matura in Bulgarian language and Literature, Math and Foreign languages, a new national placement test for 7th graders and a new census-based test of 4th graders.</td>
<td>The Matura examination (national secondary school-leaving certification test) in all subjects is implemented nationally. Capacity for quality assessment is in place and enhanced as shown by the new Reports on National and International Student Achievement testing programs prepared by CRKOKO and made available to the public. (increase from a baseline of 0 to a target of 5)</td>
<td>Matura examination results are increasingly used as a credential for admission to Bulgarian universities. The Ministry of Education is using the results of national assessment testing programs to formulate quality improvement-oriented policies, as shown by the number of programs financed which rely on the 4th and 5th grade national tests' results (from a baseline of 0 in 2007 to a target of 2).</td>
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<td>Overarching objective 2: promote fiscal sustainability through efficiency gains in social sectors</td>
<td>The Council of ministers has: (i) approved an action plan for the implementation of the national strategy for the introduction of information technologies in Bulgarian schools, and (ii) started to implement such action plan.</td>
<td>The Ministry of Education and Science (MES) has trained at least 50 percent of school directors through the Institute of School Directors.</td>
<td>The stock of arrears in hospitals has decreased at least 10 percent relative to the 2005 baseline level (BGN 60.8m, October 2008: BGN 19.6m). Percentage of payments to hospitals channeled through NHIF remains constant or increases. Baseline: 55 percent (January-December 2005); target: 80 percent; value 2008: 86 percent; Increase in efficiency through changes in payment mechanisms to hospitals, as reflected in a decrease in average length of stay over time. In 2006: 6.59; in 2007: 6.32, in 2008: 6.3; NHIF data showing that pharmaceutical spending is growing at a rate not higher than 10 percent annually in 2008-09 (2005-06: 11 percent; 2006-07: 10.3 percent; 2007-08: 5 percent)</td>
<td>Increase in efficiency through changes in payment mechanisms to hospitals, as reflected in a decrease in average length of stay over time. In 2006: 6.59; in 2007: 6.32, in 2008: 6.3; NHIF data showing that pharmaceutical spending is growing at a rate not higher than 10 percent annually in 2008-09 (2005-06: 11 percent; 2006-07: 10.3 percent; 2007-08: 5 percent)</td>
</tr>
<tr>
<td>Health service provision is inefficient and the financial sustainability in the National Health Insurance system is threatened</td>
<td>In order to improve the financial balance of its national health insurance system, the Government has: (i) increased the health insurance premium revenue; (ii) unified payment mechanisms for hospitals; (iii) included limits in the volume of services to be paid by NHIF to hospitals in the draft NHIF budget law for 2007; and (iv) signed recovery plans with university, national and regional hospitals with a state majority ownership.</td>
<td>The role of the NHIF as a primary payer of hospitals is maintained and payment system has been improved to promote an efficient use of resources and financial sustainability of the national health insurance system.</td>
<td>The Government is implementing measures to improve incentives for more efficient use of hospital resources by further strengthening the role of NHIF as the primary payer of hospitals and refining the contracting and payment system to hospitals.</td>
<td>The Government is implementing measures to strengthen the primary health care system by: (i) allowing for an increase in the relative share of primary care expenditure; (ii) promoting primary prevention by raising reimbursement prices and expanding the eligible population; (iii) changing regulative standards to increase number of diagnoses under responsibility of general practitioners.</td>
</tr>
<tr>
<td>Issues/problems</td>
<td>Actions DPL I</td>
<td>Prior Actions DPL II</td>
<td>Prior Actions third phase</td>
<td>Desired outcomes 2009</td>
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<tr>
<td>-------------------------------------------------------------------------------</td>
<td>-------------------------------------------------------------------------------</td>
<td>-------------------------------------------------------------------------------------</td>
<td>------------------------------------------------------------------------------------------</td>
<td>------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Current governance and financing system for schools provide only weak incentives to focus on quality, drop-out rates, and efficiency of spending.</td>
<td>The Council of Ministers has approved: (i) a new financing formula (&quot;unified standard&quot;), for allocating funds to municipalities for their school networks; and (ii) the plan for a phased introduction of the new financing formula.</td>
<td>The Government has maintained the unified standard and per student financing, and introduced delegated school budgets as a national policy.</td>
<td>School-based management is further strengthened, with school principals having increased discretion over school budgeting, including over staff salaries, and over staffing for the budget year 2009.</td>
<td>Increased efficiency as shown by halting the decreasing trend in pupil-teacher ratio in public schools (for grades 1-13) observed since 2002 (14.2 in 2002, 13.1 in 2006). Increased efficiency as shown by the reductions in average drop-outs as a percent of total enrolments in small mountainous municipalities (proxies for regions that struggle with largest declines in population) (from baseline of 3.7, 5.1 and 4.2 percent for grades 1-4, 5-8 and 9-13, respectively, in 2008). Percent of municipal schools financed through unified standard increases from baseline: 0 to target: 100 percent (intermediate output).</td>
</tr>
</tbody>
</table>

The Government has maintained the package of measures and incentives to support the introduction of the unified standard and school consolidation.|

The Government has maintained the package of measures and incentives to support the implementation of the unified standard and school consolidation.|

The Government maintains the package of measures and incentives to support the implementation of the unified standard per student, and has closed down and transferred state schools to municipalities.
ANNEX 3: BULGARIA FUND RELATIONS NOTE

As of April 9, 2009

**Date and place of last Article IV mission:** December 5-14, 2008, in Sofia. The concluding statement of the mission was posted at [www.imf.org](http://www.imf.org) on December 15, 2008.

**Country interlocutors:** Prime Minister Stanishev, Minister of Finance Oresharski, Minister of Economy and Energy Dimitrov, Minister of Labor and Employment Maslarova, BNB Governor Iskrov, other senior officials, representatives of parliament, international organizations including the European Commission and European Central Bank, financial sector, and think tanks. Mr. Yotzov (OED) attended the discussions.

**IMF team**: Messrs. Bakker (head) and Breuer, Ms. Zhou (all EUR), Mr. Dudine (PDR), Mr. Vandenbusche (MCM), Mr. Lybek (Regional Resident Representative), and Ms. Mihaylova (Resident Economist).

**Previous Article IV consultation:** The previous consultation was concluded on December 14, 2007, and the reports were posted at [www.imf.org](http://www.imf.org) on December 19, 2007.

**Data:** Bulgaria subscribes to the SDDS, and economic data are adequate to conduct effective surveillance (Appendix III).

**Exchange rate arrangement:** The currency of Bulgaria is the Bulgarian lev. Since July 1, 1997, the Bulgarian National Bank has operated a currency board arrangement. The peg currency is the euro at the rate of lev 1.95583 per €1. Bulgaria maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions, except for restrictions that are maintained for security reasons and that have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51)

<table>
<thead>
<tr>
<th>I. Membership Status</th>
<th>Article VIII</th>
</tr>
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<table>
<thead>
<tr>
<th>II. General Resources Account</th>
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<th>%Quota</th>
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<td>Quota</td>
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<td>Fund holdings of currency</td>
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<td>Reserve position</td>
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<table>
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<th>III. SDR Department</th>
<th>SDR million</th>
<th>%Allocation</th>
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</thead>
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<tr>
<td>Holdings</td>
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</tbody>
</table>

| IV. Outstanding Purchases and Loans | None. |

---

36 The team members, as of September 2008
V. Latest Financial Arrangements:

<table>
<thead>
<tr>
<th>Type</th>
<th>Date of arrangement</th>
<th>Expiration date</th>
<th>Amount approved (SDR million)</th>
<th>Amount drawn (SDR million)</th>
</tr>
</thead>
<tbody>
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<td>Stand-by</td>
<td>08/06/2004</td>
<td>03/31/2007</td>
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<td>0.00</td>
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<td>Stand-by</td>
<td>02/27/2002</td>
<td>03/15/2004</td>
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<td>240.00</td>
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<td>EFF</td>
<td>09/25/1998</td>
<td>09/24/2001</td>
<td>627.62</td>
<td>627.62</td>
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</table>

VI. Projected Payments to Fund: None.

VII. Implementation of HIPC Initiative: Not Applicable.

VIII. Implementation of Multilateral Debt Relief Initiative (MDRI): Not Applicable.
IMF Executive Board Concludes 2008 Article IV Consultation with Bulgaria

On March 4, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Bulgaria.¹

Background

Bulgaria has been hit by the global financial crisis, with clear signs that the country’s capital-inflows driven boom has come to an end and that the real economy is slowing down.

Since agreement was reached on EU accession in 2004, Bulgaria experienced a surge in capital inflows and a credit boom. Inflows were driven by expectations of rapid convergence with the EU, and were further boosted by the confidence-enhancing effect of the currency board and a strong fiscal policy. By 2008, net inflows had increased to about 27 percent of GDP. Boosted by capital inflows, credit to the private sector rose rapidly, and the credit-to-GDP ratio climbed from 36 percent in 2004 to 67 percent in 2007. The surge in inflows generated strong GDP growth, but also a sharp widening of external and internal imbalances. GDP grew by more than 6 percent annually, leading to a significant narrowing of the income

¹ Under Article IV of the IMF’s Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country’s economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country’s authorities.
gap with Western Europe. Growth remained strong in 2008—at 6 percent, Bulgaria was one of the fastest growing countries in Europe.

As the growth of domestic demand outpaced GDP growth, the current account deficit widened from 5 percent of GDP in 2003 to an estimated 25 percent of GDP in 2008. As unemployment dropped and the labor market tightened, wage growth accelerated to 25 percent in June 2008. The overheating of the economy, together with rising food and oil prices, resulted in a surge of inflation, which peaked at 14.7 percent in June 2008. Competitiveness deteriorated, and the unit labor cost-based real effective exchange rate appreciated 27 percent in the two years ending in mid-2008.

The global financial market turmoil has had a severe impact on financial asset prices in Bulgaria. Foreign parent banks have reduced new financing to their local subsidiaries and credit growth to the non-government sector has slowed sharply.

**Executive Board Assessment**

Executive Directors commended the Bulgarian authorities for their prudent policies that have built strong balance sheets in the public sector including large foreign reserves, low public debt, and a substantial Fiscal Reserve Account. They noted that there are substantial buffers in the banking system. At the same time, large capital inflows contributed to an investment and consumption boom, creating a large current account deficit and increasing private sector debt, while heavy reliance on foreign capital is a source of vulnerability. Looking forward, Directors considered that economic growth would slow sharply with the downturn in partner countries and only modest net capital inflows. Moreover, as risks are predominantly on the downside, the authorities were advised to monitor developments closely and adapt policies, as warranted.

Directors considered that the currency board arrangement has served Bulgaria well as an anchor for macroeconomic stability. They took note of the staff assessment that the real effective exchange rate is somewhat overvalued, but that determining its extent is a difficult question. The authorities were encouraged to avoid any further erosion in international competitiveness as a result of real wage increases exceeding productivity gains.

Directors considered that the most immediate policy challenge will be to maintain confidence in the currency board arrangement and in the banking system. While the banking sector remains well capitalized, liquid, and highly profitable, a severe recession could cause nonperforming loans to increase and bank capital to erode. Directors welcomed steps to improve depositors’ confidence, increase capital cushions by curtailing most banks’ dividend payout, and to secure commitments from parent banks to provide adequate liquidity and capital to their subsidiaries. They observed that the substantial Fiscal Reserve Account allowed a major lender-of-last-resort capacity. They supported the authorities’ efforts to improve Bulgaria’s crisis management capacity by intensifying the monitoring of liquidity and credit risks, further
strengthening the stress testing capacity, and cooperating more closely with foreign supervisors.

Executive Directors welcomed the authorities’ commitment to maintaining prudent fiscal policies, which will provide crucial support for the currency board arrangement. They concurred with the authorities’ intention to maintain a fiscal surplus of 2 percent of GDP in 2009, in part by containing public spending. They cautioned, however, that were growth to slow more than expected, additional expenditure cuts will be necessary to achieve the targeted surplus. They viewed the rule to restrict spending to 90 percent of the amount budgeted as an effective short-term tool, but emphasized that prioritization and further spending restraint will be needed to sustain appropriate fiscal surpluses over the medium term.

Directors noted that further structural reforms will be key to a smooth and speedy economic recovery and achievement of convergence with the European Union. They welcomed the recent education and labor market reforms to raise productivity and labor market participation rates, and the progress made in reducing administrative burdens for businesses.

Public Information Notices (PINs) form part of the IMF’s efforts to promote transparency of the IMF’s views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2006 Article IV Consultation with Bulgaria is also available.
ANNEX 5: FIDUCIARY ASPECTS

Budget formulation
1. The 2003 CFAA noted that budgeting with a medium term outlook and program budgeting was at an early stage of development. Since 2003 the budget document has addressed many of these concerns and now includes (a) macro-economic assumptions underpinning the budget; (b) a three year tax policy; (c) a proposed national expenditure policy; and (d) a public debt policy with forecasts of payments due. The Government also progressively implemented program budgeting to comprise 10 ministries in 2006. With the 2009 State Budget Act all Ministries and some agencies develop their budgets and report on their execution in program format. Capital budgets are fully integrated into these program budgets. Performance indicators and targets are also published for all line ministries and are included in the budget documents presented to the National Assembly. The Ministry of Finance has developed and implemented a system that would allow for recording, monitoring and reporting of all capital expenditures and a Strategic Investments Division has been established to coordinate investment policy in the public sector. With the Law on the State Budget for 2006 for the first time appropriation of funds by policy areas by parliament has been introduced. With Council of Ministers Decree on the implementation of the State Budget for the respective year appropriation of FLSU’s expenditures by line ministries/agencies’ programs has been introduced. The Government is in the process of developing a new Public Finance Budget Act which will supersede the Organic Budget Law and regulate the consolidated fiscal program, including new fiscal regulations related to state financial statistics, budget accounts and internal control.

Budget execution, including cash and debt management
2. Overall the CFAA concluded that the systems and processes of cash management and treasury worked well and broadly in conformity with modern practices. The process of integrating the BGN-denominated budget accounts of the Central Government into the SEBRA system has been by and large finalized with the inclusion of the Supreme Judicial Council in 2005. In this way, the main objective of the reform within the payments system for the central budget supported sector - the centralization of cash management within the single account and the rationalization of the payment processes by means of concentrating all payments within the structure of the respective first level budget spender via SEBRA, as well as through the implementation of an integrated expenditures control by means of the introduction on behalf of the Ministry of Finance of spending ceilings for the payments made through the BNB accounts of the first level budget spenders. The linkage between the cash management system and the management of debt has been improved thanks to the organizational transformation of the structure of the Ministry of Finance related to the creation of the State Treasurer function, which integrates the responsibilities involved both in State Treasury management and in public debt management.

Public sector accounting and reporting
3. The proposed strategy of the Government for FMIS development had been to develop a financial management information system, using SAP R/3 ERP software. The complexity of the project was under-estimated and in the end a less ambitious approach has been undertaken to set more realistic goals for the achievement of which adequate resources and staff have been ensured. Further to that and in view of continuing changes in the legal framework in the course of the strategy implementation a decision was made to initially introduce the project in the whole system of the Ministry of Finance and those line ministries, that have relation to the accounting information, related to the management of EU financial instruments. As a result the FMIS as an
An internet/intranet based system was introduced in MoF, all second level spending units to the Minister of Finance, all EU PHARE and ISPA Implementing Agencies, all Managing Authorities of the Operational Programs under the EU Structural Funds and Cohesion Fund, as well as all territorial offices of the National Revenue Agency. The line ministries were allowed to develop their own accounting systems although the Government's goal remains the development of an integrated FMIS, the realization of which is subject to upcoming projects.

Internal control and internal audit

4. The CFAA reported that the structural reforms were at an early stage and identified a number of key steps to be taken in the areas of financial internal controls and public sector internal audit. Bulgaria made changes in the Public Internal Financial Control framework through the introduction of three new Acts in consultation with the EC, with supporting guidelines, which cover financial management and control, internal audit and financial inspection at all levels of Government. The new legislative framework introduced managerial responsibility, with specific responsibilities for the heads of public sector organizations and a wider interpretation of financial management and control applicable to all managers. The internal audit function is now completely decentralized and integrated within the structures of the respective budget units. Functional independence is assured through the internal audit function reporting to the management/line minister. An Internal Control Directorate has been established in the MoF (consisting of Central Harmonization Units for financial management control and internal audit). Training and capacity building continues with all internal auditors required to be certified by 2009.

External audit

5. The CFAA noted that the National Audit Office (NAO) submits its reports to the National Assembly, and had adequate operational independence, resources and staff. Bulgaria amended in 2004 the SP37 audit act, further harmonizing the Bulgarian external audit legal framework with current EU practice. The NAO has also made a number of other changes to improve its methodology and approach to its work including new manuals, audit standards and building a clearer and more coherent relationships with inspection and oversight agencies in Government. The NAO is currently finalizing its strategic long term plan which will be submitted to the National Assembly shortly. The focus of future capacity building efforts from the UK NAO will be on fraud and corruption and the audit of EU Funds.

Procurement

6. A Country Procurement Assessment (CPAR) was submitted to the Government in July 2004 which concluded that the environment for conducting public procurement in the country was high risk. This CPAR has informed PAL-3 and DPL preparation, specifically, the regulatory framework for public procurement has been improved under PAL-3, and the government has made good progress in the initial implementation of the CPAR action plan. Bulgaria has adopted a new public procurement law (effective as of July 1, 2006) with the objective of being fully aligned with the EU acquis communautaire. Since July 1, 2006, the Public Procurement Act has been enforced and it is aligned with all European directives with regard to public procurement. All the by laws have been in force since the above stated date: Manual for the implementation of the Public procurement Act, Ordinance for the award of special public procurement, Ordinance for the award of small public procurement. Model tender documents are being used under Regulation 2005/1564 of the EC. There is an operational Public Procurement Register, where all the info of public procurement is available. The Register is public and the access to it is free.

37 SP - Smetna Palata – Bulgarian National Audit Office
Foreign exchange environment

7. The IMF conducted a safeguards assessment of the Bulgarian National Bank (BNB) in 2002 and found that safeguards are generally adequate. The 2004 follow up assessment carried out by the IMF concluded that further progress had been made in strengthening the overall safeguards framework of the BNB. Recommendations by the IMF were promptly addressed by the BNB. Significant developments included:

- BNB’s financial statements have been improved and earlier qualifications eliminated.
- The internal audit function has been significantly strengthened, its scope of operations has been widened and a risk-based methodology has been introduced.
- Foreign reserves management has been strengthened, including the adoption of detailed investment guidelines and the establishment of risk analysis and control capabilities.
- Furthermore, accounting functions have been further automated and procedures manuals have been completed for a number of activities.

Overall, the 2004 Safeguards Assessment report concluded that the risk was low. The BNB’s audited financial statements, together with the audit opinion are published in the BNB’s annual report and on the BNB website. The audit reports for the last 7 years (2001-2007) have unqualified opinions. Past audits and the positive assessment by the IMF indicates that there are no additional fiduciary safeguards considered necessary as far as management of the foreign exchange is concerned.
### ANNEX 6: STATUS OF BANK GROUP OPERATIONS IN BULGARIA

CAS Annex B8 - Bulgaria

Operations Portfolio (IBRD/IDA and Grants)

As Of Date 4/15/2009

| Closed Projects | 34 |

#### IBRD/IDA *

- Total Disbursed (Active) 118.67
- of which has been repaid 10.62
- Total Disbursed (Closed) 1,949.67
- of which has been repaid 1,193.55
- Total Disbursed (Active + Closed) 2,068.34
- of which has been repaid 1,204.17

- Total Undisbursed (Active) 252.53
- Total Undisbursed (Closed) 0.90
- Total Undisbursed (Active + Closed) 253.44

#### Active Projects

<table>
<thead>
<tr>
<th>Project ID</th>
<th>Project Name</th>
<th>Development Objectives</th>
<th>Implementation Progress</th>
<th>Fiscal Year</th>
<th>IBRD</th>
<th>GRANT</th>
<th>Cancel.</th>
<th>Undisb.</th>
<th>Orig.</th>
<th>Frm Rev'd</th>
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<td>S</td>
<td>S</td>
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<td>0.02</td>
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<td>HS</td>
<td>S</td>
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<td>13.65</td>
<td>7.32</td>
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<tr>
<td>P099894</td>
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<td>MS</td>
<td>MS</td>
<td>2007</td>
<td>122.50</td>
<td>127.69</td>
<td>26.50</td>
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<td>S</td>
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<td>P100657</td>
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<td>45.54</td>
<td>20.42</td>
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</table>

#### Overall Result

- Original Amount in US$ Millions: 337.75 10.00 252.55 24.45
### Bulgaria

#### Prices and Government Finance

<table>
<thead>
<tr>
<th>Year</th>
<th>Domestic Prices (%)</th>
<th>Implicit GDP Deflator</th>
<th>Government Finance (% of GDP, includes current grants)</th>
<th>Current Revenue</th>
<th>Current Budget Balance</th>
<th>Overall Surplus/Deficit</th>
<th>Inflation (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>1.96</td>
<td>1.39</td>
<td>2.55 - 2.1</td>
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<td>2.2</td>
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<td>36.3</td>
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<td>38.8</td>
<td>7.6</td>
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#### Trade

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<td>1.14</td>
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<td>15,286</td>
<td>15,286</td>
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<td>15,286</td>
<td>-6,299</td>
<td>1.14</td>
<td>1.14</td>
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#### Balance of Payments

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<td>1987</td>
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<td>7,011</td>
<td>4,432</td>
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<td>-5,780</td>
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<td>8,054.92</td>
<td>2,274.92</td>
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</table>

#### External Debt and Resource Flows

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Debt Outstanding and Disbursed (US$ millions)</th>
<th>Total Debt Service (US$ millions)</th>
<th>Composition of Net Resource Flows</th>
<th>Memo</th>
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<tr>
<td>1987</td>
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<td>1,014</td>
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<tr>
<td>1997</td>
<td>11,100</td>
<td>1,014</td>
<td>Official credits</td>
<td></td>
</tr>
<tr>
<td>2006</td>
<td>1,014</td>
<td>2,473</td>
<td>Official credits</td>
<td></td>
</tr>
<tr>
<td>2007</td>
<td>1,014</td>
<td>2,473</td>
<td>Official credits</td>
<td></td>
</tr>
</tbody>
</table>

#### Current Account Balance to GDP (%)

<table>
<thead>
<tr>
<th>Year</th>
<th>Memo</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td></td>
</tr>
<tr>
<td>1997</td>
<td></td>
</tr>
<tr>
<td>2006</td>
<td></td>
</tr>
<tr>
<td>2007</td>
<td></td>
</tr>
</tbody>
</table>

#### Composition of 2006 Debt (US$ millions)

- A: IBRD 1.331
- B: IDA 0.241
- C: IMF 0.060
- D: Other multilateral 0.020
- E: Bilateral 0.001
- F: Private 1.550
- G: Short-term 0.001

This table was prepared by country unit staff. Figures may differ from other World Bank published data. 9/24/08

This table was produced from the Development Economics LDB database.

* The diamonds show key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.