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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT

FOR A PROPOSED LOAN

IN THE AMOUNT OF EURO 116.1 MILLION
(US\$150 MILLION EQUIVALENT)

TO

THE REPUBLIC OF BULGARIA

FOR A PROPOSED

THIRD PROGRAMMATIC ADJUSTMENT LOAN

May 4, 2005

Human Development Unit
South Central Europe Country Unit
Europe and Central Asia Region

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Currency Equivalent

(Exchange Rate Effective as of May 4, 2005)

Currency Unit = Bulgarian Lev (BGN)

US\$1.00 = BGN 0.66

Government Fiscal Year

January 1 – December 31

Weights and Measurements

Metric System

Abbreviations and Acronyms

ALMP	Active Labor Market Program	ISA	Insurance Supervision Agency
ARCS	Administrative and Regulatory Cost Survey	LDP	Letter of Development Policy
ASAL	Agriculture Sector Adjustment Loan	MDG	Millennium Development Goals
BNB	Bulgarian National Bank	MES	Ministry of Education and Sciences
BOP	Balance of Payments	MEW	Ministry of Environment and Waters
BTC	Bulgarian Telecommunications Company	MOF	Ministry of Finance
CAP	Common Agricultural Policy	MOH	Ministry of Health
CAS	Country Assistance Strategy	MOI	Ministry of Interior
CBA	Currency Board Arrangement	MOJ	Ministry of Justice
CEE	Central and Eastern Europe	MOLSP	Ministry of Labor and Social Policy
CEP	Council for Economic Policy	MTC	Ministry of Transport and Communications
COM	Council of Ministers	MTFF	Medium Term Fiscal Framework
CPC	Commission for the Protection of Competition	NAO	National Audit Office
CRC	Communications Regulatory Commission	NBFI	Non-Bank Financial Institutions
DH	District Heating	NEK	National Electricity Company
DSK	State Savings Bank	NHIF	National Health Insurance Fund
DZI	State Insurance Company	NHM	National Health Map
EC	European Commission	NSSI	National Social Security Institute
ECA	Europe and Central Asia	OECD	Organization for Economic Cooperation and Development
EEEA	Energy and Energy Efficiency Act	PAL	Programmatic Adjustment Loan
EPSAL	Environment Protection Structural Adjustment Loan	PEIR	Public Expenditure and Institutional Review
EU	European Union	PIFCA	Public Internal Financial Control Agency
FDI	Foreign Direct Investment	PSC	Public Service Contract
FESAL	Finance and Enterprise Structural Adjustment Loan	PSO	Public Service Obligation
FRA	Fiscal Reserve Account	SACP	State Agency for Child Protection
FSAP	Financial Sector Assessment Program	SBA	Stand By Arrangement
FSC	Financial Supervision Commission	SERC	State Energy Regulatory Commission
GDP	Gross Domestic Product	SISA	State Insurance Supervision Agency
GFMIS	Government Financial Management Information System	SJC	Supreme Judicial Council
GMI	Guaranteed Minimum Income	SME	Small and Medium Enterprise
GOB	Government of Bulgaria	SOE	State Owned Enterprise
IFI	International Financial Institution	SPAL	Social Protection Adjustment Loan
IMF	International Monetary Fund	TELK	Disability Assessment Committee
IPPC	Integrated Pollution Prevention Control	USAID	United States Agency for International Development

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REPUBLIC OF BULGARIA
THIRD PROGRAMMATIC ADJUSTMENT LOAN

LOAN AND PROGRAM SUMMARY

Borrower:	Republic of Bulgaria
Amount:	EURO 116.1 million (US\$150 million equivalent)
Terms:	Variable Spread Loan (VSL) in Euro with 17 years maturity including five years grace period and level repayments
Objectives and Description:	<p>The Third Programmatic Adjustment Loan (PAL 3) continues the PAL Program support to the government's medium term program. The main objectives are the achievement of average annual growth rates of 4.5-5.0 percent during 2002-05, the reduction of the poverty rate by half by 2005 compared to 2001, and the reduction of the unemployment rate from 18.1 percent in 2001 to 12-14 percent in 2005, together with substantial progress towards European Union (EU) accession, which is now expected to occur in 2007. The medium term program balances a strategy of private sector-led growth and empowerment to ensure wide participation in growth. The program consists of five complementary pillars:</p>

- *Sustaining structural reforms* in the enterprise sector with emphasis on the completion of privatization and the restructuring of the energy, railway, telecommunications, and water sectors;
- *Establishing a market-friendly business environment*, focusing on reducing entry constraints, accelerating exits, securing deregulation and reducing regulatory costs, improving the delivery of public services to business, improving the competitive environment, and improving labor market policies;
- *Deepening the financial sector*, improving the legal framework for lending, completing banking reform, and developing financial markets;
- *Improving public sector governance*, strengthening public administration capacity, improving service delivery, reducing corruption, strengthening accountability and transparency, strengthening public expenditure management, and increasing the efficiency and effectiveness of the judicial system;
- *Investing in human capital and strengthening social programs*, improving service delivery in education and health, continuing pension reforms, increasing social assistance effectiveness, providing for better integration of the disabled and reducing the institutionalization of children.

Progress in the direction of the objectives of the program has been impressive: the average annual growth rate during 2002-05 has been estimated at 5.1 percent, unemployment has declined dramatically from 18.1 percent in 2001 to 12.7 percent in 2004, and poverty has continued to fall. PAL-3 continues the unfinished reform agenda of the previous PALs, with a focus on the *social sector agenda*.

Benefits:

There are five distinct but complementary benefits. First, PAL-3 provides continuing assistance to the government in maintaining the momentum of reforms to achieve the key goals of its medium term economic program: to achieve sustained growth and reduce poverty and unemployment while progressing towards EU accession. Second, the loan supports the strengthening of those institutional arrangements required to ensure the successful implementation, coordination, monitoring, and evaluation of ongoing and future medium term programs. Third, PAL-3 lays the groundwork for a future medium term reform program through identifying specific outcomes to be achieved over the period 2005-07 and indicating medium term directions of reform. Fourth, PAL-3 complements the government's ongoing investment projects by establishing the enabling policy framework. Fifth, the program that is supported by the loan complements and reinforces the IMF program to keep Bulgaria on its macroeconomic stabilization path.

Risks:

There are three main risks:

- *Political risk remains high, but is mitigated by the maturity of the reform agenda.* With the outcome of the forthcoming Parliamentary elections as yet uncertain, this presents risks for completing the envisioned legislative changes. Mechanisms established or being established for stakeholder consultation, are expected to strengthen support for completing the reforms and could mitigate this to some extent. There are also moderate risks regarding the continuity of reforms in the medium term. The latter risks are mitigated to a significant degree by the strong support from all political parties for Bulgaria's EU accession, which helps to provide an anchor for the remaining structural, institutional and social reforms – and particularly the reforms to public administration and the judiciary. The risks to reforms beyond PAL-3 are further mitigated by the advanced stage of implementation of several of the structural reforms, for which the foundation was established under earlier PALs. Finally, accompanying social protection measures have further mitigated the risks for these reforms.
- *Implementation risks from weak capacity remain* for continuing reforms beyond PAL-3. The institutional capacity is uneven across government agencies and the impact of the institutional reforms supported by the PALs is only beginning to be felt. The track record under the PAL program to date, however, bodes well for completing and continuing ongoing reforms. The risk is further mitigated by the implementation support in ongoing investment projects from the Bank and other donors in key areas of the reform program. Also important is the ongoing EU support to capacity building through PHARE and twinning arrangements. Nevertheless, risks remain, and there is a significant medium term agenda in institution and capacity building.

- *Macroeconomic stability faces risks and vulnerabilities.* Bulgaria faces several potential risks. The economy is vulnerable to several parameters including an increase in oil prices, higher interest rates, FDI shocks, and a weaker than expected performance in EU economies (the destination of over 50 percent of Bulgarian exports and the origin of more than half of the FDI inflows.) Domestic vulnerabilities include the degree of effectiveness of measures undertaken to address the rapid growth of credit to the non-government sector, failure to enhance domestic market flexibility consistent with the CBA, and the electoral cycle potential pressures on the budget. However, Bulgaria's sustained track record to date, the better than expected performance in 2004, and the active management of its external debt, the continuation of prudent fiscal policies, and the solid growth performance reduce the scope of these vulnerabilities. Mitigation of these risks is predicated on the continued maintenance of strict discipline in macroeconomic policies and the measures in place to respond to potential risks if they were to materialize.

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**IBRD PROGRAM DOCUMENT
ON A PROPOSED THIRD PROGRAMMATIC ADJUSTMENT LOAN
TO THE REPUBLIC OF BULGARIA**

1. The proposed Third Programmatic Adjustment Loan (PAL-3) to the Republic of Bulgaria for EURO 116.1 million (US\$150 million equivalent), is designed to support the Medium Term Reform Program of the Government of Bulgaria (GOB), the objectives of which are to sustain economic growth, reduce poverty and create employment, and make substantial progress towards EU accession.
2. This loan is the third of three programmatic adjustment loans envisaged in the Country Assistance Strategy (CAS) discussed by the Board on May 9, 2002. As articulated in the CAS, PAL-1 focused primarily on *structural, regulatory and institutional reforms* in the real and financial sectors that would move Bulgaria towards a functioning market economy (Pillars I-III of the government's five pillar program), and PAL-2 initiated broad reforms in the area of *public sector governance* (Pillar IV) while continuing the reforms initiated under PAL-1. PAL-3 continues the unfinished reform agenda of the previous PALs, particularly in Pillars I, II, and IV, while it has a particular focus on the *social sector agenda* (Pillar V).
3. This document and the accompanying updated Letter of Development Policy (LDP) present an assessment of progress in achieving the key objectives of the government's three-year program.

A. SUMMARY OF ACHIEVEMENTS UNDER PAL-3

4. **The government has successfully pursued a broad and ambitious reform program with the support of the PALs, driven by the prospect of accession to the European Union.** In the majority of reform areas supported by the PAL series, progress has been broadly on track, while in selected areas progress has been deeper and broader than anticipated. In particular, there have been significant achievements in large scale privatization, banking, and infrastructure reform, where reforms have been completed as envisioned or where performance has surpassed expectations and significantly improved the investment climate. Reforms in public sector governance provide a good platform for the significant institution and capacity building agenda lying ahead for EU accession. In the social sectors, pension reform has been put on a sound footing, and important achievements have been noted in improving the effectiveness of social assistance and enhancing equal access in education.
5. **Progress towards the objectives of the program has been impressive.** The average annual growth rate during 2002-05 has been estimated at 5.1 percent, unemployment has declined dramatically from 18.1 percent in 2001 to 12.7 percent in 2004, per capita GDP grew at over 5.5 percent per year between 2002 and 2004, and poverty has continued to fall. International financial markets have responded favorably to the achievements of the reform program. The progress in structural reforms is also reflected in recent milestones in Bulgaria's path towards EU accession. In its Regular Reports in 2002, 2003 and 2004, the European Commission (EC) has assessed Bulgaria as a functioning market economy. On June 15, 2004, Bulgaria provisionally closed all 31 chapters of the *acquis communautaire*, and the government expects to sign the accession treaty in April 2005 and join the EU by its target date of January 2007.
6. **Macroeconomic performance has remained strong throughout the program.** Economic growth accelerated to 5.7 percent during the first three quarters of 2004, following growth rates of 4.9 percent in 2002 and 4.3 percent in 2003. Macroeconomic stability has been maintained, with inflation still relatively low (at 6.1 percent average inflation in 2004). Strong GDP growth and active debt management have contributed to a further reduction in government debt to 40.7

percent of GDP in December 2004, well below the Maastricht threshold of 60 percent. Fiscal performance continued to improve as a result of a combination of tight expenditure policy and revenue over-performance: fiscal accounts ran a surplus of 1.8 percent in 2004, compared to a balanced budget in 2003. FDI inflows were estimated at US\$2.5 billion in 2004, the highest inflows recorded to date since the start of transition.

7. PAL-3, as the third in the series of loans, plays an important role in “completing” the current reform agenda as envisioned, while laying the foundation for a possible future program. To improve the investment climate, PALs-1 and 2¹ supported large scale privatization and significant restructuring in the energy, telecommunications, and railways sectors. They also completed the agenda for banking reform as envisioned, and began to implement significant deregulation to reduce the transactions costs for businesses and to simplify exit. In the area of public sector governance, the legal framework for competitive recruitment and advancement in the civil service and for improving the accountability, efficiency and effectiveness of the judiciary was established. In the social sectors, the legal and regulatory framework for a multi-pillar pension system was strengthened, and the efficiency and targeting of social assistance was significantly improved. PAL-3 has supported the completion of the reform agenda as envisioned in the area of privatization and in the energy and telecommunications sectors. In addition, to improve the investment climate, PAL-3 supports further restructuring of the railways sector, deregulation, particularly of business entry, and improvements in the delivery of services to businesses. In the area of public sector governance, it advances reforms to establish a merit based and depoliticized civil service and efficient judiciary. Finally in the social sectors, the main contributions of PAL-3 are in the completion of the first stage of pension reform, the initial reform of the disability benefits system to reduce misuse and fraud and to facilitate economic and social integration of the disabled, significant actions to enhance the opportunities for equal access to education for children from poor families and ethnic minorities, strengthened public health programs, and the implementation of hospital restructuring. Further development of comprehensive reform programs in health and education is under way, and implementation of the future reform agenda in these sectors have been identified as government priorities, including through possible support from the Bank. The remainder of this section summarizes the key achievements of PAL-3 (Table 1 presents the major achievements supported by the PAL program, and the major actions under PAL-3). A comprehensive discussion of the PAL program, including the full set of achievements under PAL-3 are discussed in Section C and also represented in the Matrix of Performance Benchmarks and Desired Outcomes (attached as Annex 6 to this report).

¹ PAL-2 was structured as a two tranche operation with the second floating tranche of Euro \$20 million linked to progress on Bulgartabak privatization and restructuring/liquidations. In fact, progress on this particular privatization has been slower than anticipated. The government has been implementing this privatization but changing market conditions have provided challenges and only partial privatization has been achieved. The government decided to let PAL-2 close on the agreed closing date of March 31, 2005 and to let the second tranche of PAL-2 lapse. At the start of the PAL program, the privatization of Bulgartabak was viewed as a sign of resolve of the government to maintain an attractive investment climate. Today, with the privatization program nearly completed, including the completion of other long awaited strategic privatizations in energy and telecommunications, with private sector share of GDP having increased significantly and exceeding government targets, and since the holding does not represent a fiscal drain, the completion of this privatization is far less critical now as an indicator of Bulgaria’s overall reform progress. Given these developments and progress achieved on other business climate reforms included in PAL3, no economic or demonstration purpose was considered to be served by carrying over this privatization in PAL-3. Bulgaria’s performance in privatization during the PAL-program is further discussed in Sections A (paragraph 8 and Table 1), Section B (especially paragraphs 25 and 32), Section C (especially Table 3, Figure 8 and paragraph 55). Discussion of status of Bulgartabak privatization is included in Table 4 and footnote 30 to paragraph 55.

<i>Reform Area</i>	<i>Major Actions Under PAL-1 and 2</i>	<i>Major Actions Under PAL-3</i>
INVESTMENT CLIMATE		
Non-infrastructure privatization	Completed 98% private ownership of banking sector and 100% private ownership of insurance sector through privatization of remaining large banks (Biochim Bank, and State Savings Bank) and State Insurance Company.	Nearly completed overall privatization program , through sale or liquidation of 80% SOEs where the government had majority control in 2002 (30% sold in PAL-3 alone), and nearly all minority packages (1225 sold in January 2004 to February 28, 2005).
Restructuring and privatization in energy and telecommunications	Restructured energy sector and prepared it for private sector entry, and reduced energy intensity , through legal separation of electricity distribution and generation companies and increase in electricity and heating tariffs, and completed establishment of legal and regulatory framework for liberalization of telecommunications market.	Completed program of restructuring of energy sector , through further adjustments in energy tariffs and approval of an electricity sector restructuring plan. Exceeded private sector entry targets in energy sector and telecom , through 100% privatization of electricity distribution sector, Bulgarian Telecom. Company, and seven district heating companies.
Restructuring of railways	Introduced organizational and institutional changes to increase efficiency and enable eventual private sector entry , by establishing new railway operating company and infrastructure state enterprise, and market rules for licensing, track access. Improved fiscal sustainability of railways through staff reductions of 10% and stopping operation of 200 km of uneconomic lines.	Continued improvement in fiscal sustainability of railways , with railway subsidies, excluding investments kept at 0.2%, down from 0.5% in 2000, and financial working ratio targets for 2004 achieved through signing of first Public Service Contract, adoption of a decision to close 250 km of uneconomic lines, termination of 9% of passenger services and additional staff reductions, bringing cumulative reductions to 13%.
Deregulation of entry, exit and operations of firms	Reduced average time period to reach resolution of insolvency cases by 6 months through enactment of legislative amendments to improve bankruptcy and introduction of stringent criteria for selection and monitoring of bankruptcy trustees.	Significantly reduced steps and time required to register a business, and reduced time for resolving commercial disputes , through legislation for single identification number for business registration and approval of strategy to take judges and courts out of registration.
Business service delivery	Improved efficiency of pilot front line government services , through introduction of pilot one stop shops in 5 central agencies and 6 municipalities.	Improved efficiency in front line government services , through rollout of one stop shops to over half of local administrations, and national replication of pilot measures to reduce processing time at all participating border crossing points and customs offices.
Banking and financial intermediation	Exceeded/met targets for increases in credit to the private sector , through legislation to improve exit process for insolvent and closed Banks; strengthening supervision powers of the Bulgarian National Bank, and improving legal/institutional framework for lending.	
PUBLIC SECTOR GOVERNANCE		
Merit and depoliticization in the Civil Service	Approved legislation and established institutional structures to create a merit based and depoliticized civil service , by legislating competitive hiring/compensation in public sector, establishing performance appraisal system and approving legislative framework for introduction of performance pay.	Increased competitiveness and depoliticization of the civil service : 100% of new civil service recruitments subject to external competitive process; 2004 pay increases across government, leading to both greater competitiveness with private sector and decompression, and introduction of performance rewards throughout civil service; submission of legal amendments to depoliticize the civil service.
Accountability and transparency in public sector	Enhanced accountability and transparency in civil service through government adoption of anti-corruption program/strategies, and strengthening of conflict of interest and asset declaration regimes.	Enhanced accountability and transparency in civil service through adoption of code of ethics for civil service, and significant expansion of information access in government.
Efficiency, accountability and effectiveness of the judiciary	Improved accountability, efficiency, and effectiveness of the judiciary , through constitutional and legislative amendments to enhance accountability for judges, and establishing a more transparent and merit-based appointment system for judges.	Increased efficiency of resolution of commercial disputes , through adoption of Mediation Law to promote alternative dispute resolution mechanism for commercial disputes, and strengthened the administrative justice system , through submission to the National Assembly of a new Administrative Procedural Code to establish nearly a dozen specialized administrative courts.

<i>Reform Area</i>	<i>Major Actions Under PAL-1 and 2</i>	<i>Major Actions Under PAL-3</i>
INVESTING IN HUMAN CAPITAL AND STRENGTHENING SOCIAL PROTECTION		
Education Access And Equity	<p>Increased integration of children from ethnic minorities into schools, through the introduction of an obligatory pre-school year.</p> <p>Increased incentives for participation of poor children in schools through legislation to make the child allowance program conditional on school attendance.</p>	<p>Increased integration of children from ethnic minorities into schools, through adoption of an updated strategy and action plan to enable access to quality education for children from ethnic minorities, and earmarking of funds in 2005 budget and enactment of an ordinance establishing a fund to support integration of ethnic minorities and to especially support school desegregation. Reduced incentives for dropping out of primary education through legislation to introduce cash assistance for purchase of school supplies for poor first grade children from the 2004/05 school year, and adoption of National Program to introduce free textbooks, school feeding, transportation in remote villages.</p>
Public health and restructuring of hospitals	<p>Created institutional structures to improve public health outcomes, including reduced incidence of tuberculosis, increased immunization rates for children, and reduced incidence of tobacco related health risks, through implementing a mechanism for funding national health programs.</p> <p>Improved hospital management and productivity through introduction of output-based payment for inpatient care services.</p>	<p>Strengthened institutional structures and capacity to improve public health outcomes, through increase in share of MOH operating budget to National Health Programs, legislation to earmark 1% of excise tax rate from tobacco products to fund national tobacco control program and increase in excise tax for tobacco, and adoption of legislation to increase tobacco control and regulate tobacco consumption in public places.</p> <p>Improved hospital management, productivity and efficiency, through expanding output-based payment for inpatient care services to cover all major case mix packages, thus providing incentives for rationalization of services, and launching of restructuring in Ministry of Health and municipal hospitals.</p>
Integration of disabled and reduction of fraud in disability benefits		<p>Enacted legislation to reduce disability pension uptake, through legal amendments disallowing new claims of disability pensions by people over retirement age, and law strengthening role of the National Social Security Institute in disability assessment and providing for reprimanding doctors for abuse/fraud in medical assessment of disability.</p> <p>Enacted improved legislative framework for a flexible system of disability benefits, through consolidated legal act and regulations for integration of the disabled.</p>
Multi-pillar pension reform	<p>Strengthened legal and regulatory framework for multi-pillar pension system, through amending framework for private pension plans to improve governance structure and supervision capacity, improve fiduciary standards, and introduce more flexibility in the investment regime; enacting Consolidated Code for implementing multi-pillar reform; and enacting regulations for transparent/prompt transfer of contributions to pension funds.</p>	<p>Passed legislation completing first stage of plan for reform of pension system into a multi-pillar one, and achieved stability in benefit indexation, contribution base dynamics, and contribution rates, through legal amendments to specify the medium term directions of key pension parameters.</p>
Social assistance effectiveness	<p>Improved efficiency of social assistance administration and increased share of funds channeled to poorest 20% households between 2001 and 2003 through introduction of welfare to work for GMI and increased eligibility threshold for vulnerable households, and full centralization of financing of most social assistance benefits; adoption of adjusted winter energy benefits program in light of energy tariff increases; means testing for child allowances.</p>	<p>Continued improvement in effectiveness of social assistance, through adjustment of winter energy benefits program in the light of energy tariff increases, and increase in eligibility thresholds of the GMI, especially for vulnerable groups to better cover basic needs and further improve targeting.</p>

8. The government has nearly completed its privatization program, and large infrastructure state owned enterprises (SOEs) have been privatized. First, PAL-3 has supported the near completion of the program for divesting non-infrastructure SOEs, and more than 80 percent of the SOEs in which the government had majority control in 2002 have been sold or liquidated; most of the companies in which the government has minority shares have also been divested. Following the significant restructuring of the energy and telecommunications sectors under the earlier PALs, PAL-3 has supported the successful completion of the long-awaited privatizations of large SOEs in the energy and telecommunications sectors – particularly the seven electricity distribution companies² and the Bulgarian Telecommunications Company (BTC). Seven district heating companies (compared to the original target of five) have been sold and more sales are ongoing. Reflecting the advanced stage of the privatization program, Bulgaria's performance in large scale privatization is now on a par with the best performing transition countries.³

9. The restructuring of the energy sector has been largely completed, and energy prices are now at cost recovery levels. With the July 1, 2004 increases in electricity and district heating tariffs for household consumers on average of 10 percent (bringing cumulative increases over the PALs to 52 percent for electricity and 33 percent for district heating respectively), residential energy prices are now set at cost recovery levels. Cross-subsidies for electricity between industry and households have been eliminated and public subsidies to the district heating sector have been eliminated (from approximately 0.67 percent of GDP in 2002). Together with the institutional, pricing and regulatory reforms and the vastly improved legislation established under previous PALs, this has resulted in substantial private sector entry. These actions are likely to contribute to further reductions beyond the 9 percent reduction in energy intensity of GDP between 2001 and 2003. The approval of a plan to further restructure the National Electricity Company and to split its power trading and transmission activities will further foster competition in the electricity market.

10. Continued restructuring of the railways has supported reduced subsidy levels and improved financial sustainability. Services and networks have been rationalized: after stopping the railway operation of 200 km of lines under PAL-2, the government adopted and has begun to implement under PAL-3 a decision to terminate services on and close a total of about 250 km of uneconomic lines, and under PAL-3 nearly 120 passenger services (9 percent of total) were terminated. The railway companies also continued to reduce staff, bringing cumulative reductions to 13 percent under the PALs. The first annual PSC (Public Service Contract) was signed under PAL-3 between the government and the railway operating company, providing financial discipline and increasing the pressure to close uneconomic lines and terminate excluded loss-making passenger services, and thus to reduce operating deficits. Finally, under PAL-3, track access charges were adjusted to remove all cross-subsidization between passenger and freight charges.

11. PAL-3 supports further deregulation, particularly of business entry. PAL-3 supports the enactment of legislation to enable businesses to use a single identification number for purposes related to registration for tax and social security payments. In addition, it supports government adoption of a strategy/submission of legislation to take judges out of registration. In addition to further simplifying business entry, taking judges out of registration will significantly reduce the delays associated with resolving commercial disputes by releasing judges from routine administrative processes.

² The proceeds from the sale of the electricity distribution companies reached Euro 693 million and far exceeded expectations.

³ This is based on the EBRD transition indicators scores. In the 2004 EBRD Transition Report, Bulgaria's index of large scale privatization was increased to 4, bringing it on a par with the Czech Republic, the Slovak Republic, and Estonia.

12. PAL-3 has supported a significant expansion in efforts to improve service delivery in front line government offices and agencies. Legislation and rules were enacted that institute one stop shop contact support for significant new FDI to improve services for foreign investors. The government also rolled out its one stop shop service delivery pilots to over half of local administrations. The replication of Transport and Trade Facilitation in Southeast Europe (TTFSE) efforts at agreed border crossing points and internal customs offices will enhance service delivery in customs offices.

13. The civil service is becoming competitive and merit based, and under PAL-3 competitive recruitment has been entrenched in the civil service. In 2004, 100 percent of newly recruited civil servants were appointed through external competitive recruitment, under the provisions of the legislation enacted under PAL-2. To ensure quality recruitment, the Council of Ministers is establishing a commission with the responsibility of holding appointment competitions for senior civil servants. In addition, under PAL-3, civil service pay was made more competitive with the private sector and compression in pay was reduced. PAL-3 also completed the introduction of performance related pay and career advancement. Finally, PAL-3 supports the submission to the National Assembly of legislative amendments needed to depoliticize the civil service, and to clarify the role of political cabinets and guarantee the merit based appointment of directors of agencies.

14. The government continued to improve accountability and transparency in the civil service. Under PAL-3, the government has adopted code of ethics for civil servants, to improve administrative procedures, reduce inappropriate discretion on the part of civil servants, and clarify accountability arrangements. In addition, PAL-3 has seen a significant expansion of information across government, in particular through the declassification of documents to make them available to the public.

15. Alternative mechanisms for the resolution of commercial disputes outside courts are being introduced and the administrative justice system strengthened. Under PAL-3, the adoption of the Law on Mediation strengthens mechanisms for the resolution of commercial disputes. To strengthen the administrative justice system, a new Administrative Procedural Code has been submitted to the National Assembly.

16. Policies for increasing access for children from poor families and ethnic minorities to quality education have been strengthened. To enable children from ethnic minorities (particularly Roma children) to attend better quality schools, an updated strategy and action plan supports desegregation. The government has established a fund to support the integration of ethnic minorities. Building on efforts under earlier PALs to increase incentives for school attendance for children from poor families and to enable them to receive good quality education, the government has further strengthened its social benefits. In addition, a new National Program was adopted by Parliament, providing free textbooks to all primary school children, introducing school feeding in primary schools, and providing transportation to enable children from remote rural schools to attend quality schools.

17. Public Health Programs have been strengthened, and efficiency in the delivery of in-patient care services is being improved. To further reduce the incidence of tuberculosis, to increase immunization rates for children, and to reduce the incidence of tobacco-related health risks, the government has increased the share of the Ministry of Health's (MOH's) operating budget going to National Health Programs has adopted legislation to earmark a share of the excise tax rate from tobacco to fund National Health Programs, and has increased excise tax rates for tobacco resulting in higher prices (and therefore lower consumption) of tobacco products. It has also increased funding for national health programs, and adopted legislation to increase tobacco control and regulate consumption in public places. In addition, under PAL-3, the

government has begun to implement its hospital restructuring strategy to improve efficiency in the delivery of in-patient care services. It has expanded the output based financing mechanism for inpatient care and has begun to restructure MOH and municipal hospitals.

18. The first stage of pension reform has been completed, and PAL-3 has contributed to the increased stability and robustness of the system for old age security. The medium term directions of key pension parameters – contribution rates and benefit indexation rules – have now been specified in an amended *Social Insurance Code* in order to avoid the need to revisit these parameters every year within the framework of the Budget Law. This will increase its predictability for beneficiaries, contributors, investors, and public finances, and thus will contribute to the robustness and sustainability of the multi-pillar pension system. The specification of the contribution rate provides stability in labor taxation. The contribution rate for the second pillar is expected to rise according to a defined schedule to 5 percent in 2007, a threshold that is considered a minimum to render the second pillar viable. Similarly, the specification of the benefit indexation formula in multi-year legislation protects it from uncertainties and political interference while providing the predictability needed for pensioners and public finances.

19. An important start has been made to reduce misuse of disability benefits and fraud in their administration and to institute a system that will provide flexible benefits to integrate the disabled into labor markets and society. First, amendments to the Social Insurance Code have been enacted to prohibit the award of disability pensions to individuals over retirement age, bringing disability pensions in line with international practice while reducing misuse. Second, the new Health Act strengthens the role of the National Social Security institute in the disability assessment process and provides for reprimanding doctors for fraud in the medical assessment of disability. Third, the *Integration of People with Disabilities Act* and its implementing regulations introduce a social assessment in addition to a medical assessment, to determine options for rehabilitation and integration and to determine non-pension benefits based on need.

20. In addition, a number of important actions under PAL-3 provide the necessary foundation for continuing the future reform agenda in several areas, including the social areas. These actions include: the completion of functional reviews and the identification of opportunities for outsourcing and rationalization across the government; improved public expenditure management processes (including the introduction of a medium term fiscal framework, the expansion of program budgeting in nearly half of all ministries, the introduction of accountability for results, and the improved management of capital expenditures); the adoption of a “National Program for the Modernization of Bulgarian Education” as the conceptual underpinning for a comprehensive and ambitious reform program in education; the approval of a national pharmaceutical policy and progress on development of a strategy for the fiscal sustainability of the National Health Insurance Fund and for the introduction of voluntary health insurance; the completion of the legislative amendments to make the deinstitutionalization of children a measure of last resort; the development of standards and regulations guiding the provision of social services; and the preparation of road maps for the restructuring of all child care institutions.

B. RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

Background and Recent Economic Developments

21. The early years of transition were marked by slow and unsustainable reform efforts.⁴ The preceding decade was marked by massive external borrowing, stop-go stabilization policies,

⁴ See *Bulgaria: Public Expenditure Issues and Directions for Reform*, The World Bank, 2003, and *Bulgaria: The Dual Challenge of Transition and Accession*, The World Bank, 2001.

and a slow pace of structural reforms. Fueled by a failure to establish market discipline, widespread rent-seeking, and the prevalence of soft budget constraints among enterprises, banks, and the government budget, Bulgaria's problems culminated in a severe economic and financial crisis in 1996-97, resulting in a cumulative decline of GDP by about 14 percent, a sharp decline in per capita income, and an increase in poverty. After several months of chaos involving a hyperinflation episode, the collapse of the banking sector, and a major foreign exchange crisis, Bulgaria adopted in July 1997 a Currency Board Arrangement (CBA).

22. Bulgaria responded aggressively to the 1996-97 crisis. Following the general elections of April 1997 and the adoption of the CBA, Bulgaria began implementing conservative fiscal policies and accelerated the implementation of structural reforms. The wide-ranging structural program included implementation of reforms in the social, agriculture, enterprise and banking sectors, and the liberalization of prices and trade. By December 1999, when Bulgaria was invited to start negotiations towards EU membership, its economy was largely stabilized, and growth and per capita income had begun to recover. This improved performance took place in a difficult external environment marked by turmoil in international markets, unfavorable commodity price developments, and trade disruptions associated with the Kosovo crisis.

Table 2: Selected Economic Indicators, 1996-2004

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2001-2003	
										Projected in PAL-1	Actual
GNI per capita (Atlas method, US\$)	1,210	1,200	1,270	1,450	1,580	1,630	1,790	2,130	2,690 ^P	2,120 ¹	2,130
Poverty Rate	5.5 ²	36				12.8 ⁴					
Unemployment Rate, Average (registered)	11.1	14	12.4	13.8	18.1	18.1	17.7	14.3	12.7		14.3
Real GDP Growth (% change)	-9.4	-5.6	4.0	2.3	5.4	4.1	4.9	4.3	5.7 ^P	4.3	4.4
CPI (e.o.p., % change)	311.6	547.7	1.6	7.0	11.3	4.8	3.8	5.6	6.1	5.5	4.7
Total Revenues and Grants ³ (% of GDP)	32.9	37.5	39.7	38.5	38.8	37.6	36.5	38.4	39.0	36.4	37.5
Total Expenditure and Net Lending (% of GDP) ³	43.2	38.6	38.4	38.3	39.4	38.2	37.1	38.4	37.3	37.2	37.9
Overall Fiscal Balance ³ (% of GDP)	-10.3	-1.2	1.3	0.2	-0.6	-0.6	-0.6	0.0	1.8	-0.9	-0.7
Current Account Balance	1.7	10.1	-0.5	-5.0	-5.6	-7.2	-5.3	-9.3	-7.5	-6.1	-4.2
FDI Inflows (% of GDP)	1.4	4.9	4.2	6.4	8.1	5.9	5.9	10.5	10.1	5.2	7.4
External Debt (% of GDP)	97.0	100.4	85.5	89.2	86.9	78.6	65.1	60.5	63.3	70.4	68.1

Notes: p refers to preliminary projection. GDP estimate for 2004 has been revised upwards based on data for the first three quarters of 2004.

¹ Refers to 2003.

² The estimate is for 1995.

³ Consolidated general government, national methodology, cash basis. Data for 2004 are preliminary and based on projected GDP.

⁴ See Boxes 1 and 2 for discussion of poverty trends after 2001. Note that poverty estimates reported are not directly comparable with those in this table due to differences in data and definitions.

Sources: National Statistical Institute, Bulgarian National Bank, Ministry of Finance, Employment Agency, and the World Bank

23. While the domestic financial sector has improved substantially in line with the resumption of growth in the real sector and strengthened banking supervision, the rapid expansion of bank credit poses new challenges to banking supervision. Following the closure of 17 banks, the consolidation of a number of banks, and the privatization of almost all state-

owned banks, mainly to foreign investors, the banking system was put back on solid ground. The Joint World Bank-IMF Financial Sector Assessment Program (FSAP) review⁵ concluded in 2001 that Bulgaria's banking system - which is the main component of the financial system - was generally well supervised, highly capitalized, and profitable. However, the legacy of the deep banking crisis in 1996-97 led to a more conservative lending policy by banks, and a low deposit base. As a result, bank intermediation remained low compared to other CEE countries, and the non-bank financial sector continued to be underdeveloped. However, with the successive years of economic growth, credit expansion (especially in retail banking) has accelerated since 2001. This has been driven by higher deposit growth, lower international interest rates on bank deposits abroad, and competition among commercial banks. In 2003 and 2004, real credit to the private sector increased by more than 40 percent year-on-year. There are no signs as yet of worsening bank portfolios—prudential indicators remain good as a result of heightened supervision and intense risk monitoring, while bank profits are increasing. In 2004, the BNB introduced several measures to contain credit growth, including the transfer of all government deposits held with commercial banks to the Bulgarian National Bank (BNB) and an expansion in the coverage of the reserve requirements. Since these measures have been in effect for only a couple of months, it is early to assess their impact on credit growth. As with other countries at similar levels of per capita income, the non bank financial sector is underdeveloped.

24. The economic recovery and sustained growth have contributed to a reduction in poverty (see Box 1). Real per capita incomes increased by 44 percent between 1997 and 2004. Tracking the magnitude of poverty reduction since 1997 is complicated by substantial changes in relative prices associated with the 1997 hyperinflation and by changes in the design of the surveys for poverty measurement after 2001, but poverty levels have declined continuously. Poverty fell significantly with the economic recovery between 1997 and 2002. According to one measure,⁶ the poverty rate fell by two-thirds between 1997 and 2001 as consumption levels recovered from the shock of the crisis. Although the magnitude of the decline may have been less than two-thirds as a result of high inflation rates, there was a notable improvement in living standards with the recovery. Poverty continued to fall in the years of sustained growth between 2001 and 2003, but the rate of decline appears to have slowed. The most reliable comparable estimates between these two years suggest that poverty fell from 24 percent in 2001 to 21.9 percent in 2003, driven by a significant fall in poverty in rural areas from 34.6 percent to 29.1 percent between the two years (see Box 1).⁷ Despite these gains, per capita GDP in PPS (purchasing power standard) was only 27 percent of the average for the EU countries in 2003. According to a forthcoming World Bank report, the poverty rate in Bulgaria is 2.5 times that in Hungary, and only 13 percent higher than that in Poland. On the other hand, poverty in Bulgaria is substantially lower than in Romania, and most South-Eastern Europe and CIS countries.⁸

25. Private sector development has been central in accelerating growth. The acceleration of privatization and the restructuring of existing SOEs, together with improvements in the business environment and the gradual decrease in the tax burden, contributed to the expansion of the private sector to 75 percent of GDP in mid-2004 compared to 60 percent in 1996.⁹ From being

⁵ A joint Bank-Fund Financial Sector Assessment Program (FSAP) mission visited Sofia in November 2001. An update of the FSAP report was done in context of the Fund's Article IV consultation mission in March-April 2004.

⁶ Based on a poverty line defined as two-thirds of the 1997 average per capita consumption, deflated to 2001 prices, the main poverty line used in the World Bank's 2002 *Poverty Assessment*.

⁷ These estimates of poverty are based on a different poverty line that reflects the cost of meeting basic nutritional and other essential needs. It provides a more reliable estimate of absolute poverty. The relevance of the poverty line derived in 1997 as a benchmark for analyzing poverty in 2003 is doubtful.

⁸ *Growth, Poverty and Inequality in Europe and Central Asia*. Comparisons here are based on poverty headcounts using the international poverty line of US\$4.30 per person per day. Notable exceptions among CIS countries where poverty is lower than in Bulgaria are Ukraine and Belarus.

⁹ EBRD data.

the country with the smallest private sector share of GDP among CEE countries in 1996, by 2004 Bulgaria was behind only the Czech Republic, the Slovak Republic, Hungary and Estonia.¹⁰ The share of new enterprises¹¹ which could spur growth and help the economy reach its full potential increased from 41 percent of total employment and 23 percent of value added in 2000 to 47 percent and 27 percent, respectively, in 2003. However, this is still lower than the share in more advanced CEE countries, where new enterprises accounted for more than 50 percent of employment and between 55 and 65 percent of value added in 1997-98.

26. Persistently high unemployment has finally started to decline. At about 18 percent in 2000-02, the unemployment rate in Bulgaria was one of the highest in the region. However, since the beginning of 2003 unemployment in Bulgaria has declined dramatically, averaging 12.7 percent in 2004. This decline has been a result of an expansion in private sector employment opportunities as well as active labor market programs. Private sector employment has been growing rapidly and job creation by the private sector has begun to increase.¹² In addition, since 2003 the government has been implementing its major program *From Social Assistance to Securing Employment*, which is aimed at providing public sector jobs to approximately 100,000 long-term unemployed. The program appears to have contributed to a reduction in the unemployment rate in 2004 by nearly 2.5 percentage points. Despite this impressive decline, unemployment remains high, especially in comparison to EU-15 countries. The employment rate is lowest among CEE countries, and labor force participation is lower than in all other CEE countries except Hungary. Long term unemployment, which is among the highest in CEE countries, has been hovering around 60 percent. Younger and lower skilled workers are particularly likely to be unemployed.

27. The external position has remained under pressure, with the external current account deficit remaining high in 2003 and 2004. The external current account deficit increased from 5.3 percent of GDP in 2002 to 9.3 percent in 2003, and declined to an estimated 7.5 percent in 2004. A strong tourism sector, lower income payments and constantly growing remittances have offset some of the negative effects of the expanding trade gap. In addition, strong FDI inflows covered more than 135 percent of the external current account deficit in 2004. FDI inflows stood at US\$2.5 billion (10.1 percent of GDP) in 2004, with revenues from privatization accounting for less than half of FDI inflows. The conclusion of several large privatization deals in 2004 (BTC and five electricity distribution companies) contributed to the highest privatization revenues registered to date. Foreign exchange reserves remained at a comfortable level, despite large debt repayments and the buy-back of the remaining Brady Discount Bonds (DISCs), and in December 2004 exceeded €6.8 billion and covered 6.1 months of imports of goods and services. At the same time, total external debt (public and private) has declined from 79 percent of GDP in 2001 to about 63 percent at end-2004.¹³

¹⁰ See *EBRD Transition Report 2004* and Table 2.

¹¹ The share of small enterprises (with up to 50 workers) in employment and value added is regarded as a proxy for the share of new enterprises in the economy. See *Transition: The First Ten Years, Analysis and Lessons for Eastern Europe and the Former Soviet Union*, The World Bank, Washington D.C., 2002.

¹² The increase, particularly in 2003, can in part be attributed to the introduction of mandatory registration of labor contracts, which may have resulted in surfacing some of the labor previously employed in the informal sector. However, job creation by the private sector has also been expanding, especially in trade, manufacturing, construction, and real estate: over 145,000 new jobs were created in end-2004 compared to end-2003.

¹³ The external debt to GDP ratio declined significantly owing to a series of debt buybacks, debt exchanges, limited new borrowing and slow disbursement of projects in the pipeline, as well as higher GDP growth and exchange rate adjustments. External debt ratios are based on US\$ values.

Box 1: Poverty in Bulgaria

Trends in Poverty. Living standards in Bulgaria have rebounded dramatically since the crisis in 1991. Per capita incomes have increased by 124 percent, from US\$1,200 in 1997 to US\$2,130 in 2003 (GNI, Atlas method), with a 65 percent increase between 2001 and 2004. Despite this, per capita GDP remains low compared to EU countries. In 2003, it was only 27 percent of the average for the EU-25 countries.

As incomes have risen, the poverty rate has fallen. According to the World Bank's Poverty Assessment (2002), poverty fell dramatically between 1997 and 2001. The report used a poverty line of two-thirds of 1997 average per capita consumption and fixed it in real terms. It found that the poverty rate fell from 36 percent in 1997 to about 12.8 percent in 2001. The depth and severity of poverty also improved. Although the overall magnitude of the decline in the poverty rate was likely to have been lower, due to the potential for measurement error as a result of the high inflation in 1997, living standards improved notably since the crisis. Poverty measures for this period were based on the Bulgarian Integrated Household Surveys in these two years, conducted by the Gallup survey organization.

Poverty estimates for 2003 are based on the new multi-topic household survey carried out by the government in November 2003. The design of the survey is superior to the earlier surveys. A casualty of this, however, is the loss of direct comparability of poverty statistics after 2001. A recent paper by Tesliuc (2004) tries to address this problem, using state-of-the-art econometric techniques to estimate trends in poverty since 2001. The study uses an absolute poverty line, which represents the cost of a bundle of essential commodities and defines as "poor" those whose consumption is below the poverty line. The poverty line is estimated to be 111.50 leva in 2003, while the extreme poverty line is estimated at 60.25 leva. The study reports that food poverty (a proxy for malnutrition) is virtually non-existent, and extreme poverty is low, at 4.8 percent of the population. However, about one in five people in Bulgaria (21.9 percent of the population) have consumption below a level needed to meet basic needs. The poverty rate is almost identical to that obtained from a relative poverty line equal to two-thirds of real per capita consumption.

The study also finds that poverty fell between 2001 and 2003. However, it fell from a higher level than previously believed, particularly when an approach that measures the cost of basic needs is used. According to this report, poverty fell from 24 percent in 2001 to 21.9 percent in 2003, driven primarily by a fall in poverty in rural areas. Rural poverty fell due to a rise in consumption aided by a slight fall in inequality. In contrast, urban poverty did not decline despite a rise in average consumption, primarily due to an increase in inequality. Inequality in Bulgaria in 2003 (the gini coefficient of consumption is 0.285) is moderate, and lower than in most countries in the ECA region, but higher than in Hungary, Belarus and Ukraine.

Who are the poor? The updated profile of poverty identifies the following key determinants of the welfare of households: location, demographic characteristics, ethnicity, education, employment status, and gender.

- *The poor are more likely to be found outside Sofia.* The poverty rate in rural areas is 29.1 percent, compared to 18.7 percent in urban areas. Welfare differences by location, however, become sharper when Sofia city is compared to other – urban or rural – areas. Even taking into account the differences in the characteristics (such as education, family size, etc.) between rural and urban households, the per capita consumption of households living outside Sofia is 10-25 percent lower than that for households living in the capital city.
- *People living in large households with two or more children are more likely to be poor.* Only a fifth of the population live households with five or more members, but they account for about 41 percent of the poor. People living in households with two or more children account for over a third of the poor.
- *Perhaps the strongest correlate of poverty is ethnicity.* Over 80 percent of Roma households are poor. Although they account for about 6 percent of the population according to the survey, they account for over a fifth of the poor. Per capita consumption in a Roma household is only half of the consumption of a similar household of Bulgarian origin.
- *Human capital is a strong policy lever for reducing poverty.* Over two-thirds of the poor consist of people living in households where the head has less than a high-school education. Per capita consumption is 30-35 percent higher in households where the head has completed high school or technical education and 45 percent higher when the head has completed university studies (relative to a household where the head has only completed primary education).
- *Private entrepreneurs and employed individuals are relatively protected from poverty.* The poverty rate is significantly lower in households headed by employers, the self-employed or employees, while the risk of poverty is twice as high in households headed by the unemployed and inactive (other than pensioners) compared to the rest of the population.
- *Poverty is not gender neutral.* The risk of poverty is slightly higher in households headed by women, usually single parent households. When differences in education, location and other characteristics are taken into account, per capita consumption in these households is 10 percent lower than in those headed by men.

28. Sound macroeconomic policies and continued progress in structural reforms are addressing current account imbalances and improving development prospects. Bulgaria's policy framework is centered on the CBA and supported by a tight fiscal policy, a strict incomes policy and a broad agenda of structural reforms. Macroeconomic performance has been robust: Bulgaria has had a primary surplus of 2-3 percent of GDP and a fiscal deficit of less than 1

percent of GDP since 1999; the Fiscal Reserve Account (FRA) has remained at about 100 percent of next year's gross public debt service requirements; inflation has remained at single digit levels; international reserves have remained at more than five months of imports; and growth has been between 4-5 percent per year. Consolidated government debt, external and domestic, has declined dramatically from over 100 percent in 1997 to below the Maastricht criterion¹⁴ and in 2004 it stood at 39 percent of GDP.

29. Provided the government maintains fiscal discipline, sustains a strict incomes policy, and accelerates structural reforms to secure sustained improvements in competitiveness, the CBA provides a stable nominal anchor and facilitates the political economy of reform.

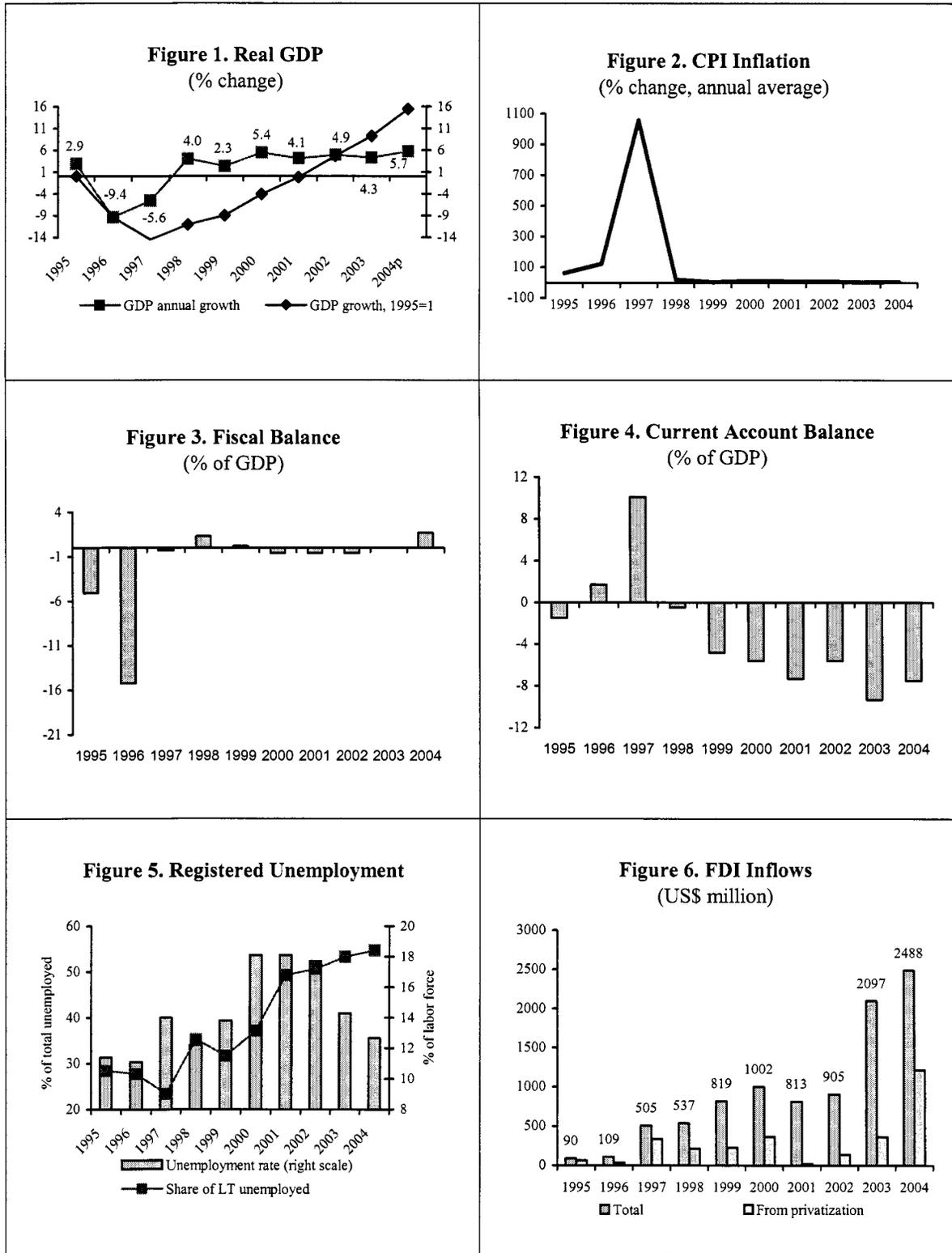
Prudent macroeconomic policies and strong progress in the implementation of structural reforms – particularly in the areas of large scale privatization, infrastructure and banking – contributed to improved economic performance in 2004 (see Figures 1 to 6). Bulgaria shows stronger fundamentals in 2004 compared to 2003: despite slow growth in the EU and other economic partners, Bulgaria's economic growth accelerated, the average inflation rate increased slightly but end-of-period inflation declined, the unemployment rate reached five-year record lows, and revenue over-performance in 2004 was among the highest in recent years. However, the high external current account deficit and the rapidly growing domestic credit are increasing the vulnerability to risks. To respond to the deterioration of the external current account balance, the government agreed with the Fund under the current Stand-By Arrangement (SBA)¹⁵ to save most of the revenue over-performance and achieve at least a balanced budget in 2004 instead of the budgeted 0.7 percent overall fiscal deficit. This target has been over-performed and the fiscal accounts closed in surplus of 1.8 percent of GDP. In addition, to limit further credit expansion and safeguard the health of the financial system, the BNB has undertaken several measures, including expanding the coverage of reserve requirements, transferring government deposits held at commercial banks to the BNB, and reducing the proportion of cash in vault that can be used to fulfill reserve requirements.

30. Significant but manageable domestic and external risks exist. Domestic vulnerabilities include degree of effectiveness of measures undertaken to address the rapid growth of credit to the non-government sector, failure to enhance domestic market flexibility consistent with the CBA, and the electoral cycle potential pressures on the budget. The pressures on the external position are high, supported by accelerated bank credit to the private sector. A failure to attract sufficient FDI or to carry out the remaining privatization program would put the projected external financing at risk, which would require additional adjustment to ensure that debt levels continued to decline. Moreover, Bulgaria's external accounts are sensitive to three key parameters: (i) continued increase in oil prices, (ii) higher interest rates, and (iii) a protracted recovery in EU economies that are the destination of over 50 percent of Bulgarian exports and the origin of more than half of the FDI inflows. However, the achievements to date, the continuing good performance in 2004, and the measures in place to address domestic and external vulnerabilities mitigate these risks.

¹⁴ This is according to Article 104 of the Treaty Establishing the European Community signed in Maastricht in 1992. The convergence criterion on debt refers to the ratio of gross government debt to GDP, which must not exceed 60 percent at the end of the preceding financial year or shall be approaching the reference value at a satisfactory pace.

¹⁵ A 25-month SBA was approved on August 6, 2004, with the intent that this precautionary arrangement would serve as an exit from IMF program engagement.

Figures 1-6: Macroeconomic Indicators, 1995-2004



Sources: National Statistical Institute, Bulgarian National Bank, Ministry of Finance (GFS2001), Employment Agency and World Bank staff estimates.

Medium Term Prospects

31. The medium term macroeconomic framework¹⁶ centered on the CBA is expected to support rapid and sustainable economic growth in the coming years. The medium term outlook¹⁷ envisages a robust growth of more than 5 percent per annum, a gradual narrowing of the external current account deficit, and a reduction in debt to GDP ratios. Growth would be driven by a continuous rise in investment and improved export performance in line with the expected recovery in external demand from the EU and the increased competitiveness of Bulgarian goods on international markets. Consistent with the planned upgrades in the infrastructure sectors and the continued progress towards EU accession, investment is likely to grow at a higher speed and reach at least 25 percent of GDP in 2007. Despite the continuing slow growth among Bulgaria's main trade partners to date macroeconomic performance has been good and is expected to improve further in 2005-07 as EU economies may recover and the cumulative effect of structural reforms in Bulgaria will become more visible.

32. FDI inflows continue to be the primary source of balance of payments financing. As in 2003, Bulgaria continued to attract significant FDI inflows, providing sufficient coverage of the external current account deficit. In 2003, FDI inflows exceeded US\$1.4 billion, or more than 7 percent of GDP, and preliminary data point to US\$2.5 billion in 2004. About US\$1.2 billion were receipts from privatization, mainly of BTC and some electricity distribution companies, and the rest were greenfield investments and investments in already existing companies. Advanced privatization in the energy sector, together with additional investments, is helping Bulgaria meeting its financing needs. The returns from FDI in the country have been growing and a further boost in investments is possible if the remaining structural and institutional impediments are addressed, including weaknesses in the business climate, public administration, and the judicial system.

33. International financial markets have responded favorably to the achievements of the reform program. In the summer of 2004, Standard and Poor's and Fitch Ratings upgraded Bulgaria's long-term foreign currency debt to investment grade rating (having assigned investment grade rating to its long-term local currency debt a year earlier). Spreads of Brady bonds and Euro bonds are continuing to decline – in December 2003 they went down by 115 and 146 basis points, respectively, compared to end-2002. In August 2004, Euro bond spreads went down further by 135 basis points compared to end-2003. Active debt management policies in 2001, 2002, and 2004 through debt buybacks and exchanges, have reduced debt levels and have reduced the interest and exchange rate risks of the debt portfolio. In July 2004 the government bought back the remaining DISC Brady bonds in the amount of US\$680 million and freed up collateral of some US\$283 million. As a result, external public debt fell to 33.7 percent of GDP in 2004, down from 63.7 percent at end-2001, with an improved currency and interest structure of the public debt. This has contributed to the substantial decline in total external debt to 63 percent of GDP from 79 percent in 2001.

34. The current course of fiscal policy is basically appropriate to ensure macroeconomic stability, growth and poverty reduction in the medium term. The main fiscal challenge, however, is to work towards an improved allocation of expenditures¹⁸ to achieve a balanced budget in the medium term, while lowering the overall tax burden - especially payroll taxes - to boost investment and employment and reduce external indebtedness. To date, fiscal adjustment

¹⁶ The medium-term economic framework presented in Annex 3 is based on projections as of end-September 2004.

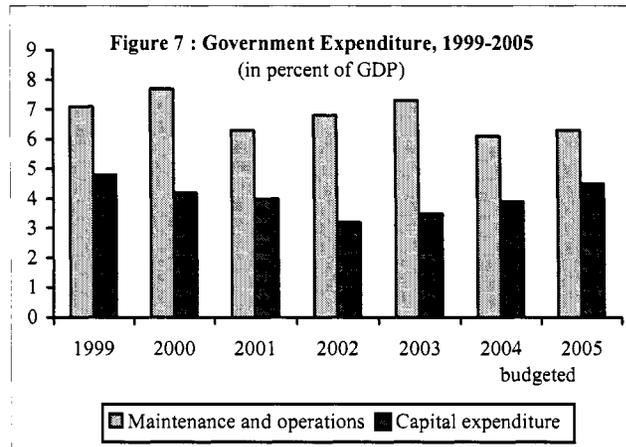
¹⁷ See *Bulgaria: Request for Stand-By Arrangement—Staff Report*, The International Monetary Fund, August 2004.

¹⁸ For more details, see *Bulgaria: Public Expenditure Issues and Directions for Reform*, The World Bank, August 2002.

has been made possible by revenue expansion rather than by expenditure rationalization. Only recently, revenues have started to decline, reflecting the gradual reduction of the tax burden. To limit revenue losses from future tax cuts, the tax administration needs to be overhauled and tax compliance improved. A decade long neglect of investment in basic infrastructure has been exacerbated by several years of declining capital and maintenance expenditures which have borne the brunt of expenditure cuts. Going forward, fiscal adjustment will need to be achieved through relying heavily on expenditure rationalization, which needs to precede reductions in the tax burden to safeguard fiscal sustainability. In addition, the fiscal strategy will have to be adjusted in response to the decline in privatization revenues - a main source of fiscal financing - as the privatization program is completed.

35. The government has improved the quality of fiscal adjustment through achieving some rebalancing of current and capital spending. As shown in Figure 7, following the overall decline in public spending since 1999,

capital expenditures declined from 4.8 percent of GDP to about 3.5 percent in 2002.¹⁹ This declining trend was halted in 2002 and the balance between current and capital expenditures has begun to improve since then. Capital spending increased to 3.9 percent of GDP according to preliminary data and is projected at 4.5 percent of GDP in 2005. Following a request by the government, the Bank prepared an analysis of proposed projects for motorway construction. The study produced a number of recommendations regarding



priorities for medium-term investment in this area. Improving the balance between current and capital expenditures also requires improvements to be secured in the budget management of operations and maintenance. As budget allocations to capital expenditures increase as a percentage of GDP, they will need to be supported by adequate levels of resources for operations and maintenance. Decisive efforts to improve public expenditure management and management of the public investment program are needed if the quantitative improvement in the balance between current and capital expenditures is to achieve the desired impact on growth.

36. Improving the allocation of public expenditure requires creating a more efficient and transparent expenditure management system with enough flexibility to adjust quickly and efficiently to macroeconomic shocks. The central key pressure points on the fiscal position are in health care, education, and the social protection system. The recent Public Expenditure and Institutional Review (PEIR) for Bulgaria²⁰ demonstrated the need to improve allocations to address the issues of overcapacity in health and education and to improve the targeting of social protection programs, which constitute about one-third of total public spending. Although important steps have begun to be taken since 2002, particularly to improve the financial position of the pension system, to improve the targeting of social assistance, and to address issues of overcapacity in health care, the agenda is still unfinished while the ageing population and rising health care costs pose continuous challenges.

37. In addition, increased efficiency in expenditure management would require the overhaul of intergovernmental relations. The government approval in mid-2002 of the *Fiscal*

¹⁹ Data for 1999 to 2003 are actuals; 2004 data are preliminary; and 2005 data are budgeted.

²⁰ *Bulgaria: Public Expenditure Issues and Directions for Reform*, The World Bank, 2003.

Decentralization Program for 2002-05 is a step forward in that direction. The program aims to reduce the fiscal pressures arising from arrears in municipal finances and improve efficiency in service delivery. A recent World Bank study,²¹ identifies the need for a sustainable solution to the issue of unfunded state mandates and municipal arrears; the need to provide improved incentives to deal with overcapacity in municipal schools and to establish more effective mechanisms to raise resources for investment; and the desirability of granting greater control to municipalities over revenues in the long term.

38. Independent reviews indicate that challenges remain in improving public sector governance. Bulgaria is characterized as a country with high levels of state capture and a medium level of administrative corruption.²² The areas most affected have been customs, health services, tax administration, higher education, and the courts. The government has put together and begun to implement comprehensive strategies and action plans for: (i) modernizing state administration; (ii) reforming the judicial system; and (iii) fighting corruption. Two commissions have been set up to combat corruption - a standing committee of the National Assembly and an inter-ministry operational commission. A number of measures have been undertaken to strengthen control within the Tax Administration, the Customs Agency, the MOI, and the National Security Service, and, more recently, the Judiciary.

39. With the external financing provided by the PALs, it will be possible to phase in structural reforms while softening the impact of adjustment, protecting the poor, and safeguarding social cohesion. Without the PAL financing, policy dialogue and support, the momentum for accelerating structural reforms is less likely to be sustained and the costs of adjustment could weigh heavily on vulnerable segments of the population. While international reserves remain at a comfortable level to support macroeconomic stability in the context of the CBA, in view of the high investment needs facing the country prior to EU accession Bulgaria may continue to rely on low cost official creditors' support, to allow it to start addressing a decade of neglected maintenance of the physical assets needed to support private sector-led growth and to soften the impact on vulnerable groups. Continuing Bank financing under the series of PALs of up to US\$150 million (equivalent) per year over the three year program period of the current CAS provides the fiscal and balance of payments support needed for the government to be able to implement this broad reform program.

Creditworthiness

40. Creditworthiness Indicators. Prudent fiscal policies, the implementation of structural reforms, and an active debt management strategy have resulted in improvement in the creditworthiness indicators (see Annex 4). These improvements resulted in an upgrade of the credit risk of foreign currency debt to investment grade rating in the summer of 2004 by Standard and Poor's and Fitch Ratings. Total debt outstanding and disbursed as a share of GDP declined from 100 percent in 1997 to around 63 percent in 2004. This share is expected to decline to below 50 percent by 2007. Similarly, total debt service as a share of exports of goods and services is expected to decline from around 13 percent in 2002 to 8 percent in 2005, and then increase to about 10 percent as a result of increased repayments on remaining Brady and Euro bonds.²³ The share of debt service to IBRD to total public debt service is expected to decline to around 6 percent in 2005 and to increase to around 10 percent in 2006 and 2007. The share of Bulgaria's portfolio in IBRD's portfolio is expected to remain under 1.5 percent up to 2006. In addition, spreads on Bulgaria's Brady bonds have been narrowing since the June 2001 election, reflecting prudent policies and markets' expectations of a more active debt management strategy. The collapse of the CBA in Argentina and the difficulties in Turkey have not had any significant

²¹ See *Bulgaria: Issues in Intergovernmental Relations*, The World Bank, January, 2004.

²² *Anticorruption in Transition 2*, The World Bank, 2004.

²³ Projections do not take into account the early repayment of Brady bonds in January 2005.

impact on this trend. There have been no discernable contagion effects in Bulgaria's domestic financial markets, and the financial fundamentals and indicators of external vulnerability remain comfortable.

41. **IBRD exposure will remain manageable in the base case scenario of the CAS.** IBRD debt service is projected to remain at below 1 percent of exports, and to increase from 7 to 8 percent of public debt service during the CAS period. The ratio of preferred creditor debt service to public debt service has remained above 50 percent with a sharp decline in 2004 and 2005 due to increased repayments to private creditors as a result of the Brady buy-back by the government in July 2004. The preferred creditor debt service ratio is projected to decline to about 46 percent in 2007. These high ratios are partly the result of debt restructuring in the mid-1990s, which stretched out Bulgaria's public debt repayments to private creditors over decades with the issuance of Brady bonds and of limited commercial bank lending until the strong recovery following the 1997 reforms. The completion of the substantial adjustment lending as envisaged in the CAS would reduce the Bank's headroom in Bulgaria, especially for further adjustment loans beyond FY05. However, since the three PALs – designed to support a robust reform program that has a high probability of succeeding – are the cornerstones of the overall Bank strategy, high adjustment lending is justified. To monitor the Bank's exposure and associated risks, a set of additional triggers for processing PAL-3 were identified in the CAS (see Box 2). These triggers have been met, confirming that Bulgaria has substantially improved its standing as a result of reforms under the first two PALs, and that the downside risks of overall economic performance are low.

Box 2: Status of Additional PAL-3 Triggers

The Country Assistance Strategy for Bulgaria, discussed by the Board on May 9, 2002, adopted additional triggers for processing PAL-3. The specific triggers – indicators of macroeconomic outcomes and structural improvements in the economy – were designed to confirm that prior reforms have been sufficiently absorbed and that the probability of a downside risk in economic performance is decreasing. They were articulated as a set of negative developments that could trigger a reconsideration of proceeding with the presentation of PAL-3 to the Board. As shown below, Bulgaria's macroeconomic and structural performance in the CAS period more than justifies proceeding to the high levels of adjustment lending envisaged in the CAS.

- *Trigger:* Material deviation from the downward trend in the total public debt to GDP ratio as projected in the CAS. *Outcome:* Total public debt to GDP ratio declined beyond CAS projections (projected to be 41.7 percent for 2005 compared to 49.2 percent projected in CAS).
- *Trigger:* Lack of improvement in the spreads on Bulgaria's sovereign borrowing vis-a-vis countries with similar risk rating, or deterioration in its own risk rating. *Outcome:* Spreads of Brady and Euro bonds are continuing to decline – in December 2003 they went down by 115 and 146 basis points, respectively, compared to end-2002. In August 2004 Euro bond spreads went down further by 135 basis points compared to end-2003.
- *Trigger:* Material deviation from the improving trend in the fiscal balance projected in the government's medium term program, reaching fiscal balance by 2005. *Outcome:* Fiscal balance to GDP ratio in 2001 was -0.6 percent, 2002: -0.6 percent, 2003: 0.0 percent, 2004: 1.8 percent.
- *Trigger:* Material slowdown in the present trend of increasing Small and Medium Enterprises' (SMEs) share of total employment. *Outcome:* SME share of total employment increased continuously from 50.6 percent in 2000 to 56.7 percent in 2003.
- *Trigger:* Inadequate progress in reducing arrears in tax payments, social insurance contributions, and energy bill payments as set out in the government's program. *Outcome:* Establishment of the National Revenue Agency (NRA) consolidating tax and social security revenue collection being supported by the Bank's project Revenue Administration Reform Project (RARP) currently under implementation and showing satisfactory progress. Under the RARP, the NRA will have operational a modern Revenue Management System which includes inter-alia the capacity to actively manage arrears. In line with similar reforms in other countries, the NRA is expected to be fully operational in 2006.

Addressing Poverty

42. As poverty has fallen, the nature of poverty has evolved and deep poverty persists among certain vulnerable groups. The profile of poverty in Bulgaria has come to resemble poverty patterns in other CEE countries more closely, with an increasing concentration of poverty among distinct and identifiable groups in the population (see Box 1). Rural residents, children, ethnic minorities, most notably the Roma, the less educated, and the unemployed constitute the “pockets” of deep poverty. Sustaining or increasing the growth performance is still necessary for poverty reduction, but there is considerable scope for obtaining a further reduction in poverty through targeted interventions (e.g., for the Roma). While the concentration of poverty among specific groups indicates that targeting interventions to address poverty will be easier, these pockets of chronic poverty are more resilient and harder to reach than shallower poverty linked to transient declines in incomes. Further, as in other countries of the region, poverty among poor Roma communities is multi-dimensional and is compounded by social exclusion and discrimination within the society.

43. Social protection reforms have helped the poor cope with transition shocks, and their effectiveness has continued to improve. Bulgaria has continuously strengthened its social protection programs. The previous government introduced a new multi-pillar pension system, strengthened unemployment insurance, and strengthened and consolidated means-tested social benefits programs to better reach the most vulnerable individuals and households. The current government has continued the implementation of pension reform and has further redesigned social assistance. In particular, it has introduced the welfare to work agenda, strengthened financing and administration, redesigned the family benefits program as a targeted program tied to school attendance, and strengthened individual programs (e.g., energy benefits) to mitigate the impact of structural reforms. As a result, Bulgaria today has an extensive but relatively effective and well performing net of social protection programs. The poverty impact of social protection is significant: the poverty rate could increase by up to 87 percent in the absence of social protection. Although the primary impact comes through the pension system, which is not explicitly designed to reduce poverty, social assistance programs have a non-negligible impact on poverty.²⁴ Despite these achievements, the social protection system faces medium to longer term challenges: low coverage and contribution levels into the pension system pose challenges to its ability to effectively reduce poverty in the longer term, and the poverty impact of social assistance could be further increased through substantially higher benefit levels (although combined with further strengthening of targeting). Increasing the effectiveness of active labor market programs is also critical to ensuring the integration of the long term unemployed into the labor market and reducing the likelihood of their return to social assistance.

44. Gaps in access to both health and education are being reduced but are still real for vulnerable groups. Although enrollment rates increased after the crisis, health indicators showed little improvement until 2000. More recently, Bulgaria has seen impressive increases in enrollment from already high levels, while most health indicators have also begun to improve. According to official data, Bulgaria appears to be on track for meeting the MDGs (see Box 3). It is important to note that recent improvements have included gains among the most disadvantaged: gaps in access to health care and education, which increased during the crisis, appear to be narrowing, especially since 2001. Despite this, gaps in attendance rates in education in Bulgaria – between rich and poor, and rural and urban children – remain among the highest in

²⁴ Tesliuc (2005), “Social Protection and Poverty Reduction in Bulgaria- An Update,” provides an update on the performance of social protection programs in Bulgaria. Without pensions, the poverty rate among pensioners could be as much as 2.3 times higher (increasing from 23.4 percent to 54.2 percent). Among social assistance recipients, the poverty rate could increase by 11 percent without social assistance. Programs such as the GMI, although they have a small impact on the overall poverty rate, have a significant impact on the severity of poverty.

the ECA region. In 2003, children from the richest income quintile were 17 percent more likely to attend primary school and 2.2 times more likely to attend secondary school.²⁵ As with education, financial barriers (formal and informal out-of-pocket costs) and differences in the quality of services accessed are in part responsible for different health care outcomes among poor and disadvantaged groups.²⁶ Minorities, and especially Roma populations, are more likely to fall through the cracks in the education and health systems, and their lower access, as has been mentioned, is compounded by social exclusion and discrimination. Disparities in the ability to invest in human capital, unless addressed, will increase the differences in future welfare and will result in lower poverty reduction.

Box 3: The Government's Medium Term Program and the MDGs

Government Objectives	Baseline Data	Update on Status	2005 Target	2015 Target
<i>Eradicate extreme poverty</i>				
• percent of population below US\$2.15 per day	7.9 (2001)	n.a.	3.2	1.5
• percent of population unable to meet basic needs	24.0% (2001)	21.9% (2003)		
<i>Achieve universal education</i>				
• percent net enrollment rate - primary school	98.5 (2001-02)	100.3 (2003-04)	97-98	100
• percent net enrollment rate - lower secondary school	83.1(2001-02)	84.2 (2003-04)	86-90	100
• percent net enrollment rate - secondary school	68.3 (2001-02)	77.1 (2003-04)	73-75	90
<i>Improve maternal health</i>				
• Maternal mortality ratio per 100,000 live births	19.1 (2001)	15 (2002) 5.9 (2003)	18	16
<i>Combat HIV/AIDS, malaria and other diseases</i>				
• Tuberculosis incidence (new cases per 100,000)	48 (2001)	47.8 (2002) 41.7 (2003)	40	26
• Polio immunization rate (percent of children under two)	94.4 (2000)	94 (2002) 96 (2003)	98	100
<i>Reduce infant mortality</i>				
• Infant mortality rate per 1000 live births	14.4 (2001)	13.3 (2002) 12.3 (2003)	13	9
<i>Ensure environmental sustainability</i>				
• GDP per unit of energy use (PPP US\$ per kg of oil equivalent)	568 (1997)	n.a.	653	751
<p><i>Notes:</i> Changes in survey design do not permit an update of the poverty indicator as originally specified. Trends in poverty since 2001 are based on a different poverty line that represents the cost of meeting basic needs in 2003. The value of this line in 2003 was 111.4 leva per person per month.</p> <p><i>Sources:</i> National Statistical Institute and World Bank; UNICEF.</p>				

²⁵ *Growth, Poverty and Inequality in Europe and Central Asia*, The World Bank (forthcoming). This information is based on household survey data. Disparities between groups have fallen with the recent increases in attendance between 2001 and 2003. In 2001, attendance in primary schools was 57 percent higher for children from the richest quintiles and in secondary schools it was 3.1 times higher.

²⁶ Health indicators, such as child and maternal mortality and incidence of infectious diseases, are higher in disadvantaged rural regions and among ethnic minorities. *Report on the Health of the Nation at the turn of the 21st Century*, Ministry of Health, June 2004.

C. THE REFORM PROGRAM

Objectives of the Government's Medium Term Program

45. **The incoming government in mid-2001 identified two objectives: (i) sustaining economic growth and (ii) reducing poverty and creating employment, both key to EU membership.** The agenda of the previous government had been driven more by dealing with the economic and financial crisis of 1996-97, restoring the focus on macroeconomic stabilization, accelerating the much delayed privatization program, establishing a sound fiscal regime to support the CBA by cutting expenditures and closing non-viable SOEs, and launching the reform of the social protection system.²⁷ The reform program of the current government builds on the gains of the previous five years while marking a strategic shift in emphasis towards promoting growth and reducing poverty through increasing investment and productivity and building human capital. The updated LDP is attached as Annex 5. *The government has articulated the following as the key outcomes of its program: (i) achieve average annual GDP growth rates of 4.5 to 5.0 percent during 2002-05; (ii) reduce the poverty rate by half by 2005 compared to the rate in 2001; and (iii) reduce the unemployment rate to 12-14 percent in 2005 compared to 17.5 percent in 2001. The program components that address the strengthening of market institutions, modernizing the public administration, fighting corruption, reforming the judicial system, and increasing social inclusion are all critical to the EU accession agenda.*

46. **The strategy for attaining the sustained growth and poverty reduction objectives has two main themes.** *First, the government intends to use private initiative as the main engine of growth.* For this reason, the government program focuses on creating an investment climate that encourages private investment and enhances productivity. This requires redefining and upgrading the role and capabilities of the public sector, establishing credible institutions such as the judiciary, and putting in place a stable legal and regulatory environment. *Second, the government is taking steps to ensure that the population is empowered to participate in future growth.* The government is working towards reforms in the education and health sectors to improve the quality of services, while improving the efficiency of these large public expenditures. The aim is to develop human capital capable of adapting to an increasingly dynamic work environment, which is especially important in view of the greater competition expected from EU countries. In addition, there is recognition that poverty reduction policies need to be tailored to reach certain groups that have not benefited from the recent increase in welfare. The government realizes that growth alone will not lift certain groups out of poverty.

47. **To implement its growth and poverty reduction strategy, the government has built its medium term reform program on five pillars:**

- *Sustaining structural reforms* in the enterprise sector with emphasis on the completion of privatization and the restructuring of the energy, railway, telecommunications, and water sectors;
- *Establishing a market-friendly business environment*, focusing on reducing entry constraints, accelerating exits, securing deregulation and reducing regulatory costs, improving the delivery of public services to business, improving the competitive environment, and improving labor market policies;

²⁷ Since 1997, the Bank has supported structural reforms with a Critical Imports Rehabilitation Loan, a Social Protection Adjustment Loan, two Finance and Enterprise Sector Adjustment Loans (FESALs), two Agriculture Structural Adjustment Loans (ASALs), and an Environmental Protection Structural Adjustment Loan (EPSAL).

- *Deepening the financial sector*, improving the legal framework for lending, completing banking reform, and developing financial markets;
- *Improving public sector governance*, strengthening public administration capacity, improving service delivery, reducing corruption, strengthening accountability and transparency, strengthening public expenditure management, and increasing the efficiency and effectiveness of the judicial system; and
- *Investing in human capital and strengthening social programs*, improving service delivery in education and health, continuing pension reforms, increasing social assistance effectiveness, providing for better integration of the disabled, and reducing the institutionalization of children.

Cross-cutting Themes: Growth, Poverty and Governance

48. The five program pillars complement each other. All five pillars contribute to the growth agenda. Pillars I to III provide for rationalizing the role of the state in the economy through: (i) completing privatization; (ii) improving the efficiency of energy, water and district heating and securing greater private sector participation in these sectors; (iii) creating conditions to attract FDI and allowing for the significant growth of SMEs through deregulation; (iv) advancing tax and customs reform; (v) reducing subsidies, (e.g., to the railways) so as to free up resources to invest in infrastructure that is critical to supporting investment; (vi) pursuing accounting reform; (vii) accelerating insolvency reform; (viii) strengthening the new regulatory agencies in telecommunications, energy, and financial services; (ix) maintaining labor market flexibility; and (x) strengthening banking system effectiveness. Pillar IV supports this agenda through strengthening mechanisms to improve governance, modernizing the civil service and administrative structure, rebuilding interactions between the private sector and public officials; increasing the effectiveness of capital investments; accelerating judicial reform; and seeking to reduce corruption (thereby reducing the rate of return investors require for investment projects). Pillar V seeks to create a longer-term capability to respond to the needs of a dynamic market economy through supporting investments in human capital.

49. All five pillars contribute to reducing poverty and social exclusion. Pillars I to III are designed to achieve growth with equity. Restructuring and privatization in these pillars have been accompanied by measures to reduce negative social impacts through strengthening of social assistance programs in Pillar V and active labor market programs in Pillar II. In addition specific interventions (e.g. energy tariff increases) have been accompanied by measures to protect the poor. Pension reform is pursued through Pillars III and V. Pillar IV contributes to this agenda through supporting measures to reduce corruption, including corruption in education and health (which bears disproportionately on the poor); to rebuild interactions between the citizens and public officials as well as between the private and public sectors; to improve public sector service delivery; and to increase the effectiveness of the judiciary. Pillar V provides explicitly for improving quality with equity in education and health; protecting the disabled from discrimination and allowing them full access to education and work opportunities; achieving de-institutionalization; improving coverage and targeting in social assistance; and reducing disincentives for work.

50. All five pillars contribute to improving governance. Pillar I provides for transparency in privatization. Pillar II focuses on deregulation, on reducing administrative discretion, developing an effective administrative court system, strengthening competition, reducing corruption in insolvency proceedings, and advancing tax and customs reform. Pillar III aims to strengthen corporate governance, to improve the governance of pension funds, and to introduce greater transparency through the introduction of international accounting standards, and provides for enactment of the money laundering law. Pillar IV tackles a number of specific issues relating to public sector accountability and transparency, such as: strengthening the arrangements for

conflict of interest and freedom of information; improving public administration through implementing reforms to secure merit and depoliticization; strengthening administrative structure; and requiring the publication of service standards and client charters. Pillar IV also focuses on accelerating judicial reforms through strengthening the accountability framework for judges and other magistrates while keeping their independence, and on improving court administration as well as alternative dispute resolution systems. Pillar IV also supports the strengthening of accountability and transparency in the public expenditure management system. The government's *Anticorruption Program for 2004-2005* provided a focus for tackling corruption in education and health and in the judiciary, to complement the earlier focus on tax and customs and the Ministry of Interior. Pillar V aims to tackle some accountability and transparency issues in the delivery of education and health services, through improved transparency in financing arrangements, strengthened quality assurance and the accreditation of institutions, and improved governance structures. Increased transparency in public finances for social programs have also been supported in Pillar V through the increased predictability and fiscal transparency in the pension system and the improved administration of disability and social assistance benefits.

51. The PALs also support the government's EU accession and integration agenda, which is the major driving force for reforms in Bulgaria. The PAL program complements and supports the government's efforts in building a functioning market economy and creating the capacity to cope with the competitive pressures and market forces within the EU in the medium term. The achievement of the PAL program's objective of building a dynamic and competitive economy through stable macroeconomic performance, deep structural reforms, sustainable private sector-led growth, an improved investment climate, and appropriate investments in human capital, to some extent determines the degree to which Bulgaria will be able to benefit rapidly from EU accession. The PAL program also complements the EU accession-related efforts to strengthen and develop the ability of the public administration and judicial system to implement and enforce the *acquis communautaire*.

52. The various reform pillars are at different stages of implementation. Structural reforms for the most part (in particular, many in Pillars I and III) are at a more advanced stage, having been the focus as well of earlier Bank support before the PAL program, particularly under FESAL 1 and 2. Table 3 provides a more nuanced picture of the progress made within the areas of structural reforms supported by Pillars I-III while indicating, even within these, an unfinished agenda, particularly in the areas of business environment, infrastructure and non-bank financial institutions. In contrast, reforms under many of the other pillars are at a much earlier stage and have only gained momentum under one of the three PALs. For example, the policy, institutional and legislative basis for the reforms to improve public sector governance was put in place only under PAL-2, and implementation begins under PAL-3. Many of the desired outcomes of this program will be achieved only over the period 2005-07. Similarly, reforms in health care and education are at a much earlier stage of design or implementation, and many of the desired outcomes will only be achieved beginning in 2007. These are wholly realistic time-scales and are fully in line with the practice and experience of Organization for Economic Cooperation and Development (OECD) countries. When developing and launching such reforms in the context of a three year time-scale, as is the case with the present PAL program, care needs to be taken in evaluating the impact of these reforms over a short-term time-scale.

53. The effectiveness of the above program is underpinned by the maintenance of sound macroeconomic policies. The government is committed to the successful completion of its precautionary Stand-By Arrangement with the IMF, approved in August 2004. The program represents a continuation of Bulgaria's solid track record in macroeconomic policies, including: (i) maintaining the CBA at least until accession to the EMU; (ii) implementing a flexible fiscal policy and a disciplined incomes policy to safeguard stability and growth; and (iii) undertaking measures to address the challenge of rapid growth of credit to the non-government sector. The First Review of the program has been completed in March of 2005.

Pillar I: Sustaining Structural Reforms

54. **The government program in Pillar I aims to rationalize the role of the state by privatizing activities that can be performed by the private sector.** The government also aims to improve the efficiency of energy services and prepare the energy sector for EU accession; to improve the efficiency of the railway sector and secure a decrease in railway subsidies; and to liberalize the telecommunications market, modernize the water sector, and mitigate environmental risks.

Table 3: Progress Made in Structural Reforms

	Enterprises			Markets and Trade			Financial Institutions		Infrastruct ure reform
	Large-Scale private- zation	Small-scale private- zation	Governan ce & enterprise restructur- ing	Price liberali- zation	Trade & foreign ex- change system	Compe- tition policy	Banking reform & interest rate liberali- zation	Securities market & non-bank financial institu- tions	
Bulgaria 2002	4-	4-	2+	3	4+	2+	3+	2+	3-
Bulgaria 2004	4↑	4-	3-	4+	4+	2+	4↑	2+	3↑
Croatia	3+	4+	3↑	4	4+	2+	4↑	3-	3↑
Czech Republic	4	4+	3+	4+	4+	3	4-	3+↑	3+
Estonia	4	4+	3+	4+	4+	3-	4↑	3+	3+
Hungary	4	4+	3+	4+	4+	3	4	4-	4-
Latvia	4-	4+	3	4+	4+	3-	4-	3	3
Lithuania	4-	4+	3	4+	4+	3	3	3	3-
Poland	3+	4+	3+	4+	4+	3	3+	4-	3+
Romania	4-↑	4-	2	4+	4+	2+	3↑	2	3+↑
Slovak Republic	4	4+	3	4+	4+	3	4-↑	3-	3-
Slovenia	3	4+	3	4	4+	3-	3+	3-	3

Source: EBRD, Transition Reports 2002 and 2004. The transition indicators range from 1 to 4+, with 1 representing little or no change from a rigid centrally planned economy and 4+ representing the standards of an industrialized market economy. For Bulgaria 2004, arrows reflect areas of recent upgrade (in 2004).

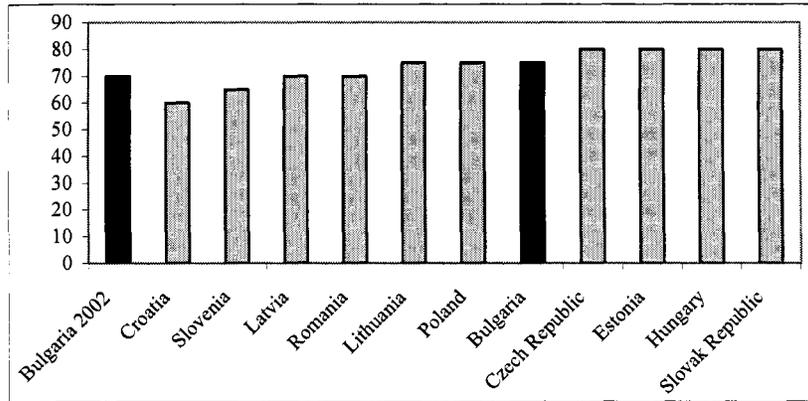
55. **The current privatization program has focused on infrastructure SOEs, and PAL-3 has seen the successful completion of the privatization of large infrastructure SOEs in telecommunications and energy.** The PAL program has supported the implementation of the government's privatization program which is now nearing completion.²⁸ First, to improve transparency, reduce corruption, and accelerate the privatization process, the legal framework was improved, including through the enactment of the new *Law on Privatization and Post Privatization Control* and the restructuring of the privatization agency (under PAL-1). Second, the PAL program and PAL-3 have supported the near completion of the program for divesting non-infrastructure SOEs: more than 80 percent of the remaining SOEs in which the government had majority control in 2002 have been sold or liquidated, and most of the companies in which the government has minority shares have also been divested.²⁹ Third, following the significant restructuring of the energy and telecommunication sectors under the earlier PALs, PAL-3 has seen the successful completion of the long-awaited privatizations of large SOEs in the energy and telecommunications sectors – particularly the seven electricity distribution companies and the Bulgarian Telecommunications Company (BTC). As a result of these privatizations and privatization in shipbuilding under PAL-2, the EBRD recently upgraded Bulgaria's transition

²⁸ Privatization of the Banking and Insurance sectors has also largely been completed (see Pillar III).

²⁹ In September 2002, at the start of the PAL program, the remaining SOEs in which the government had majority control numbered 440, of which one-quarter were considered large, mainly in the utilities and manufacturing sectors. There were another 1800 non-infrastructure privatized enterprises where the government had minority shares. By January 2005, there were only 90 SOEs in which the government has majority shares, and the government had minority shares in only 653 companies (309 of these minority packages were under restitution claim arrangements). Nearly 1,225 minority packages were sold between January 2004 and February 28, 2005 alone.

indicator for large scale privatization (Table 3). The few remaining large privatizations to be completed are mainly in the infrastructure sector, and include those of the large thermal power stations, initiated under PAL-3, while the only large non-infrastructure privatization that remains to be completed is Bulgartabak.³⁰ By mid- 2004, the private sector share of GDP had reached 75 percent (comparable to the share in Poland, and approaching those in Hungary and the Slovak Republic – Figure 8). By January 2005 there were only 90 remaining SOEs with government majority shares; thus the government’s objective that by end-2005 the only remaining state enterprises would be those listed in Annex 6A (thus reducing the size of the public sector to about 25-30 percent of GDP) has substantially been met.

Figure 8: Private Sector Share of GDP mid-2004 (%)



Source: EBRD, Transition Reports 2002 and 2004.

56. The energy sector has been fundamentally overhauled, reducing Bulgaria’s energy intensity³¹ and enabling the private sector to assume an increasing share of commercial risks (Box 4). First, energy prices have been rationalized, and with the July 1, 2004, increases in electricity and district heating tariffs for household consumers, prices are now set at cost recovery levels. All cross-subsidies in electricity between industry and households and all public subsidies to the district heating sector have been eliminated. PAL-3 has further prepared the basis for the complete removal of the cross-subsidies within the household consumer group for electricity and heat.³² Second, the legal and regulatory framework has been improved through the enactment of a new *Energy Act* consistent with EU energy directives, the adoption of key sector regulations and market opening measures, and the upgrading of the institutional capacity of the State Energy Regulatory Commission (SERC). Third, electricity distribution and generation companies were spun off from the former monopoly electricity company (NEK), and (under PAL-3) a plan was approved for the further restructuring of NEK by legally separating its transmission business from power trading, thereby improving competitive conditions in the electricity market. Fourth, the

³⁰ The government has been working on the implementation of this privatization but changing market conditions have provided challenges and only partial privatization has been achieved. Specifically, as of mid-March, five of the twelve tobacco processing companies had been sold. Progress is also being made with the restructuring and liquidation of companies originally identified as non-saleable: five cigarette manufacturing companies are being restructured as companies dealing with tobacco processing only, while a sixth company is currently under liquidation. The government attempted but was unable to successfully complete a deal for the remaining four companies of the holding – the four most attractive cigarette manufacturing companies.

³¹ In 2001, Bulgaria had the highest energy intensity ratio in the ECA region.

³² These cross-subsidies were introduced as a temporary social protection measure during the period of large price adjustments (see Box 4). A plan for their removal has been prepared, and the related adjustments to the energy subsidy program to ensure adequate protection for low income customers will be worked out and implemented in cooperation with the Ministry of Labor and Social Protection.

government has successfully implemented its district heating strategy, which called for commercialization in the short term and private sector entry in the medium term. Fifth, the combined effect of these measures has led to private sector entry beyond the original expectations: the electricity distribution sector has finally been completely privatized and the privatization of three power generation companies is under way, seven district heating companies have been privatized with several more expected in the near future, and the gas sector has been opened to the private sector with licenses being awarded in six of the eight gas distribution regions. *The government is on track for achieving its aim to reduce energy intensity of GDP by 15 percent in 2005. Bulgaria's energy intensity of GDP was reduced by 9 percent in 2003 compared to the level in 2001.*

57. In the railway sector the government's restructuring program is increasing efficiency and financial sustainability, improving staff productivity, and decreasing subsidies to the sector. First, organizational and institutional changes included the establishment of a new railway operating company (BDZ) and a new railway infrastructure state enterprise (NCRI) under PAL-1, and the full accounting separation of the freight and passenger operating services under PAL-3. In addition, market rules were established to enable the entry of private firms and the eventual privatization of the railway operating company. Second, the network and services have been significantly rationalized through the closure of non-economic lines and the termination of loss-making passenger services. Under PAL-2, about 200 km of uneconomic lines were closed. Under PAL-3, the Council of Ministers adopted a decision to enable the NCRI to terminate services on and close about 250 km of uneconomic lines, and the NCRI is implementing this decision. Under PAL-3, the government has also terminated 120 passenger services (over 9 percent of the total). Third, the railway labor force was reduced by 13 percent at end-2004 compared to the level at end-2001. Fourth, under PAL-3, track access charges have been adjusted to remove all cross-subsidization between passenger and freight services effective as of October 1, 2004. Fifth, cost recovery has been increased in inter-city passenger services by a further 20 percent under PAL-3, bringing it to over 90 percent. Sixth, under PAL-3 a Public Service Contract (PSC) is now agreed annually between the government and the railway operating company BDZ EAD, providing financial discipline and increasing the pressure to close non-economic lines and terminate loss-making passenger services that are not covered in the PSC, and thus reducing the operating deficit of the railway companies. Moving forward, the unfinished agenda includes achieving balance between PSC costs and payments by securing further efficiencies, and addressing the increasing VAT obligations of the passenger company associated with higher track access charges. In addition, a new railway law is under preparation to facilitate private sector entry. *The government's targets for financial sustainability established for end-2005 had been met by end-2004: operating subsidies (excluding funds for investment) fell from 0.5 percent of GDP in 2000 to 0.2 percent; for the operating company and railway infrastructure company, respectively, financial working ratios were close to 100 percent (not including government subsidies). The debt service ratio for freight operations was 2.9 times. The government's objective is to reduce this to 1.5 times by end-2005. Railway productivity increased by 12 percent in line with the government's aim to achieve by end-2005, increases in the overall railway labor productivity of 16 percent.*

Box 4: The PAL Program and the Successful Transformation of the Energy Sector

At the start of the PAL program, while substantial progress had been made in the privatization of the non-infrastructure sectors, the environment for growth remained handicapped by the largely state-owned and inefficient infrastructure sector in which the policy and regulatory environment was not conducive to private sector entry. Bulgaria faced several challenges in restructuring these sectors and in preparing them for EU accession. In particular, delays in restructuring the energy sector, and particularly in improving supply efficiency and setting economic prices, had been costly in terms of lost industrial output and consumer welfare, and a loss of confidence regarding whether existing services could be made cost-effective and affordable. The PAL has successfully supported a fundamental overhaul in the energy and district heating sector, resulting in the improved efficiency of energy services.

The government began in earnest to undertake significant reforms of the energy sector beginning in July 2002 with the adoption of a comprehensive strategy for reform. The PAL program has supported key elements of the policy and pricing reform that have created a favorable environment for, and have resulted in, private sector participation beyond the original expectations. PAL-1 provided the framework, while the subsequent PALs supported the specific actions needed to implement the strategy:

Gradual removal of the cross-subsidy between industry and household electricity tariffs, and of public subsidies to the district heating sector. In 2002, SERC (the sector regulator) approved a three-year plan for the gradual increase of the residential electricity and district heating tariff. Electricity prices were increased by 20 percent in mid-2002, 15 percent in mid-2003, and 10 percent in mid-2004. District heating price increases of 10 percent annually contributed to a dramatic reduction in subsidies to district heating companies (from 50 million leva in 2001 to 45 million leva in 2003 and to 24.3 million leva in 2004) and to their complete elimination by 2005.

Addressing the social impact of price adjustments by structuring energy tariff increases in a way that minimized the impact on the poor – through the creation of a first block (“social”) tariffs, while strengthening the social assistance provided through the existing winter energy benefits program in response to the anticipated price increases.

Adoption of new legislation consistent with the EU energy and gas directives that provides for market liberalization. With technical support from the World Bank and other donors a new *Energy Law* was adopted in December 2003. A series of secondary legislative/regulatory and market opening measures were adopted by SERC. The institutional capacity of SERC has been significantly upgraded.

Additional legislative changes in support of the implementation of the District Heating Strategy. Reforms in the district heating sector have made possible the revival of the sector and have benefited the economy by enabling district heating – by far the most economical way of providing heat to highly urbanized areas – to be the primary form of heating in urban areas. The implementation of policy reforms under the PAL as laid out in the 2002 strategy have included (in addition to tariff and subsidy adjustments) legislative changes to make the installation of heat regulators and cost allocators mandatory at the apartment level. This has strengthened demand side management, enabling consumers to control their consumption and to be billed accordingly; together with the steady increase in tariffs, this has resulted in initial energy savings of approximately 15 percent at the apartment level. The government has also replaced old and inefficient substations in many district heating companies, resulting in a reduction in their heat losses. These reforms have been complemented by investment support from the Bank and other donors through a major rehabilitation project for the Sofia and Pernik district heating companies – which account for more than 50 percent of the district heating customer base.

Private Sector Participation. As a result of the substantially improved policy and regulatory basis of the sectors, investor interest in the energy sector has increased. The government has successfully completed the privatization of all seven electricity distribution companies (with larger than expected revenues). The next stage of privatization of the power generation companies has started. Privatization of 7 of the 21 district heating companies is also successfully completed, and several other privatizations are underway. The gas market has also been opened to the private sector.

58. In the telecommunications sector, markets have been liberalized consistent with the government’s EU accession agreement. First, the legal and regulatory framework has been improved substantially through the establishment of the Communications Regulation Commission (CRC) and its institutional upgrading, and through the enactment of a new *Telecommunications Law* in September 2003 consistent with best practice and with the government’s EU accession agreement. The new law reinforces the CRC’s independence, transparency, and accountability, secures the liberalization of the telecommunications market, and

ensures effective and fair competition. Second, the government has completed the long awaited privatization of BTC and abolished its monopoly over the provision of fixed voice telecommunications services, leased lines and trans-border voice transmissions.

Third, to continue to satisfy EU accession commitments, which entail a migration from the *acquis communautaire* 2000 to the *acquis communautaire* 2002, PAL-3 supports, inter alia the adoption of an updated sector policy consistent with the new *acquis*, progress in the digitalization of the backbone network, and efforts towards promulgating legislation providing for the legal recognition of electronic contracts and personal data protection in electronic communications. The transition to the new *acquis* will mean further revisions to the existing legal and regulatory framework as well as the institutions created by them. *At end 2004, the degree of digitalization of the transfer network was 94 percent, of transit exchanges 79 percent, and of fixed telephone network subscribers 33 percent, reflecting substantial progress towards the government's aim to achieve, by end 2005, a degree of the digitalization of transfer network of 100 percent, of transit exchanges, 82 percent, and of fixed telephone network subscribers, 46 percent. The government's target that, by end-2005, 94 percent of households would have telecommunications services has already been met.*

59. In the water sector, the government's new modernization program envisions stronger public private partnerships to address the problems of inefficiency, water losses, and lack of investment. Under PAL-2 the government adopted a new *Water Sector Strategy*, which emphasizes the importance of public/ private partnerships to provide adequate water service for all citizens, to implement wastewater treatment in line with EU directives, and to rehabilitate and construct water and sewerage networks to improve efficiency and reduce health risks. The worldwide decline in private support for investment in the water and wastewater sector has posed challenges to private sector entry. An additional challenge to private sector participation has been the need to coordinate private sector entry with the flow of EU grant funds in view of the difficulties in channeling EU grant funds to utilities with concessions or management contracts – a primary reason for the delays in developing a public/private model in the water and wastewater utilities in Varna and Shumen. The government recognizes the importance of establishing the appropriate institutional and regulatory framework and has developed a framework for a water regulator (water supply and sewage services) to ensure that quality services can be provided at affordable prices. A new *Water Regulatory Law* was enacted in January, 2005. Moving forward, policy efforts in the water and wastewater sectors in 2005 and beyond³³ will focus on establishing the regulatory and institutional changes required – including strengthening the capacity of the Water Regulator and establishing an appropriate tariff structure - and on establishing a suitable financing framework for the sector. *The government's aim is to secure a reduction in the operating ratios (the ratio of operating costs including depreciation to total revenues) of water companies to 86 percent by the end of 2005. As of November 2004, the operating ratio of water companies was 88 percent.*

60. The government has maintained its momentum in environmental reforms to meet the challenges of EU accession compliance with the environmental *acquis*. Environmental laws and regulations continue to be harmonized with those of the EU, and Bulgaria has almost fully transposed the *acquis* in the environment. The capacity of environmental institutions and agencies to enforce environmental laws and regulations is being strengthened. A new *Environmental Protection Act* was adopted which is fully harmonized with the EU *acquis*. The regulation on Environmental Impact Assessment was issued under PAL-2. The government is also implementing the provisions of the *EU Integrated Pollution Prevention and Control (IPPC) Directive*, and extending the issuance of integrated permits. It is implementing its environment

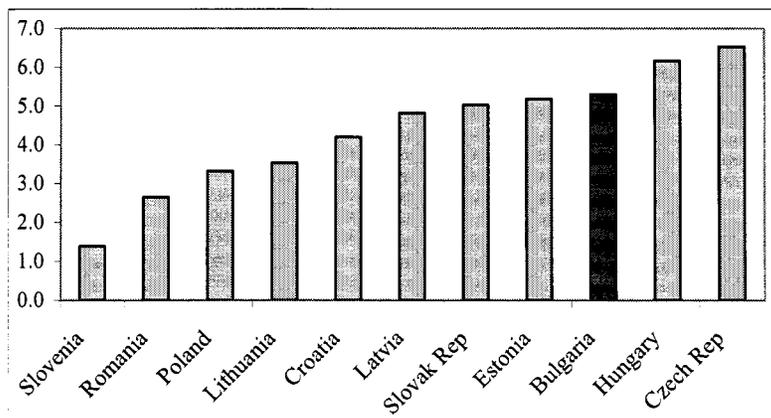
³³ These efforts will be guided by the findings of the recent Water Sector Report prepared by the Bank. The government plans to use this to finalize the investment needs and priorities for the sector in 2005-15. This report also provides the basis for continued discussions with the EU, with other donors, and with the private sector.

strategy and action plan, harmonizing water management legislation, and is implementing a new strategy for biodiversity. *The government's aim by end-2005 is to have issued 20 integrated environmental permits under the IPPC directive and by end-2007 it is to have issued permits to all enterprises covered by the IPPC directive.*

Pillar II: Establishing a Market-friendly Business Environment

61. While the liquidation of loss-making SOEs and the implementation of the privatization program have increased productivity, future growth will depend on the emergence of dynamic private sector enterprises. Experience in advanced transition economies indicates that gains from further labor shedding and other defensive restructuring measures will taper off over time. New sources of growth will have to come from increased investment by the private sector in both new and existing enterprises. The government program aims to expand private sector activity through attracting FDI and developing a dynamic SME sector. To achieve this, the government program in Pillar II aims to reduce entry constraints and regulatory costs, to improve business service delivery by government offices, to ensure competition and functioning markets, to maintain flexibility in the labor market, and to improve the efficiency of the insolvency regime.³⁴ Figure 9 shows that FDI flows in Bulgaria in recent years (2000-2003) compares favorably with those in new EU member states. In addition, over two-thirds of FDI flows to Bulgaria come from EU member states – which is above the average for the new states and Bulgaria, Croatia and Romania – thus reflecting deeper than the average levels of integration with EU markets. *Average annual FDI inflows have been about US\$1.6 billion a year between 2001 and 2004; the SME share in employment increased to 56.7 percent in 2003 from 50.6 percent in 2000; the SME share in value added increased to 36.2 percent in 2003 from 29.5 percent in 2000; the private sector share of GDP increased from nearly 70 percent in 2001, to 75 percent in 2003. This reflects substantial progress towards the government's aim to attract, with these reforms, FDI at an average annual rate of US\$1.0 billion (of which greenfield FDI is expected to be at least 50 percent) during 2002-05; to increase the share of SMEs³⁵ in value added and employment to at least 50 percent by 2005; to increase the private sector share of GDP to at least 70 percent by 2005; and to increase total factor productivity by 2.5 percent annually during 2002-05.*

Figure 9: Foreign Direct Investment in Bulgaria and other Central and European Countries, 2000-03 (net FDI as a percent of GDP)



Notes: Data for Bulgaria for 2000-03, while that for other countries is from 1995-2003.
Source: Bank staff estimates presented in Bulgaria's CEM: Policies for Growth, forthcoming, 2005, The World Bank.

³⁴ The PAL-3 agenda in this pillar has been informed by the World Bank's Private Sector Assessment, "Doing Business in Bulgaria: Progress, Prospects and Potential for Growth," completed in June 2004.

³⁵ Defined as enterprises with 100 or fewer employees.

62. The government is streamlining the regulatory regimes that increase transaction costs for the private sector and is institutionalizing measures to ensure that a clear rationale, a proper cost-benefit analysis and an appropriate consultation underpin the introduction of new regulatory regimes. First, good progress has been made in implementing the program to eliminate or modify centrally managed regulatory regimes for licensing, permission and registration, and about 80 percent of the program developed in 2002 has been completed.³⁶ An Internet-based public register of all current operative regulatory regimes is in place which represents an important step forward in creating a transparent and accessible approach to regulatory activities. Second, to control the development of future licensing regimes, the *Law on Administrative Regulation and Administrative Control on Economic Activities* was enacted under PAL-2, codifying the principles that are to underpin the introduction of new regimes. Under PAL-3, specific guidelines have been issued to central administrative and municipal bodies on the design of proposed new regulatory regimes, including the identification and measurement of costs and benefits, and the establishment of a process by which new regimes evolve appropriately from concept to implementation. Moving forward, continuous implementation of deregulation remains a top priority for Bulgaria, and options to institutionalize the deregulatory efforts through the establishment of an independent oversight agency will need to be considered. *The government expects, by end-2005, to see the elimination or modification of 50 percent of the regulatory regimes (issued by central authorities) that existed at mid-2002, and, by 2005, a reduction in regulatory costs compared to the baseline figure of 25 percent of management time spent on regulatory compliance in 2002.*³⁷

63. The government is implementing reforms in business registration aimed at significantly easing business entry as well as increasing judicial efficiency. First, PAL-3 supports the enactment of a new *Law on the Bulstat Register* to enable businesses to use the “Bulstat” number as the single-identification number for purposes related to registration including registration, for tax and social security payments. Second, under PAL-3 the Council of Ministers has adopted a new strategy to modernize the registration of all legal entities (including businesses) and of property, and to establish a modern electronic administrative registration system in Bulgaria. The strategy lays out the stages for the transformation of the registration system from one that relies on the courts to a non-judicial administrative process, and for the establishment of a unified national register. Modernization of business registration will reduce transactions costs for businesses. In addition, the release of judges from routine administrative procedures will significantly reduce the delays associated with the resolution of commercial disputes (Box 5). Through the implementation of its new strategy, the government is preparing to meet by January 1, 2007, the EU directive on company law that envisions the obligatory implementation of electronic registration. *By end-2006, the number of procedures required for business registration are expected to decrease to about 6 (from 11 in 2004), and the time required to register a business is expected to be reduced by about two-thirds (from 32 days in 2004 to about 10 days). By end-2006, there will be a reduction in the time taken to resolve commercial disputes from 440 days in January 2004.*

64. In parallel with regulatory reform, the government has continued to implement reforms to front line government offices and agencies (including customs offices and services for foreign investors) to improve service delivery and cost effectiveness. First, institutional development initiatives are ongoing in Customs, the Tax Administration Office, the

³⁶ At the start of the PAL program the Inter-ministerial Working Group for the Optimization of Regulatory Regimes reviewed 360 centrally-managed regulatory regimes (for licensing, permission, and registration) and approved a program eliminating 71 and modifying 121 of these regimes.

³⁷ As measured in the Administrative and Regulatory Costs Surveys (ARCS). The survey completed in March 2004 did not show a reduction relative to 2002, in part because the full impact of the measures had not yet been felt.

Real Estate Registry Office, the National Social Security Institute (NSSI), and various regulatory agencies such as the SERC and the CRC. Second, for the regulatory regimes that are considered essential, the cost of compliance is being reduced by simplifying the administrative processes. Simplification measures, initiated under PAL-2, in three sectors are ongoing. These sectors are construction, tourism, and food processing, which together account for about 10 percent of GDP and are subject to a maze of administrative requirements. In addition, enactments to the *Health Act* under PAL-3 provide for a number of simplified procedures in all sectors, including requirements for business premises registration and inspection. Third, measures adopted at the TTSFE pilot sites at agreed border crossing points and internal customs offices are being rolled out. Under PAL-3 these measures include expedited procedures for the delivery of containers arriving at seaports, acceptance of advance declaration in inland customs offices, and increasing precision in the process of selection through uniform reporting and analysis of the results of physical examinations. Further improvement of services at the border will require continued roll-out, but also more effective cooperation between state agencies. Fourth, the National Revenue Agency has been established and PAL-3 supports the development of the Revenue Management System. Finally, through the enactment of the *Act on Encouraging of Investment* and the rules for its implementation, PAL-3 has supported the implementation of one-stop-shop administrative support for significant FDI. *By 2004, customs revenues had increased by 66 percent compared to 2001, and average border processing time at pilot sites had fallen, reflecting good progress towards the government's objectives of achieving by end-2005 an increase in customs revenues by 55 percent and a reduction in processing time at all border crossing points and internal customs offices by 20 percent in comparison with 2001.*

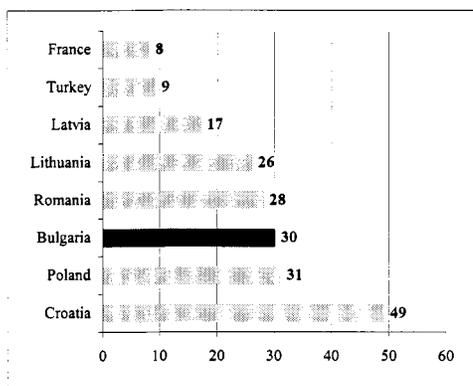
65. The government has strengthened competition policies and is improving the effectiveness of the Commission for the Protection of Competition in the context of EU accession. First, to strengthen the effectiveness of the Commission for the Protection of Competition (CPC), following the enactment of amendments to the *Law on the Protection of Competition* the government has continued to enhance the administrative capacity of the CPC. Second, the CPC has made good progress in the development and enforcement of anti-trust legislation, especially under PAL-3: the number of antitrust decisions nearly doubled between 2003 and November 2004 (from 64 to 112) and progress is also being made in competition advocacy. Third, in the area of state aid, the *Law on State Aid* enacted in 2002 ensures the consistency of intervention policies with the *acquis communautaire*. The legislative framework for state aid was further strengthened through the adoption under PAL-3 of the Rules for its implementation, the amendment of several pieces of legislation with fiscal aid measures to align these with the act, and a review and identification of other legislation to eliminate the provision of implicit state aid. The CPC has also developed its state aid enforcement record, and it had concluded 106 state aid cases by November 2004 compared to 49 in 2003. In line with its commitments under the Second Agriculture Structural Adjustment Loan, ASAL 2, the government has abstained from establishing an agricultural commodity market stabilization facility, except for an intervention agency which is required to implement the EU's Common Agricultural Policy (CAP). In particular, PAL-3 supports amendments to the *State and Wartime Reserves Act* and *Grain Trade and Storage Act* which will facilitate the change of status of the State Reserves to a public institution subject to full public disclosure, and will limit its interventions in the grain market to those necessary for grain rotation. *By end-2005 the government hopes to have secured an increase in the competitiveness of the private sector compared to the position in 2002.*

Box 5: Business Registration in Bulgaria

While business entry in Bulgaria is not the slowest by European standards, it is neither simple, nor fast, nor cheap. Also, it does not properly address the public needs of providing easy access to information and strengthening the corporate governance system. The business registration system is carried out by 29 courts, which is increasingly out of step with good European practices. Bulgarian registration takes, on average, 30 days, of which 21 days are spent in the court. Over 40,000 new companies, partnerships and sole proprietors are registered annually, and about 26,000 revisions are made to current registrations. Some 40 percent of the time of the 107 commercial judges is spent reviewing and approving the documents filed by companies. The available statistics are inconsistent and the court records differ significantly from those of Bulstat. Some private services maintain databases of companies that, while they are valuable sources of market information, are of no legal security and are perhaps incomplete. The registration system has been criticized for being time-consuming, uncertain, and inconsistent across the country, not only in the initial registration but in the registration of amendments. It has become a highly profitable, although nontransparent, tax on business. Business registration has been used as a system of control rather than as an information system. Although registration is essentially an administrative task, inappropriate and unpredictable judge-intervention in company decisions is not uncommon.

Business registration reform in Bulgaria needs to be modernized to promote business entry, reduce the costs of operation, and free judges from routine procedures so that they can focus on commercial and insolvency cases. The view taken in European directives is that business registration is an information disclosure service. Business registration in Europe has evolved into an electronically accessible administrative process, away from the paper-driven judicial approaches such as that used in Bulgaria today. The increase in efficiency is apparent: entrepreneurs in countries where registration is a judicial process spend 14 more days to start a business. Two dozen countries – from the Netherlands to Lithuania, from Romania to Italy – have transferred business registration from a judicial to an administrative procedure since 2001. In all cases, the reforms have lowered the time needed to register new business.

Registration Duration (days)



Approaches to Business Registration Reform

Single ID number

- Belgium (2003 reform)
- Estonia (2002 reform)
- Finland
- France
- Latvia (2001 reform)
- Norway
- Slovak Republic
- Turkey (2003 reform)

Take registration out of judges' hands

- Belgium
- Denmark
- Finland
- Germany (but in court)
- Ireland
- Italy
- Baltics
- the Netherlands
- Norway
- Portugal
- Spain
- Sweden, and 70 others

The recently developed government Strategy for Establishment of a Central Register for Legal Entities and an Electronic Registration Center of the Republic of Bulgaria is in line with this general reform trend. It supports the consolidation of registration into a central electronic registry outside the courts, within the Ministry of Justice, to operate as a one-stop shop for business registration of all types. The biggest benefit from this reform is the reduction in the delays associated with commercial disputes. Such delays are recognized by the EU and foreign investors as the major constraint to improvements in the business environment.¹ Just by making registration an administrative process, and relieving the commercial judges of the burden of reviewing and approving documents related to business registration, the government can reduce delays in commercial dispute resolution by 50 percent. This may cut as much as 8 months of the current time to resolve a simple debt dispute

¹ See white papers by the EU and the Bulgarian International Business Association, both published in 2004.

Source: World Bank, "Doing Business in 2005: Starting a Business."

66. Government policies in the labor market aim to complement measures to improve the investment climate for the generation of productive private sector employment opportunities. To complement other Pillar II measures aimed at enhancing the creation of productive employment opportunities by the private sector, the government is continuously reviewing and adapting its policies in the labor market – with a view to maintaining or increasing

flexibility while aligning them with the requirements of EU accession. In addition, the government is designing and strengthening policies and programs to enable the integration of the disadvantaged and long term unemployed into the labor market. First, amendments to the *Labor Code* were enacted in 2004 inter alia to strengthen anti-discrimination provisions, thus providing the legal basis for eliminating discrimination in the labor market (including discrimination against minorities, who constitute a disproportionate share of the long term unemployed). Second, the government is taking steps to address selected rigidities in its labor legislation. Amendments to the *Health Act*, enacted under PAL-3, aim to reduce the incidence of abuse of sick leave provisions.³⁸ Under PAL-3 the government is also encouraging a dialogue between social partners to address selected rigidities in its legislation – in particular, to increase the adaptability of wages and to improve the flexibility of working hours – although the dialogue has not been without difficulties. In addition, drawing from the recommendations of an ongoing review of institutions affecting the labor markets, the objective is to adjust Bulgarian legislation and regulations and to bring them in line with international best practice.³⁹ Third, the government has also continued to improve the effectiveness of its employment services and its Active Labor Market Policies (ALMPs). Regulatory barriers to the private provision of employment services have been removed, and the efficiency of public employment services is being improved through the introduction of the one-stop-shop approach. Under PAL-3, the government is also completing its first intermediate net impact evaluation of the major program “From Social Benefits to Securing Employment,” and is taking measures to improve its effectiveness, including through increasing the participation of the private sector in the program. *In line with the government’s objectives, the unemployment rate fell⁴⁰ from 19.8 percent to 12 percent between 2001 and 2004, the employment rate increased from 50.9 percent to 56.5 percent between the third quarters of 2001 and 2004, the share of long term unemployed fell from 63.7 percent in 2001 to 59.3 percent in 2004, and the youth unemployment rate fell from 38.4 percent in the second quarter of 2001 to 25.8 percent in 2003; continued progress is needed to bring these rates closer to the average levels in EU member states.*

67. The government’s initiatives to accelerate the insolvency process are facilitating the exit of non-viable enterprises (Figure 10). First, amendments were introduced in 2003 to Part IV of the *Commercial Code* to simplify insolvency procedures, to establish shorter and binding deadlines for insolvency procedures, and to provide additional powers to creditors. Opportunities for appeal were reduced.⁴¹ PAL-3 supports the development of further amendments to the *Commercial Code* to accelerate insolvency procedures, in particular through guaranteeing the rights and independence of trustees, and strengthened protection of the rights of private creditors. Second, more stringent criteria for the licensing and dismissal of trustees have been introduced, and their monitoring and control by the Ministry of Justice and the courts has been strengthened. Third, an information and monitoring system has been introduced in all commercial departments of the courts under PAL-3 which should make possible the close monitoring of insolvency cases and the timely identification of the main bottlenecks to their resolution. Finally, institutional reforms in the judiciary, discussed in Pillar IV, are intended to upgrade the skills and

³⁸ The aim is to eventually contribute to a reduced burden on social security and to increase participation in the formal labor force. Beyond the first day, sick leave payments are covered by the General Sickness and Maternity Fund managed by the National Social Security Institute. Importantly, sick leave appears to be a route to the disability pension for many older workers who have not yet reached pensionable age. In addition to posing a burden on the social security system through disability pensions, the misuse of disability provisions contributes to significantly lower participation in the formal labor force, and thus to lower contributions.

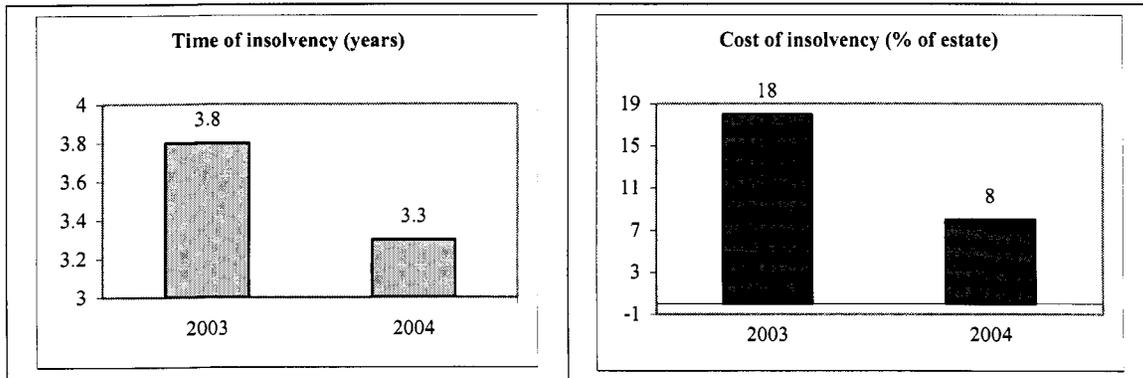
³⁹ With technical assistance from the PHRD grant, the government has also begun work on a thorough review of Bulgarian labor regulation with a view to identifying further measures to bring these in line with international best practice.

⁴⁰ Labor market indicators reported here are based on Labor Force Surveys. The employment ratio is an approximation for the population aged 15-64 years for comparability with EU-15 statistics.

⁴¹ Through amendments to the *Civil Procedure Code* (See Pillar III).

qualifications of execution judges and improve the efficiency of court administration. *The government has already made good progress (the average time for resolving insolvency cases fell by six months between 2003 and 2004) towards its aim of achieving a substantial reduction in the average time for resolving insolvency cases, from 3.8 years in 2003, towards levels found in other advanced transition economies.*

Figure 10: Closing a Business in Bulgaria, 2003-04



Source: World Bank, Doing Business indicators.

Pillar III: Deepening the Financial System

68. Bulgaria has completed the agenda for banking reform, and financial intermediation is rapidly increasing. First, following the aggressive privatization program in 1999-2001, Biochim Bank and the State Savings Bank DSK were privatized under the PAL program in 2003. Second, to complete the agenda for banking reform, the *Bank Bankruptcy Law* was enacted to improve the exit process for insolvent and closed banks, and the supervision powers of the Bulgarian National Bank were strengthened to enable it to identify and investigate direct and indirect owners of banks. Third, the legal and institutional framework for lending has been further improved to encourage financial intermediation. The foreclosure provisions of the *Civil Procedure Code* were amended to help reduce delays in the enforcement of valid claims, amendments were enacted to the *Law on Registered Pledges* to increase secured lending.⁴² Financial reporting and auditing requirements in Bulgaria are currently in a period of transition from compliance with national standards to compliance with International Financial Reporting Standards (IFRS), International Standards on Auditing (ISA), and the European Union (EU) Directives and Regulations⁴³. The transition to full IFRS and ISA compliance will be demanding and require enhanced institutionalized enforcement mechanisms. In addition, the *Law on Measures against Terrorist Financing* was enacted, and the *Law on Measures against Money Laundering* was amended in line with international standards and good practices. *In line with the government's objectives, the M2/GDP ratio increased to an estimated 53 percent of GDP in December 2004 from 42 percent at end-2001, credit to the private sector increased to an estimated 36.9 percent of GDP in 2004 from 15 percent in 2001, and real credit to the private sector increased annually by almost 40 percent in 2003 and 43 percent in 2004. By 2005, the government's objectives are to ensure that the quality of the banks' portfolios is preserved in the*

⁴² Further amendments are currently under preparation.

⁴³ A new Accountancy Law came into effect in 2002 and seeks to attain maximum compliance with the EU Fourth and Seventh Directives and to create an environment for the comprehensive implementation of IFRS for both legal entity and consolidated financial statements in 2003-05. A new Independent Financial Audit Law came into effect in 2002 and seeks to attain compliance with the EU Eighth Directive and ISA beginning in 2003.

face of rapid credit expansion. By end-2003 the government's target of 98 percent for the private sector share of banking assets had been met.⁴⁴

69. The authorities are taking measures to stimulate capital markets. The development of the pension fund and the insurance sectors is intended to mobilize long term savings which could be invested in long term financial instruments in the market. First, the State Insurance Company (DZI) has been privatized, resulting in 100 percent private ownership of the insurance sector. Second, to improve investor confidence, the *Commercial Code* and the *Law on Public Offering of Securities* have been amended to address deficiencies in minority shareholder protection and to strengthen corporate governance provisions. Third, supervision of Non-Bank Financial Institutions (NBFIs) has been integrated and the Financial Supervision Commission has been established to oversee the regulation and supervision of securities markets, insurance companies, and pension funds.⁴⁵ In addition, the Consultative Council for Financial Stability, a separate body of senior officials from all financial services supervisory agencies, has been established to ensure proper coordination and the development of a system-wide perspective in assessing and dealing with risk and vulnerability. Finally, in the beginning of 2004, the authorities also achieved significant strengthening of the governance structures and fiduciary standards of private pension funds. In addition to the strengthening of the supervisory capacity of the FSC, the legal framework was amended to introduce global custodianship as well as more flexibility in the investment regime, to eliminate inconsistencies in the existing legislation, to facilitate the movement of pension fund members among funds, and to eliminate related party activities. These efforts have been complemented by the pension reform measures undertaken under Pillar V, particularly the enactment of legislation specifying a stable path of increases in second pillar contributions. *By end-2004, the combined pension fund portfolio had reached 2 percent of GDP, and the custody services had been improved in line with the desired program outcomes.*

Pillar IV: Improving Public Sector Governance

70. The development and the implementation of a broad program to improve public sector governance are providing a good platform for the significant institution and capacity building agenda still ahead in preparation for EU accession. This agenda has included developing and beginning to implement programs intended to reform and strengthen the capacity of public administration, to improve service delivery, to strengthen public expenditure management, to reduce corruption, and to pursue fundamental judicial reform.

71. The government has developed and begun to implement a comprehensive approach to public administration reform and has strengthened reform management. Under PAL-3 the government has begun to implement its medium term public administration reform strategy and action plan – the *Strategy for State Administrative Modernization: From Accession to Integration* - that was developed, updated and approved under the earlier PALs. The public administration and civil service reform structures of the Council of Ministers, the Council for State Administration Modernization, and the State Administration Directorate have been strengthened. A system for monitoring the outcomes of the State Administration Reform Strategy and Program has been developed, and the government has begun, under PAL-3, to monitor the outcomes of its program in the areas of merit, depoliticization, the implementation of performance related pay, the implementation of functional review recommendations, and performance against service standards. *By end-2006 the government expects to see demonstrated evidence of an improved*

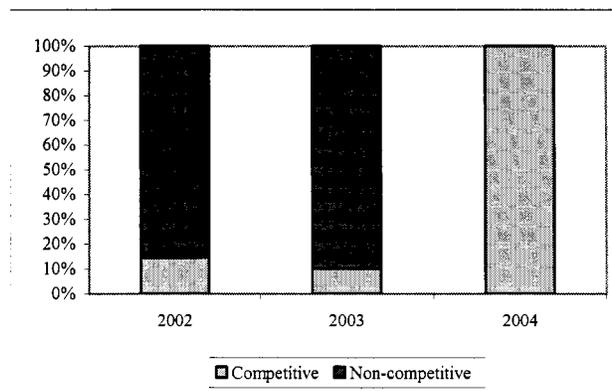
⁴⁴ The Municipal Bank (owned by the municipality of Sofia) and the Business Promotion Bank are the only remaining non-private sector banks, and these two banks accounted for only 2.5 percent of banking assets as of end 2003.

⁴⁵ Technical assistance is now being provided by the Bank through the FIRST initiative in support of the effective functional integration of the regulatory agencies and the initial development of an Early Warning System.

capacity in the Council of Ministers to develop and manage public administration and civil service policy and reform, and to see evidence of progress in public administration and civil service reforms through the development and implementation of key policy frameworks.

72. The policy and legislative framework for a merit-based and depoliticized civil service is in place, and important progress has been made under PAL-3 in implementing competitive recruitment. First, to provide for the introduction of mandatory competitive selection for new entrants into the civil service, major amendments to *the Civil Service Law* were enacted in 2003 (under PAL-2). PAL-3 has supported its implementation and the share of recruitment exercises concluded through competitive procedures has increased dramatically (Figure 11). All civil service recruitment exercises launched in 2004 involved externally competitive processes, as required under the improved merit-based provisions. To ensure quality recruitment, the Council of Ministers is establishing a commission with the responsibility of holding appointment competitions for senior civil servants. The commission’s membership will include independent experts with experience in the field of management. Second, good progress has also been made in the gradual conversion of posts in the general administration from labor contracts to civil service status through the implementation of the new classifier of positions in the state administration. Third, major amendments to the *Law on State Administration* have been submitted to the National Assembly under PAL-3, requiring ministries to set strategic objectives (linked to program budgets); to strengthen ministry-level strategic planning and policy development processes; to provide a clear definition of the role of secretaries general; and to provide for depoliticization with respect to the appointment and tenure of senior civil servants. *By end-2004, all new recruitment exercises in the civil service had been filled through external competitive recruitment, and by end-2006 all recruitment exercises (central government, regional administrations, and local governments) will be filled through competitive or performance-based recruitment or advancement.*

Figure 11: Share of Competitive Recruitment Exercise in Bulgaria, 2002-04



Source: Government of Bulgaria.

73. A merit and performance-based rewards and career advancement system is in place in all core ministries. A comprehensive performance appraisal system was introduced in all core ministries from January 1, 2003, and the first round of appraisals was completed by end-2003. Under PAL-3 the government completed the introduction of the new system of performance-related pay and career advancement, linked to the results of the performance appraisal system. In addition, under PAL-3, the government has made progress in enhancing civil service pay and making it more competitive with the private sector – particularly in areas of recruitment and retention. The average increase in the public sector for 2005 was 8.5 percent, which narrowed the gap with the private sector, and the average increase in the higher levels of the public sector exceeded 10 percent, with a number of increases greater than 20 percent, thereby reducing

compression in public sector pay.⁴⁶ *By end-2006, civil service employment conditions will be increasingly competitive with the private sector, as demonstrated through increases in civil service pay and the increase in the internal decompression ratio (the ratio of the base pay for a junior expert to that for a secretary general).*

74. The government has begun to implement its program to reorganize all ministries and agencies on the basis of functional reviews. This program is designed to align ministry and agency structures, functions and staffing with those required to deliver key government work program priorities, and to put in place the administrative capacity necessary to meet the requirements of EU accession and integration. Thirteen functional reviews (for 7 ministries and 6 regional administrations) were completed under PAL-3. The functional review methodology is in place and has been used as the basis for surveys of all other central administrative structures. Based on these reviews and surveys, the Council for State Administration Modernization approved a report (“Review of Options to Outsource Administrative Activities”) which provides the basis for all future decisions on reorganization and outsourcing, and includes detailed reorganization action plans to implement functional review recommendations. The actual reorganization of administrative structures has been initiated in selected pilot entities. *By end-2006 there will be evidence of adjustments in government structures, functions, staffing levels and skills, to increase their appropriateness for the effective delivery of priority government work program objectives and the requirements for EU integration.*

75. The introduction and appraisal of performance standards, one-stop shop services in local administration, and e-governance are expected to improve service delivery by the public sector. First, a number of steps are being taken to require government ministries and agencies providing services to businesses and citizens to determine and publish service and performance standards. These performance objectives, and the specific performance standards adopted for administrative organizations and officials involved in delivering services to the public, will be linked to the civil service organizations’ performance management system and the civil servants’ performance appraisal system that are now in place in all first and second line spending units of all core ministries. Institutional performance mechanisms for service delivery institutions also include client charters, which are being implemented in two ministries and more than three municipalities and will be rolled out in 2005. Second, one-stop shop pilots are in place in more than half of the local administrations, and active deployment is expected by end-2006 in all local administrations to improve point-of-service delivery contact with citizens. Third, the government has been implementing its e-governance action plan, including introducing on-line forms for tax and customs services and establishing an electronic registry of state institutions and civil service positions. By end-2003, the government’s optical cable network covered 60 percent of the administrative buildings in Bulgaria, thereby facilitating e-governance. *By end-2006, there will be evidence of further increases in numbers of e-services delivered to citizens and businesses and in the associated volume of services/transactions completed/number of hits on key government service websites; there will also be evidence of an increase in the perceptions of civil servants as to the degree of performance orientation in the civil service.⁴⁷ By end-2003, various service areas (notary public services, construction supervisor services, local water and garbage collection) were subject to contracting out. By end-2007, there will be a significant increase in the extent to which administrative services are subject to formal competitive processes, and in the outsourcing of services and the analyses of savings generated.*

⁴⁶ The 2002 baseline pay and benefits survey of the public and private sectors in Sofia showed that for civil service pay to reach the 80 percent median for the equivalent private sector jobs, the following levels of pay increases would be necessary: junior expert, 38 percent; senior expert, 88 percent; chief expert, 144 percent; head of section, 201 percent; department head, 277 percent; and director, 379 percent.

⁴⁷ The 2001 baseline public officials’ survey revealed that only 26 percent of civil servants were familiar with the performance standards expected of them.

76. Under the PAL program, the government has developed and has begun to implement its Anticorruption Program. The National Anticorruption Strategy adopted under PAL-1 provided a comprehensive framework for approaching the problem of corruption and a unifying framework for the government's cross-cutting attempts to combat corruption in all areas of its work program.⁴⁸ On the basis of early experience in this area, the Council of Ministers approved, under PAL-2, an anticorruption program for the period 2004-05 which included specific sectoral anticorruption strategies for education and health, and the Supreme Judicial Council (SJC) approved a linked anticorruption strategy for the judiciary. The agenda is continuously being translated into a sequence of concrete actions in selected priority areas, and, in addition, under PAL-3 the government has begun to publish monitoring reports on progress made with ministry and agency specific plans. First, the MOI and the tax and customs administrations have been implementing detailed anti-corruption action plans, and under PAL-3 this implementation is now under way in the judiciary. Second, accountability and transparency in the civil service are being strengthened. The legal framework for conflict of interest and asset declarations was strengthened under PAL-2. Under PAL-3 the Council of Ministers has adopted a code of ethics intended to improve administrative procedures, reduce inappropriate discretion on the part of civil servants, and clarify accountability arrangements. In addition, freedom of information regulations are being implemented to provide for more timely access to information and for more effective and transparent appeals mechanisms, and many ministries have declassified documents to make them available to the public under the provision of these regulations. *By 2003, the number of applications to government bodies for access to public information had increased by 213 percent compared to 2002 (following an increase of 39 percent between 2001 and 2002), 0.5 percent of these requests were turned down, and 12 percent of the refusals were appealed. By end-2006, the government's aim is that levels of state capture and administrative corruption will have been reduced in comparison with 2001, and that the public administration will display stronger external accountability and transparency.*

77. The government has made good progress in the development and implementation of a comprehensive program for strengthening public expenditure management. This has included actions designed to increase allocative efficiency and transparency in budget formulation; to strengthen the procurement and financial accountability mechanisms; and to strengthen the system of intergovernmental finance.

78. The government has moved ahead with the implementation of a Medium Term Fiscal Framework, program budgeting, and has introduced accountability for results. Starting with a single pilot in the Ministry of Environment and Waters (MEW) in the 2003 budget year, the government's program budgeting initiative has expanded to comprise seven ministries.⁴⁹ The pilot program documents include program classifications and descriptions, as well as information about the objectives and potential performance measures. In all of these pilots the intention is to create direct links between programs, budgeted allocations, objectives and actual performance targets. In addition to strengthening the technical side of the reform (through the development of budgets), progress is being made under PAL-3 in ensuring accountability (by strengthening evaluation), with the release by the National Audit Office of a report on the MEW's program budget. The medium-term aim is to expand the program budgeting initiative to all spending entities in government, with all 19 line ministries expected to have program budgets by 2007. As progress in this direction under PAL-3, performance indicators and targets for all line ministries were published in the 2005 budget. The move towards a program budgeting classification and the

⁴⁸ The 2001 public officials' survey showed that 50 percent of officials covered felt that corruption was a significant problem affecting the performance of government institutions.

⁴⁹ These are the Ministry of Environment and Waters (MEW), the Ministry of Transport and Communications (MTC), the Ministry of Labor and Social Policy (MOLSP), the Ministry of Education and Science (MES), the Ministry of Economy, the Ministry of Energy and Energy Resources, and the Ministry of Youth and Sports.

identification of more specific objectives and goals is also expected to help enhance the transparency of the national budget and to help create incentives for responsive service delivery to the public, which is particularly important in health and education. The Government is aware that these reforms have many iterations to pass through in the future, and are committed to a properly sequenced reform approach. The government has also moved ahead with the development of the MTFF in the 2005 budget. *The government objective is that by end-2007, there will be evidence of an improved performance focus in the entire budget, through program orientation across government and the publication of all first level spending unit goals and objectives in the budget and through accountability for results as reflected in active audits of programs. By end-2006 (for the 2007 budget preparation cycle), the public expenditure management system will be based on the MTFF.*

79. The government has improved public sector capital expenditure management processes and systems. The Ministry of Finance (MOF) has taken a number of steps to improve the processes and practices involved in planning, appraising, monitoring and reporting on capital expenditures. The 2003 draft guidelines for capital expenditure planning and appraisal were developed according to EU standards and distributed to all line ministries. These draft guidelines served as the basis for the guidelines approved by the MOF in 2004 and were used for the first time in analyzing and prioritizing the limited number of new capital expenditure proposals in the 2005 budget. There is a need, however, to strengthen the rigor of the analysis. The MOF has developed and implemented, under PAL-3, a system that will allow for recording, monitoring and reporting on all capital expenditures, which will also be evaluated and further strengthened in years to come. The National Investment Division has been established within the MOF as the agency responsible for the coordination of the national investment policy in the public sector. By end-2006, the processes for managing capital expenditures in the central government will be standardized and institutionalized, facilitating improvements in both the efficiency and effectiveness of capital expenditures and enhanced accountability. *Capital expenditures are targeted to increase to 4.5 percent of GDP in the 2005 budget, compared to 3.9 percent in 2003. By 2006 there will be evidence of an improved focus on investment expenditures and investment expenditure management, as reflected in improved allocations to investment and maintenance items and more active management of these items.*

80. The regulatory framework for public procurement is being improved. The government has begun to develop procedures and a system to manage EU pre-accession funds and to improve the legislative and regulatory framework for all public procurement. Under PAL-3, the government has made good progress in the initial implementation of the CPAR action plan aimed at improving the efficiency and transparency of procurement with public funds, and in the alignment of public procurement with EU directives. A new *Public Procurement Act* and related secondary legislation have been enacted (for example, an ordinance for the award of small public procurements), a public procurement register is being established, and rules and procedures for arbitration in procurement related disputes are in place. Moving forward, the government will continue to harmonize its procurement legislation in line with EU requirements and to improve its procedures and practices. *By end-2005, there will be evidence of a more robust procurement system.*

81. The government is improving its internal and external audit practices. These improvements have been carried out in line with CFAA recommendations. The Public Internal Financial Control Agency (PIFCA), which is responsible for internal audit, had by October 2004, located internal audit teams in all central and local government entities and had ensured that the annual internal audits were carried out in all government entities, and that reporting on internal audits was carried out. At the same time, the National Audit Office (NAO) has, under PAL-3, conducted a pilot performance audit (of the MEW). It has also developed a multi-year program for the external auditing of operational and financial performance in all government ministries and agencies. There will be an increased focus on ensuring that recommendations from the NAO

and PIFCA are acted upon, including through enacting amendments to the NAO Law to strengthen the responsibility of ministries and agencies to take action in line with NAO recommendations. By end-2005, the aim is to see improved internal and external accountability in the public expenditure management process. This is expected to result in greater incentives for improved fiscal and operational performance, lower corruption and improved transparency. *By end-2005, the government intends to show clear evidence that the NAO and PIFCA reports are leading to appropriate action by the MOF (remedial, system and process improvements).*

82. The government has made some progress in strengthening the system for intergovernmental finance. A fundamental reform of intergovernmental fiscal relations went into effect in 2003 – a necessary step to improve efficiency in the provision of public services and to strengthen local finances. The reform made a legal distinction between autonomous functions and functions delegated to the municipalities, substantially changed the method used to calculate municipal expenditure needs, introduced a more transparent mechanism for distributing funding among municipalities, and reduced incentives for overstaffing, particularly in health care. In 2003, the government reached and fully implemented an agreement with the National Association of Municipalities to partially liquidate outstanding local government arrears. To discourage municipalities from running up arrears in the future, debt relief was provided only to specific categories of arrears.⁵⁰ As in 2004, the 2005 budget fully funds all centrally mandated delegated functions based on agreed expenditure standards. The government has also adopted a transparent formula for allocating revenue equalization grants for the 2004 budget and has fully funded this equalization transfer in the 2005 budget. Moving forward, the agenda includes providing assistance to municipalities in responding to the efficiency incentives, assigning of greater control to municipalities over property taxes and introducing effective mechanisms to raise resources for investment. *In accordance with the government's objective, the 2005 budget facilitates increased predictability and transparency in the allocation of government transfers to municipalities.*

83. A new accountability framework for the judiciary is being implemented, and the institutional capacity for the implementation of the medium term reform agenda is being strengthened. First, the most significant step has been the establishment of an appropriate accountability framework for the judiciary, particularly with respect to immunity, mandates, and replaceability. The framework was introduced through amendments and additions to the *Constitution of the Republic of Bulgaria* promulgated on September 26, 2003 (under PAL-2) – limiting immunity for members of the judiciary, limiting the mandate of senior judicial appointments, and introducing principles limiting irreplaceability (including the introduction of performance appraisals) – and through consequential amendments to the *Judiciary Act* in March 2004. The new accountability framework is being implemented under PAL-3, including through the competitive appointment of magistrates in accordance with the amended legislation. Work has begun on the development of performance standards for judges; completing this work remains an important medium term priority.⁵¹ Second, the Supreme Judicial Council has approved an Anti-Corruption Program for the Judiciary, and implementation has begun under PAL-3. The strategy provides for measures to strengthen the accountability of magistrates, and to prevent corrupt practices within the judiciary through the introduction of a random case assignment system, more transparent access to court documentation and files, and an active public information campaign. Third, to facilitate the successful implementation of the medium term judicial reform agenda, the administrative capacity and organization of the Supreme Judicial Council (SJC) are being strengthened continuously; in addition, the SJC approved, under PAL-3, the first annual monitoring report on the implementation of the judicial reform program. Although a

⁵⁰ The largest single item of debt relief compensated for the underestimation of hospital care costs.

⁵¹ In addition, the promulgation of Rules for Court Administration in October 2004, introducing the concept of a court administrator and defining the court clerical staff's performance appraisal mechanisms, ranks, etc., will bring additional professionalism and transparency to the courts, while relieving judges and court presidents from time-consuming administrative tasks.

comprehensive legislative framework for a more independent and efficient judiciary has been put in place, significant efforts are still needed on the part of the Bulgarian authorities and the judicial community to implement the enacted changes, particularly, in the areas of anti-corruption efforts, improvement of the court organization, reduction of court delays, and enhancement of the quality of justice. *By end-2005, the accountability, efficiency and effectiveness of the judiciary should have increased as demonstrated through the improved structure and administrative capacity of the SJC, a more transparent and merit-based appointment process for judges, a reduction in complaints and disciplinary measures against judges, and an improved perception of judges' ethics.*

84. The basis for securing further efficiencies in the resolution of commercial disputes is being established. Significant improvements in court efficiency will require continued efforts and commitment in order to speed up court proceedings, reduce the case backlog and enhance the quality of court decisions. Efficiency in the resolution of commercial disputes will be enhanced by the successful introduction of a systematic approach to case management through an automated uniform case system⁵² in 2005. To effectively enforce judgements, consideration is also being given to the introduction of private enforcement. Taking non-adjudicative transactions, such as the registration of business entities, out of the hands of judges under PAL-3 (Pillar II) is also expected to contribute to the speedier resolution of commercial disputes by courts. In addition to steps to improve the efficiency of courts, the legal basis for alternative mechanisms for resolving commercial disputes is being established under PAL-3 through the enactment of the Law on Mediation and the establishment of a network of professional mediators. If these measures are successful, *by mid-2006, the length of court proceedings should be reduced, and the percentage of commercial disputes resolved through mediation and other alternative venues should increase.*

85. The administrative justice system is also being strengthened under PAL-3. A new Administrative Procedural Code has been submitted to the National Assembly to provide the legal basis for the establishment of nearly a dozen specialized administrative courts (there is at present only one Supreme *Administrative* Court in Sofia). Work is underway on the development of a comprehensive plan for the establishment of the courts. *By end-2006, at least 50 percent of specialized administrative courts will be operational.*

Pillar V: Investing in Human Capital and Strengthening Social Protection

86. The government has expressed its commitment to increasing investments in human capital and reducing poverty and social exclusion. To ensure that the population is empowered to participate in future growth and to prepare for successful integration into the EU, the government is developing and implementing programs to improve the quality of health and education services, to equip the population with the skills required in a competitive market economy, to enable the disadvantaged to invest in education, to strengthen national public health programs, and to improve the governance and efficiency of health and education services. The government is also defining and implementing policies to empower the disabled and the improve the administration and targeting of disability benefits, to ensure the successful implementation of pension reform, to improve coverage and efficiency of social assistance programs, and to reduce the institutionalization of children through helping families and fostering community-based alternatives to institutional care.

87. The government is implementing its education reform program at the same time that it is further developing a strategy for comprehensive and ambitious reform. Bulgaria has a strong tradition of high educational attainment. However, there is now wide consensus that comprehensive reform is necessary to address the persistent challenge of access and an apparent

⁵² This is currently under way with assistance from the EU and USAID.

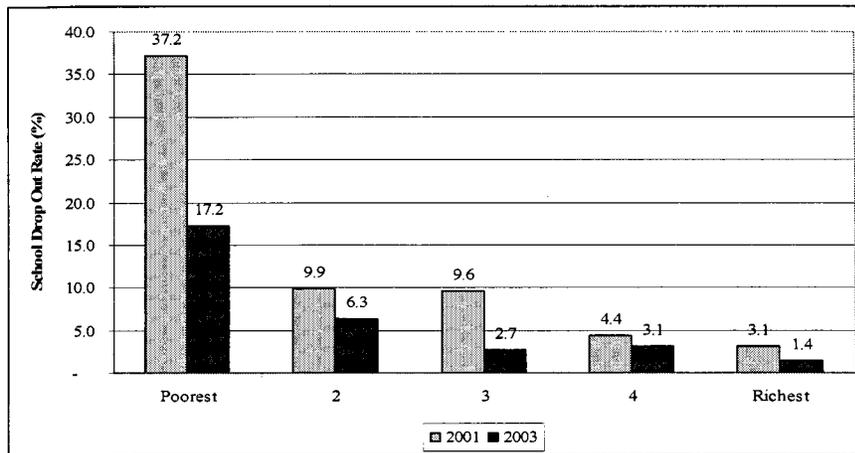
decline in quality and relevance, and to increase efficiency in preparation for the demands of EU accession. On December 10, 2004, the Council of Economic Policy adopted the “National Program for the Modernization of Bulgarian Education” as the conceptual underpinning for its reforms. It envisions adjustments to the teaching and learning process, the structure, governance and management, and the financing mechanisms of the education system. PAL-3 supports the adoption and implementation of specific elements of the government’s strategy, focusing particularly on enhancing access while also assisting the development of the future policy framework. Following the public debate and discussion on the specific directions of the medium term reform program, particularly on structure, governance and financing, the intention is to establish a completely new legislative and regulatory framework to replace the existing National Public Education Act and Higher Education Act.

88. Significant progress has been made in implementing programs to increase the opportunities for equal access to the educational system and to integrate all disadvantaged groups into primary and secondary education. First, the government has introduced a number of policies, programs and funding mechanisms to support the integration of children from ethnic minorities into the education system. An obligatory pre-school year was introduced in September 2003, which is especially beneficial for the early integration of children from minorities. Under the government’s updated strategy and action plan for this educational integration (supported by PAL-3), Roma children who wish to attend better quality schools outside their neighborhood will be enabled to do so.⁵³ The government has earmarked funds in the 2005 budget, and has also established (under PAL-3) an “Educational Integration of Ethnic Minorities Children and Pupils Fund” to channel funds to government and non-government programs supporting educational integration, with a principal focus on the desegregation of Roma schools. Second, the PALs have supported changes to the child allowance program to provide incentives for increasing school attendance among children from poor families. The monthly child allowance benefit was made conditional on school attendance for all eligible school age children, starting from the school year 2002-03. Under PAL-3, the *Law of Family Benefits for Children* was further amended to introduce an additional cash allowance at the beginning of the school year to enable poor children in the first grade to purchase educational materials. Third, under PAL-3, a decision was taken by the National Assembly to provide free textbooks to all children in primary schools, to introduce school feeding, and to provide transportation to children in remote rural villages. Finally, to facilitate the participation of children with special educational needs in the mainstream school system, the government has been implementing its National Plan for the Integration of Children with Special Education Needs in the Public Education System for the period 2004-07. The *Public Education Act* and the relevant secondary legislation were amended to allow the integrated education of children with special education needs into the mainstream schools and kindergartens.⁵⁴ For the 2004-05 school year, 10 special schools for intellectually impaired children (where most of the children are of Roma ethnic origin) began teaching the regular school curriculum. At this point, 675 children with special education needs are integrated and 130 resource teachers have been appointed. *The government’s aim is to continuously reduce the gaps in school attendance between children from disadvantaged families and other children, and, by end-2007, to integrate 40 percent of Roma children into mainstream schools. School non-attendance rates for children from the poorest quintile fell by 20 percentage points* (Figure 12).

⁵³ Other initiatives for 2005 include the introduction of mother tongue learning and second chance education for older ethnic minority children.

⁵⁴ The amendments address granting physical access to schools, providing specialized training equipment and appointing resource teachers for children with special needs.

Figure 12: Reduction in School Drop-Out Rates by Quintiles, 2001 versus 2003



Source: MTHS 2003.

89. **The government has also begun to implement strategies to increase the relevance of the skills of current and future entrants into the labor force.** To respond to the needs of a knowledge-based society and to meet the Lisbon goals, the government's program identifies several priority areas for reform. These areas include the provision of core general compulsory programs, the teaching of foreign languages and the introduction of information technologies (ICT), the introduction of independent external assessments, the facilitation of transfers between education levels and types of schools, and an emphasis on lifelong learning. Several initiatives are already under way, including the introduction of foreign language training. In addition, under PAL-3 the National Assembly approved the National Program for introducing ICTs in secondary schools aimed at supporting the needs of the information society and meeting the Lisbon target.⁵⁵ The first phase, equipping about 50 information and research centers or teachers training centers, has been completed. In the second phase, 700 schools will be equipped and 16,000 teachers trained. The government, under PAL-3, has also adopted a Strategy for Continuous and Vocational Training and an Action Plan for implementing the strategy in 2005, to enhance the professional qualifications of the workforce.⁵⁶ Moving forward, important priority areas include the preparation of new regulations for the professional development of teachers, establishment of an effective system of appraisal and rewards, and structural adjustments to reduce profiling in compulsory education. *To continue to upgrade its education system, the government aims to gradually increase the share of public resources devoted to education from 4.1 percent of GDP in 2002, with a view to achieving levels of expenditure by end-2007 that are closer to those in OECD countries (5.6 percent of GDP). By end 2007, the government expects to begin to see a reversal in the present trend of declining performance in international surveys such as TIMSS, PISA and national assessments.*

90. **The government has begun to implement measures to strengthen the governance and financing of education.** The government's concept for the modernization of education envisions significant changes in the management and financing of education. Some initial steps have been taken under the PALs, but a large future agenda remains. First, in the case of primary and

⁵⁵ The Lisbon target was 100 percent of schools to be connected to the internet. According to the TIMSS 2003 study, Bulgarian teachers of eighth grade students reported that the percentages of students who did not have access to computers for mathematics and science teaching were 91 percent and 85 percent respectively, which is greater than in all EU countries and Romania.

⁵⁶ Only 1.4 percent of the employed in Bulgaria engage in continuing education compared to 9.7 percent in the EU.

secondary education, financing moved in 2003 from funding of inputs to financing based on enrollments, with adjustments for classroom size. However, regulatory constraints limit the ability of local governments or schools to adequately respond to the reduced incentives for overstaffing. The government plans to further develop the funding method to link it to quality, and to introduce a competitive element. The roles of central and local government institutions and schools will be reviewed and clarified. Second, in the case of higher education, the government has prepared an action plan which includes inter alia reform of the governance and financing of universities. It envisions changes in the composition of the governing councils and in the appointment of rectors. The plan includes the introduction of a competitive element in funding to provide incentives for efficiency and to support other priorities, such as increased employability or greater responsiveness to market demand. These are ambitious reforms which will require a considerable amount of consensus and capacity building. In addition, to successfully implement these reforms the government plans to strengthen quality assurance mechanisms and to introduce independent external assessment. *By end-2007, the government's objective is to gradually raise the student-teacher ratio particularly in higher education towards the average level in OECD countries. By end-2007 there will also be greater autonomy and accountability in the management of higher education institutions.*

91. The government is implementing its comprehensive health care reform strategy while further defining future directions intended to improve the health status and the use available resources efficiently. The reforms are aimed at enhancing the quality of care and strengthening national health programs, while improving the efficiency and fiscal sustainability of the health care system. The essence of the government's reforms in the health sector is the separation of service provision from financing and the movement towards a publicly administered insurance fund, implemented through a mix of public and private providers of care. At the center is the National Health Insurance Fund (NHIF), which combines the roles of pooling risks and purchasing medical care through contracts with physicians, group practices, and hospitals. Having completed the major elements of the reform in the primary care sector, the government's focus during the PAL period has been to implement the reforms in the hospital sector, while continuing to evaluate and fine tune the overall reform agenda. PAL-3 has thus additionally supported the development of elements of the future policy framework for health reform – in particular in the areas of drug policy and health insurance. Moving forward, the government is developing a new health strategy, laying out future directions for continuing health reform. The new strategy aims to address the outstanding issues of access, informal payments and corrupt practices and the particular challenges posed by the rapidly aging population. It will examine the options for the ownership and management of hospitals, define future directions for health insurance to improve its financial sustainability, define the role and development of private voluntary supplementary health insurance, and identify the role of social assistance in health care. The government has begun to prepare – and is expected to enact in 2006 – a health insurance code which will consolidate the existing legislation in a consistent legal framework while providing the framework for future reforms. Once completed, the reforms should bring about significant improvements in access to care regardless of socioeconomic status, should enable service use according to need, and should ultimately lead to improved health status and to consumer and provider satisfaction.

92. The government has taken important steps to improve the governance and financial sustainability of the health care system. It has consolidated the separation of the functions of stewardship, financing and service provision by emphasizing the role of the Ministry of Health in system stewardship and by strengthening the institutional capacity and information infrastructure of the NHIF. First, hospital financing has been streamlined and is gradually becoming output based. The reimbursement mechanisms are being expanded and improved. Second, a vastly improved hospital accreditation system is being introduced under PAL-3, with the remaining legislative amendments planned in 2005 to ensure the independence of the new Accreditation

Council. Third, the government is upgrading the institutional capacity of the NHIF⁵⁷ and rolling out the piloted information platform that will enable it to handle all financial and clinical data – a critical step in rendering the NHIF a strategic purchaser of health services capable of monitoring the mix, volume and quality of all services that it purchases from the providers and health care facilities. Fourth, on the revenue side the government is building an evidence base to revisit the contributions, benefits and entitlements under the NHIF and voluntary health insurance schemes. PAL-3 supports the development of a strategy with realistic revenue and expenditure projections to ensure universal access to essential services within the context of the long-term fiscal sustainability of the NHIF. *The government is making progress towards its objective of consolidating all hospital financing under the NHIF by 2006: in 2005, the NHIF budget allocation for inpatient care increased by 20 percent and accounted for 50 percent of all inpatient expenditures. Overall, more than 90% of the hospital financing in 2005 has become activity-based, with MoH also introducing new methods of payment for hospital services. The government's aim is that by 2007 the NHIF will have a balanced budget and will no longer require supplements from its reserves or the consolidated government budget. This will also require keeping the NHIF's administrative costs under 3 percent of total expenditures. By end-2005 the new cycle of accreditation of all medical care facilities will have been completed.*

93. The government has designed and is implementing a unified national policy, strategy and action plan for pharmaceuticals. Under PAL 3, the government has developed the National Drug Policy Framework and the accompanying action plan, and has enacted several ordinances for its implementation, in line with EU directives. Together, these are expected to maintain and ensure the quality, safety and efficacy of the pharmaceuticals in the Bulgarian market, to institute pricing and reimbursement policies to safeguard the equitable access to drugs, to promote the rational use of drugs, and to advance the process of the harmonization of the Bulgarian legislation in the Human Medicine Drugs and Pharmacies Act with the EU requirements. The positive drug list, completed as part of this framework, is already being used to guide the reimbursement of drugs covered by the NHIF in order to ensure cost-effectiveness in pharmaceutical financing. *This has resulted in a fall in the NHIF's expenditures by more than 14 percent between 2003 and end-2004.*

94. To better align the health care system with the needs of the population and to improve the quality of inpatient services, the government is implementing its hospital restructuring strategy. PAL-3 supports the implementation of the strategy and action plan for hospital restructuring developed under the earlier PALs. Under PAL-3, the government has completed the implementation of the first year/phase of its five year restructuring plan. First, PAL-3 supports the development of an updated National Health Map (NHM). This NHM reassesses all regional and national health facilities, taking into account health care needs, and sets the ground for closures of beds and hospitals or their conversion for other uses, to guide future restructuring and capital investments in the secondary and tertiary care facilities. Second, the process of restructuring of selected national hospitals and of municipal hospitals in three regions has started.⁵⁸ The restructuring will continue over the medium term until all facilities are realigned in accordance with the needs of the population. The next stage will be the adjustment of human resources. The upgrading of existing capital assets for inpatient care, investments in new equipment and facilities, and adjustments in human resources are, together, expected to contribute to visible improvements in the quality and efficiency of inpatient services. *The occupancy ratio in acute care hospitals supervised by the Ministry of Health (MOH) increased from 66 percent in 2001 to 79 percent in 2003, and the average length of stay fell from 11 days in 2001 to 8.8 days in 2003. By end-2005, the government's objective is to achieve an average of 85 percent in the occupancy*

⁵⁷ With the support of Bank financing under the Health Sector Reform project.

⁵⁸ Investments for restructuring the national hospitals are being provided with the support of the Health Sector Reform project.

ratio of acute care hospitals and a reduction in the average length of stay towards the EU average of 8.2 days.

95. The government has designed a new mechanism to fund national health programs and has strengthened preventive care and tobacco control. First, in 2003 (under PAL-2) the government designed a new mechanism for financing preventive health services in order to increase the budgetary allocations to priority national public health programs, namely, tuberculosis control, immunization and HIV/AIDS prevention and care. Under PAL-3, the government has increased the proportional allocation to national public health programs in the MOH's operating budget. Second, to prevent the worsening of tobacco-related health risks and problems, in July 2004 the National Assembly enacted amendments to the *Health Act* earmarking 1 percent of the excise tax collected from tobacco and tobacco products for the funding of the national tobacco control programs. The government also completed the harmonization of its tobacco control legislation with the relevant EU directives. In 2004 it ratified a *Framework Convention for Tobacco Control* and enacted the *Law on Tobacco and Tobacco Products*. *The government's aim is to have in place by the end-2005 a monitoring and evaluation system to gauge the progress and assess the impact of these programs; Immunization coverage has already begun to increase (96 percent of children age 2 years had been immunized against polio in 2003, compared to 94.4 percent in 2000), and tuberculosis incidence has begun to fall (in 2003 there were 41.7 new cases of tuberculosis per 100,000 population compared to 48 in 2001) in line with the government's objectives. The government has gradually increased the excise duty on tobacco products as per the EU directive.*

96. An important start has been made to promote the full and productive integration of the disabled into society and the labor markets and to improve the effectiveness of disability benefits. First, a new legal framework for fostering the recognition and integration of disabled people into mainstream employment and the mainstream society is now in place, which constitutes a sharp departure from the historical approach, in which the focus was on separation and which entailed large costs relating to the unrealized potential of individuals.⁵⁹ Following the adoption of a National Strategy for Equal Opportunity for the Disabled, the National Assembly has enacted, under PAL-3, the *Integration of People with Disabilities Act*. As of January 2005, a social assessment will be included in addition to a medical assessment to determine the options for rehabilitation and integration and to determine the non-pension benefits based on need. Second, important steps are being taken to address the increasing problems with administering and targeting the disability benefits, and to reduce incentives for abuse. Amendments to the *Health Act* enacted in July 2004 provide for representation of the National Social Security Institute (NSSI) on the Disability Assessment Committee (TELK). This should, in principle, contribute to a reduction in unjustified disability uptakes, although the impact will need to be monitored. The new *Health Act* also provides greater control to the NSSI over medical staff assessment of temporary and long-term disability, and establishes strict rules – including the withdrawal of medical licenses – to reprimand doctors who abuse and misuse the disability assessment process. In addition, under PAL-3, the *Social Insurance Code* has been amended to prohibit the awarding of disability benefits to individuals over retirement age, bringing disability benefits in line with international practice while reducing the incentives for misuse. Moving forward, efforts will focus, inter alia, on implementing improvements in the assessment process and on instituting a system of non-pension benefits that is aligned with individuals' specific requirements. *Starting from 2005, no new disability pensions will be awarded to people over retirement age; by end-2006, there will be improved control over disability uptake and fraud, and needs (social) assessment regulations will be in place and applied to the disabled.*

⁵⁹ The historical approach to disability in Bulgaria established state owned institutions for residential and employment purposes, which created a high degree of dependency between the disabled, and their families and the state. The focus was on separation rather than on integration, which lead to social and economic isolation.

97. The government has completed the implementation of the reform of the pension system towards a multi-pillar system. The system comprises three pillars: first, the publicly managed pay-as-you-go system; second, the mandatory supplementary defined contribution universal (for those born after December 31, 1959) and occupational (for those working under hazardous conditions) pension plans; and third, the voluntary supplementary plans. The government has successfully completed the implementation of its action plan to help ensure the successful implementation of the multi-pillar reform. First, the legal and regulatory framework concerning private pension plans and their supervision has been amended to improve governance structures and supervision capacity, to improve fiduciary standards and to introduce more flexibility into the investment regime (Pillar III). Second, a consolidated *Social Insurance Code* was enacted to consolidate mandatory and voluntary pension insurance as well as other social insurance legislation and to eliminate inconsistencies, thus providing a more coherent legal framework for social insurance. Third, regulations were adopted to transfer pension fund contributions in a prompt and transparent manner. Fourth, amendments to the *Social Insurance Code* were enacted (under PAL-3) to specify the medium term directions of key pension parameters (the contribution rates allocated to public and private pillars, the timetable for increasing second pillar contributions and for establishing a 50:50 split in employer and employee contributions, and the benefit indexation rule). This action will ensure their effectiveness, by default, over a multi-year period and will avoid the need to revisit these parameters every year within the framework of the *Public Social Insurance Budget Law*. This is an important step towards enhancing predictability for beneficiaries, contributors, investors, and for public finances, and thus it contributes to the robustness and sustainability of the multi-pillar pension system. *In line with the government's objective, by 2005 greater stability has been achieved in benefit indexation, contribution base dynamics, and contribution rates.*

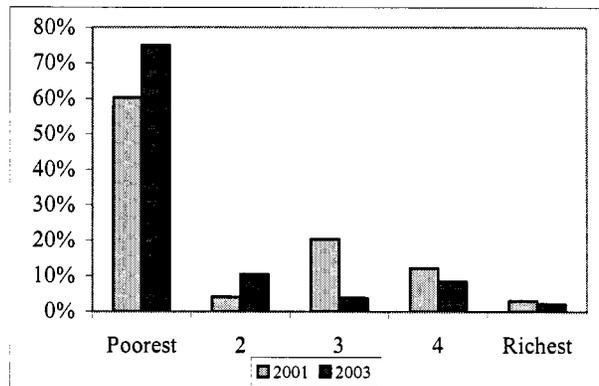
98. Many fundamental changes have been introduced into the administration and design of social assistance programs, significantly improving their effectiveness (Box 6). First, the introduction of the concept of welfare to work, by shifting the focus of support for those who can work from social assistance to subsidized employment, has contributed to the improved targeting of the government's main program for direct income support (the Guaranteed Minimum Income or GMI program). The adequacy of this program to cover basic needs as well as its targeting to the poorest was further improved by increasing the eligibility threshold particularly for vulnerable groups, including under PAL-3. Second, through amendments to the *Social Assistance Act*, the responsibility for financing most forms of social assistance (and social services) was fully transferred to the state budget. This has completely eliminated the problem of in-kind payments and arrears in the GMI. Third, a new *Law of Family Benefits to Children* has introduced means testing in the child allowance program. In addition, to provide incentives for increasing school attendance among poor families, the monthly child allowance was made conditional on school attendance for all eligible school age children, starting from the school year 2002-03. Fourth, the administration of all family benefit payments was consolidated under the umbrella of the Social Assistance Agency, and coverage of the child benefits was expanded to include poor children not previously covered (e.g., children of the uninsured self-employed). The administration of social assistance benefits has been further improved by the empowering of the Social Assistance Agency to verify eligibility for social assistance programs through spot checks. Finally, the winter energy benefits program has been adjusted annually in the light of tariff increases, while targeting has been further improved through increases in thresholds for vulnerable groups. *These changes resulted in substantial improvements in the effectiveness of social assistance programs between 2001 and 2003: the coverage of the poorest quintile by the GMI program increased 2.7 times, and the energy benefit program 1.5 times. The share of funds channeled by the GMI program to the poorest quintile increased from 60 percent to 75 percent, the share of funds channeled to the child allowance program increased from 20 percent to 36 percent, and the heating allowance increased from 47 to 54 percent. School non-attendance rates for children from the poorest quintile fell by 20 percentage points.*

Box 6: Improved Effectiveness of Social Assistance under the PAL Program

The achievements in enhancing the effectiveness of the main social assistance benefits in Bulgaria under the PALs have been impressive. With the “New Social Policy Strategy” the government advocated a substantial change in the philosophy of social assistance from providing benefit assistance to providing employment assistance. The organization and administration of social assistance was substantially improved by securing funding from the state budget and consolidating payments under the umbrella of the Social Assistance Agency. The government also took important steps to improve the design of the main programs, with the clear goal of improving the effectiveness of the system. For example, the child allowance benefit was restructured to become a means-tested benefit conditional on school attendance. As a result, the child allowance now provides support to low-income families with children and, at the same time, fosters school attendance among the children who are at a higher risk for school drop-out.

The results of these efforts in the short time frame are already evident. First, Figure 10 in the text showed the fall in school non-attendance among all children, particularly the poorest. The targeting performance of the child benefit program has also improved substantially: the share of funds channeled to the poorest quintile of the population in 2003 was more than one-and-a-half times that in 2001. Second, the figure in this box, shows dramatic improvements in the targeting performance of the GMI: In 2003, 75 percent of funds went to the poorest quintile of the population, up from 60 percent in 2001. This has placed the program among the best performing means-tested programs internationally. The impressive targeting performance of the GMI is due in part to an effective system of means-testing and in part to the self-targeting brought about by the “From Social Assistance to Employment” program for the long-term unemployed. It is important to note that the improvement in targeting has occurred while the program has expanded its coverage substantially: the coverage of the poor has more than doubled. Third, the share of funds channeled by the winter energy benefits program increased from 47 percent to 54 percent.

Targeting Performance of the GMI Benefit (% of funds by consumption quintile)



Based on Tesliuc, Cornelia (2004), “Social Protection and Poverty Reduction in Bulgaria – an Update,” mimeo. The World Bank.

Note: The magnitudes of the changes in effectiveness need to be interpreted with caution as they are generated from different, non-comparable surveys. Moreover, the MTHS substantially under estimates coverage rates for the GMI program, which could additionally affect the findings. The direction of the changes, however, is without doubt.

Source: Bulgaria Integrated Household Survey 2001 and Multi Topic Household Survey, 2003.

99. The provision of social services for vulnerable groups is being reorganized. These groups include children as well as the disabled, elderly and mentally handicapped. Developing effective social service provision outside of the traditional institutional care for these groups is central to the inclusion agenda as Bulgaria joins the EU. Developing non-institutional services for the elderly will also become increasingly important in view of Bulgaria’s rapidly aging population. A number of important steps have been taken, particularly in the provision of child care services. First, the legal framework for private and NGO provision has been established through amendments to the *Social Assistance Act*, and the previous licensing procedure for services for the disabled, elderly and mentally handicapped has been replaced with a more open but better controlled registration process. Minimum standards for the provision of services are

being adopted. Second, comprehensive road maps for the restructuring of all existing childcare institutions – including downsizing, and closing down and/or opening these institutions for the provision of day-care services – have been prepared by municipalities and agencies under PAL-3 and implementation is expected in 2005. Moving forward, the reform agenda includes the design and adoption of financing arrangements that will provide incentives for phasing out institutional care and encouraging alternative service provision by a diverse range of providers, including municipalities, NGOs, commercial providers and community groups. *By 2007 there will be an increase in the number of non-governmental child care providers and community-based child welfare services, and an increase in the number of alternative child care providers subject to transparent, modern, licensing procedures, and all childcare institutions will have been restructured.*

100. The legal and institutional framework for a national system of child protection has been established and the number of children being placed in specialized institutions has fallen. Just under 2 percent of Bulgarian children were in institutions in 2001, implying a rate of institutionalization that is high by international standards and entailing high costs for the development of human and social capital. The government has taken a number of steps to facilitate the rearing of children in families and with the support of communities. The basic framework for these reforms is provided by the *Child Protection Act* of 2001, which makes institutionalization an option of last resort and requires court approval of child protection measures. First, the institutional capacity of the State Agency for Child Protection (SACP) – charged with the responsibility for implementing and enforcing the regulation – is being upgraded.⁶⁰ Second, several individual pieces of primary and secondary legislation have been aligned with the provisions of the Child Protection Act. PAL-3 has seen the implementation of many of these revised provisions. In particular, under the amended internal regulations of the MES (which houses the largest number of institutionalized children), new entry procedures are being implemented. Third, to provide incentives for the supply of alternative services, amendments to the *Family Support for Children Act* now provide foster care givers and guardians with the same entitlements to family benefits as biological and adoptive parents, while amendments to the *Social Insurance Act* and the *Labor Code* provide them with the same entitlements to parental, maternity and child sick leave. Fourth, a new ordinance adopted by the COM under PAL-3 facilitates the selection of foster care givers and the placement of children in foster care, and training is being provided to social workers, judges and foster families. *Between 2001 and 2003, there has been a reduction in the number of specialized institutions by 3.5 percent, a decline in the number of children placed in institutions by 9.5 percent, and a fall in the rate of institutionalization from 1.9 percent of the child population to 1.8 percent. The government's objective is to achieve, by end-2007, a decline in the number of children in specialized institutions by at least 10 percent (compared to 2001) and an increase in the number of institutions that are restructured.*

101. The government has strengthened its capacity for the analysis and monitoring of living standards. Under PAL-1, a Policies, Analysis and Forecasts department with the responsibility for poverty monitoring and for evaluating the impact of government policies and programs on poverty and living standards was established within the MOLSP. In October 2003, the government implemented its first multi-topic household survey, and based on this the government has carried out a detailed analysis of poverty trends and causes, and intends to disseminate its findings. The first municipal-level poverty map has been produced based on the survey data, and the government is developing its system for the monitoring of social indicators that will be used to track the progress made towards meeting the EU accession-related commitments taken within the Joint Action Program. The government's objective is to increasingly use its analyses to inform the updating of its strategic documents relating to poverty

⁶⁰ This is supported by a well coordinated effort of the EU (through a twinning arrangement) and the World Bank (through the Child Welfare Reform Project).

and social exclusion, and has done so in its Joint Inclusion Memorandum signed with the EU in February 2005.

D. BANK GROUP STRATEGY

Country Assistance Strategy

102. **The proposed PAL-3 is fully consistent with the 2002-05 Bank Group Country Assistance Strategy for Bulgaria which was reviewed by the Board of Executive Directors on May 9, 2002.** The CAS focused on three main themes: (i) promoting competitive private sector led growth; (ii) strengthening public administration and tackling corruption; and (iii) mitigating the social impact of restructuring and delivering social services more effectively. Drawing on the lessons of the previous CAS, the 2002-05 CAS recognized the need for a comprehensive policy reform program to support the wide range of remaining policy and institutional reforms required for Bulgaria to be able to complete the transition to a fully competitive market economy. Under the CAS, Bank support is to be provided over the CAS period through the planned series of PALs. This approach was designed to enable the Bank to be comprehensive in its approach while at the same time maintaining a focus on ensuring the sustainability of the outcomes being pursued under this multi-year program.

103. **Bulgaria has satisfactorily met the CAS conditions for remaining in the base case.** PAL-3 supported the government in maintaining satisfactory progress in the implementation of the government program. The macroeconomic performance remains robust and satisfactory, and structural reforms remain on track. The portfolio performance has improved recently following concerted efforts by the government jointly with the Bank, and a quarterly portfolio review process is now in place. The Bank has decentralized procurement and has set up a regional procurement unit in Sofia. A Country Financial Accountability Assessment (CFAA), completed in December 2003, has provided an important input to PAL-2 and PAL-3. A Country Procurement Assessment Report (CPAR), submitted to the government in July 2004, has informed the PAL-3 preparation.

Portfolio Quality

104. **The performance of the Bulgaria program has improved with an 87 percent satisfactory rating and a considerable acceleration of the implementation pace.** This positive development is the result of proactive portfolio management and of the portfolio's entering a more mature stage. A system for proactive portfolio monitoring was set up by the government, led by the Deputy Prime Minister and the Minister of Economy. The government of Bulgaria and the Bank have been actively engaged in quarterly monitoring against agreed targets to address delays in project implementation. Further to the Quarterly Portfolio Monitoring process, the Bulgaria Country Unit contracted an external consultant to undertake a limited review of the Bulgaria portfolio, with a focus on projects that were at risk for not achieving their development objectives by their current closing dates. The review proposed detailed actions to address gaps in the portfolio performance and digression from the development impact goals, including measures such as the restructuring of projects and the cancellation of project/loan components which have been under-performing. Based on the review, the government adopted decisions for the restructuring of projects at risk which include tight monitoring and closer follow-up to ensure the sustained improvement and optimization of portfolio performance. At this stage, only the registration and cadastre project has an unsatisfactory status and is subject to a closely monitored six-month action plan. Accelerated project implementation is reflected in a substantive improvement in the disbursement ratio, which reached 17.8 percent as of mid-February 2005, compared with a disbursement ratio of just 9.9 percent for the entire FY04.

Cooperation with the IMF

105. **The IMF Board, on August 6, 2004, approved a 25-month SDR 100 million Stand-By Arrangement of a precautionary nature.** The IMF supports the Bulgarian authorities' economic program as articulated in the Memorandum of Economic Policies dated July 21, 2004. The ability of the government to fulfill its commitments under the IMF program depends to a large extent on the structural and institutional reforms to be supported by the PALs. Cooperation between the Fund and the Bank has been strong, including the completion of the joint Bank-Fund Financial Sector Assessment Program for Bulgaria and the joint technical assistance initiative to upgrade the MOF debt management capacity. *Annex 7 sets out in more detail the roles of the Bank and the IMF with respect to the government's economic program.*

Coordination with Donors

106. **The Council for Economic Policy (CEP) coordinates the economic reforms and the PAL program.** The amendments to the Council for Economic Policy (formerly the Council for Structural Policy), introduced at end-December 2003, specify that the Council has coordinating, informational and analytical functions related to the economic policy issues, and takes the lead role in donor coordination. The amendments also provide for the establishment of thematic working groups under the overall oversight of the Deputy Prime Ministers. The Council of Ministers' Directorate for European Integration and Relations with International Financial Institutions (IFI) acts as the secretariat (coordination unit). On the basis of the experience over the last 18 months, and in order to respond to the demands and priorities of the government (namely, to accomplish the reform and EU accession agenda) the CEP has decided to reorganize the Working Groups (WGs). Development partners and the government are working on the next steps that will operationalize the revised WGs structure. The Bank has maintained, under the PAL program, very strong and effective joint working arrangements and relationships with donor partners. These include for Pillar I USAID and EBRD (e.g. in the energy sector), for Pillar II the EC and USAID (e.g. EC on insolvency, USAID through their Commercial Law Reform Program and on labor market reform), for Pillar IV the EC, DFID, OECD and EU (e.g., especially on Public Administration and Judicial Reform, including the EU Advisor on PAR funded by DFID, Support for Improvement in Governance and Management – a joint program of OECD and EU, and the Open Government Initiative funded by USAID), and for Pillar V USAID, DFID, EC and UNICEF (e.g. USAID on pensions and health, UNICEF, EC and DFID on child welfare and de-institutionalization).

E. THE PROPOSED LOAN

Major Policy Areas and Actions Taken Prior to Board Presentation

107. **PAL-3 supports an impressively broad and deep set of substantial and concrete actions.** The maintenance of macroeconomic stability, which was discussed in the first section of this memorandum, is a precondition for proceeding with PAL-3. As discussed in section C, the CAS adopted additional triggers for processing to PAL-3 to ensure that adjustment lending would reach the proposed US \$450 million level⁶¹ only if the indicators of economic outcomes confirmed that Bulgaria had substantially improved its standing as a result of reforms in the first two PALs, and if the downside risks of overall economic performance were low. These additional triggers have also been met. PAL-3 supports nearly 100 benchmarks in the government's program in all five pillars. Bank staff have worked closely with the government in developing and implementing this rich program, reflecting the comprehensive policy dialogue

⁶¹ In fact, with the completion of PAL-3, actual adjustment lending would have reached US\$425 million equivalent instead of the total \$450 million, as the total amount disbursed under PAL-2 was US\$ 125 million equivalent instead of the originally planned \$150 million equivalent.

underlying the loan. These benchmarks are included in Annex 6, an attachment to the Government's Letter of Development Policy (Annex 5). Selected key policy areas and actions under PAL-3, completed prior to Board Presentation, are presented below.

108. **Prior to Board Presentation, the government has completed several key actions:**

Pillar I: Sustaining Structural Reforms

Mostly completed its privatization program, through the sale or liquidation of 80 percent of SOEs in which the government had majority control in 2002 (30 percent sold in PAL-3 alone), and nearly all minority packages (1,225 sold January 2004 to February 28, 2005).

Completed the existing program of the restructuring of the energy sector to increase competition and private sector entry, through:

- An increase in electricity tariffs bringing cumulative increases to 52 percent and resulting in the complete elimination of cross-subsidies between industry and households
- An increase in district heating tariffs, bringing cumulative increases to 33 percent and resulting in the complete elimination of subsidies from about 0.67 percent of GDP in 2002
- The approval of an electricity sector restructuring plan to legally separate the transmission business from the public wholesaler role of NEK, enabling non-discriminatory access to the transmission network by independent market participants.

Achieved significant private sector entry in the energy sector, through:

- The 100 percent privatization of the electricity distribution sector, with the sale of all seven companies
- The sale of seven (compared to the target of five) district heating companies, with several more ongoing.

Completed privatization in the telecommunications sector, through the privatization of the Bulgarian Telecommunications Company and the introduction of effective competition.

Continued improvements in the fiscal sustainability of railways (railway subsidies, excluding investments, kept at 0.2 percent, down from 0.5 percent in 2000, and financial working ratio targets for 2004 achieved) through:

- Signing of the first annual Public Service Contract between the government and the railway operating company to provide financial discipline and incentives for increased efficiency
- Rationalization of services and networks, including adoption and implementation of a government decision to terminate services on and close approximately 250 km of lines, and termination of nearly 120 passenger services (over 9 percent of total) since June 2004)
- Additional staff reductions, bringing cumulative reductions to 13 percent
- Adjustment of track access charges to remove all cross-subsidization between freight and passenger services.

Pillar II: Establishing a Market-friendly Business Environment

Completed 83 percent of a program for streamlining regulations to reduce transactions costs to the private sector, through further streamlining of centrally managed regimes.

Enabled the application of new principles to control the future development of regulations that have an impact on the private sector, through the issuance and dissemination of guidelines for implementation to central administrative and municipal bodies on the design of proposed new regulatory regimes.

Significantly reduced the number of steps and the time required to register a business from 11 procedures and 32 days to 6 procedures and 10 days by 2006, and reduced the time for resolving commercial disputes from the present 440 days, through:

- Enactment of legislation for a single identification number for business registration
- COM approval of strategy to take judges out of registration.

Improved efficiency in front line government services, through:

- Enactment of legislation and rules instituting one-stop shop contact support for significant new FDI to improve services for foreign investors
- Rolling out of one-stop shops to over half of local administrations to improve service access (also Pillar IV benchmark)
- Replication at the national level of the measures piloted under the TTFSE and resulting in reduction in the processing time at all participating border crossing points and customs offices.

Pillar IV: Improving Governance

Increased the competitiveness and depoliticization of the civil service, through:

- Filling of the majority vacancies for civil service positions in 2004 through external competitive recruitment
- First reading by the National Assembly of legal amendments to clarify the role of political cabinets and guaranteeing the merit-based appointment of directors of agencies
- Implementing pay increases in 2004 that (i) reduced the gap with the private sector; and (ii) increased the gap between higher and lower level pay scales to increase the attractiveness of senior civil service positions to qualified candidates
- Completing the introduction of performance related pay and advancement in all core ministries by basing 2005 pay on outcomes of the performance appraisal.

Enhanced accountability and transparency in the civil service through:

- Adopting a code of ethics for the civil service
- Implementing freedom of information legislation, particularly the Protection of Classified Information Act, leading to the expansion of information access in government and greater transparency in information access, and few refusals of access.

Increased the efficiency of the resolution of commercial disputes, through the adoption of a Mediation Law to promote alternative dispute resolution mechanism for commercial disputes.

Strengthened the administrative justice system, through submission to the National Assembly of a new Administrative Procedural Code to establish nearly a dozen specialized administrative courts (in addition to the Supreme Administrative Court).

Pillar V: Investing in Human Capital and Strengthening Social Protection

Increased the integration of children from ethnic minorities into schools, through:

- Adoption of an updated strategy and preparation of action plan to enable the integration of children from ethnic minorities into education, including through desegregation of schools, mother tongue learning and second chance education

- Enactment of an ordinance establishing a fund to support the educational integration of ethnic minorities.

Reduced incentives for drop-outs in primary education, through:

- Enactment of legislation to introduce cash assistance for the purchase of school supplies for poor first grade children from the 2004-05 school year
- Adoption by the National Assembly of a program to increase coverage and reduce the drop-out of children in primary schools in 2005-06 school year, including the provision of free textbooks, school feeding, transportation for children in remote villages, and improved community and institutional partnerships to increase access.

Strengthened institutional structures to improve public health outcomes, including reducing the incidence of tuberculosis, increasing the immunization rates for children, and reducing the incidence of tobacco related health risks, through:

- Increases in the proportional allocation to national health programs in the MOH operating budget for 2005
- Enactment of legislation to earmark 1 percent of the excise tax rate from tobacco products to fund national health programs
- Increases in the excise tax for tobacco as per EU directives, resulting in increased prices for tobacco products and increased funding of the national tobacco control program
- Enactment of legislation to increase tobacco control and regulate consumption in public places.

Improved efficiency in the delivery of in-patient care health care services, further increasing the occupancy ratio and further reducing the average length of stay, through:

- Expansion of output-based financing mechanisms for inpatient care (to cover more than 50 percent of all hospital payments in 2005), providing incentives for the rationalization of services
- Launch of hospital restructuring in Ministry of Health and municipal hospitals, and preparation of an updated National Health Map to guide future restructuring.

Reduced disability pension uptake, through:

- Enactment of legal amendments disallowing new claims of disability pensions by people over retirement age
- Enactment of legislation to strengthening the role of the National Social Security Institute in the disability assessment process and providing for reprimanding of doctors for abuse/fraud in the medical assessment of disability.

Completed the first stage of reform of the pension system into a multi-pillar system, and achieved stability in benefit indexation, contribution base dynamics, and contribution rates, through:

- Legal amendments specifying the medium term directions of key pension parameters (contribution rates allocated to public and private pillars, timetable for increasing second pillar contributions and for establishing a 50:50 split in employer and employee contributions, and the benefit indexation rule).

109. **In addition, a number of important actions under PAL-3 provide the necessary foundation for continuing Bulgaria's future medium term reform agenda in several areas.** These include (i) approval of a new transport sector strategy; (ii) enactment of legislation enabling the establishment of a regulator in the water sector to introduce an appropriate tariff structure and to improve service quality; (iii) completion of functional reviews in 7 government ministries and 6 public regional administrations and approval of a report identifying options for reorganization and out-sourcing; (iv) introduction of performance standards and reporting on

performance for all services provided by the public sector, and the development and publication of client charters in various national and three sub-national administrations; (v) adoption by the Supreme Judicial Council of an anti-corruption program for the judiciary; (vi) adoption of improved public expenditure management processes, including the introduction of a medium term fiscal framework, expansion of program budgeting in nearly half of all ministries, introduction of accountability for results, and improvement of the management of capital expenditures; (vii) adoption of a “National Program for the Modernization of Bulgarian Education,” as the conceptual underpinning for a comprehensive and ambitious reform program in education; (viii) approval of a national pharmaceutical policy and a strategy for the fiscal sustainability of the National Health Insurance Fund and for the introduction of voluntary health insurance; (ix) improvement of the legislative framework for a flexible system of disability benefits through the enactment of a consolidated legal act and regulations for the integration of the disabled, instituting social assessment in addition to medical assessment; and (x) completion of the legislative amendments to make the deinstitutionalization of children a measure of last resort, increased licensing of non-governmental providers, development of standards and regulations guiding the provision of social services, and preparation of road maps for the restructuring of all child care institutions.

110. **The actions completed prior to Board Presentation under PAL-3 have a substantial overlap with the PAL-3 triggers as proposed in PAL-2 Board Documents.** Table 4 compares the PAL-3 Board Conditions now proposed with the PAL-3 triggers as originally proposed in the PAL-2 Board documentation

Medium Term Reform Priorities beyond PAL-3

111. **Although the PAL program has been completed successfully, Bulgaria has a significant medium term reform agenda as it gets ready for a successful integration into the EU.** Future support to Bulgaria will assist in addressing these demands and will support the objectives of increasing competitiveness, improving efficiency in the use of public resources, and increasing social inclusion. Specific areas to be addressed include (i) further improvements in the business environment including judicial reform and the reduction of corruption; (ii) capacity weaknesses and improvement to public service delivery at the central and local levels; (iii) addressing infrastructure bottlenecks, particularly in transport and water; (iv) continued reforms in education and health care, addressing quality, access, governance and fiscal sustainability; (v) enhancing labor market flexibility; and (vi) social protection and social services, including further controls on disability uptake, flexible benefits and an improved assessment of disability, possible new directions in pension and social assistance, and inclusive social services. These needs and possible modalities of assistance will be further specified in the new Country Partnership Strategy that will be prepared by the end of 2005. In particular, the present government has identified continuation of comprehensive policy reforms in health and education, the foundation for which has been established during PAL-3 as priorities for Bulgaria in the medium term, and as possible priority areas for future Bank assistance.

Table 4: PAL-3 Triggers (as laid out in the PAL-2 Program Document) and Related PAL-3 Board Conditions

PAL-3 Triggers as approved by the Board in the May 4, 2004 Board PAL-2 Program Document	Status/Comments	Related Proposed PAL-3 Condition of Board Presentation
<p>Pillar I: Sustaining Structural Reforms <i>Privatization or liquidation of the large SOEs listed in Annex 6B</i></p>	<p>Trigger adjusted and substantially met. The privatization program is nearly complete and on the whole the government has over-performed, particularly in the privatization of large infrastructure. Seven electricity distribution companies have been privatized with proceeds exceeding expectations resulting in 100% privatization of the electricity distribution sector. Seven district heating companies have been privatized (exceeding the original target of five). Bulgarian Telecommunications Company (BTC) has been privatized. The government made significant efforts once again to complete the privatization of Bulgartabak; however changing market and political conditions provided challenges to completing the sales. In particular, only one bid was received for the four most attractive cigarette manufacturing companies. Other parts of the holding, however, are being sold or liquidated. Privatization and liquidation will continue as market liberalization takes place with EU accession, but will take time. The government has also exceeded targets for privatization of small SOEs. The adjusted Board condition now excludes Bulgartabak, but instead recognizes the progress on the privatization of BTC.</p>	<p><i>Privatization or liquidation of the large SOEs listed in Annex 6B (adjusted Annex 6 B now substitutes Bulgartabak with Bulgarian Telecommunications Company)</i></p>
<ul style="list-style-type: none"> <i>Reduction in railway labor force by 20% compared to the level at end of 2001</i> 	<p>Trigger adjusted and met. The trigger was adjusted to focus on the financial position of railways which has substantially improved as a result of several actions under PAL-3 including line closures, termination of services, and additional staff reductions. The revised board condition now also includes specific financial indicators based on international financial accounting standards</p>	<p><i>Implementation of actions to improve financial sustainability of railways including (i) adoption and initial implementation of CoM decision to terminate services on and close 250 Km of uneconomic lines; (ii) termination of 9% of passenger services; and (iii) continued staff reductions bringing cumulative total to 13% as of end-2004 compared to end-2001; resulting in achievement of subsidy of 0.2% of GDP and financial working ratio of 100% in 2004.</i></p>
<p>Pillar II: Establishing a market friendly business environment</p>		
	<p>New strengthened prior action for PAL-3 Board; strengthened condition met. PAL-2 board documents included a benchmark to</p>	<p><i>Implementation of business registration reform, through (i) enactment of the Law of on the</i></p>

<p>PAL-3 Triggers as approved by the Board in the May 4, 2004 Board PAL-2 Program Document</p>	<p>Status/Comments</p>	<p>Related Proposed PAL-3 Condition of Board Presentation</p>
<p><i>Enactment of amendments to the Labor Code to promote flexibility</i></p>	<p>support the introduction of one stop company registration. Because reforms to improve the conditions for entry of new firms are central to increasing the dynamism of the economy, the benchmark was strengthened, further clarified, and elevated to a Board condition. Implementation of the reforms as envisioned are likely to significantly reduce the number of steps and time required to register a business, and also to improve judicial efficiency.</p> <p>Trigger downgraded to benchmark; benchmark met. International comparisons, investment climate assessments, and a thorough review of the Bulgarian labor code suggest that the Bulgarian labor code is not overly restrictive from an international perspective. However, it does contain important rigidities that have to be addressed in the medium term. Recognizing this, and also recognizing the political infeasibility of meaningful dialogue with social partners on specific reform options in a pre-election year, the trigger was downgraded and replaced with a benchmark to encourage dialogue on the selected rigidities – in particular inflexibility of working time and insufficient adaptability of wages – between the social partners with a view to eventually amending the legislation. The government has launched consultation with the social partners, but legislative action will only take place after elections in June 2005; and the Bank will continue to support the government through future instruments as requested. Some success was achieved through amendments to the Public Health Law which provide for greater control of misuse of sick leave, thus potentially addressing a distortion in the labor market but also reducing the burden on social security</p>	<p><i>Bulstat Register introducing single identification number; (ii) approval by the CoM of a strategy to transfer business registration from the courts and judges into a non-judicial administrative process; and (iii) establishment of a working group including business representatives to draft necessary legislation for the implementation of the strategy</i></p>
<p>Pillar IV: Improving Public Sector Governance</p>		
<p><i>Satisfactory number and % of recruitment exercises (central government, regional administrations, local governments) filled through external competitive recruitment (merit and competition)</i></p>	<p>Trigger retained and specified, new condition exceeded. The trigger was specified to establish a target of 51% of recruitment exercises to be filled competitively. In fact, 100% of external recruitments were filled competitively in 2004.</p> <p>Trigger retained and further specified; specified condition met. The trigger further clarifies the reform process, specifying intermediate steps and products (surveys and action plans)</p>	<p><i>Majority of vacancies for civil service positions in 2004 being filled through external competitive recruitment</i></p> <p><i>Government optimization and rationalization under way through completion of 13 functional reviews and surveys, report identifying</i></p>
<p><i>Government structure optimized and rationalized through completion of functional review for further ten pilot state</i></p>		

PAL-3 Triggers as approved by the Board in the May 4, 2004 Board PAL-2 Program Document	Status/Comments	Related Proposed PAL-3 Condition of Board Presentation
<p><i>administration structures (Ministries and regional administrations)</i></p> <p><i>Program budgets for existing and four new pilot ministries (Ministry of Education and three others, making seven in all) and including performance indicators and targets prepared and included in 2005 budget</i></p>	<p>between functional reviews and actual reorganization. No other change in substance and final outcomes of prior action as specified and trigger as presented in PAL-2 Board documents.</p> <p>Trigger retained and strengthened; strengthened condition met. Condition is slightly stronger than original trigger, now requiring all first level spending units to publish organizational objectives, an initial step towards expanding program budgeting to all ministries.</p>	<p><i>reorganization opportunities, reorganization action plans to implement functional review recommendations, and evidence of reorganization in pilot areas</i></p> <p><i>Program budgets for existing and four new pilot ministries (Ministry of Education and three others, making seven in all) and including performance indicators and targets prepared and included in 2005 budget, and organizational objectives for all first level spending units published in 2005 budget</i></p>
<p>Pillar V: Investing in Human Capital and Strengthening Social Protection</p> <p><i>Satisfactory progress with implementation of education reform strategy</i></p>	<p>Trigger retained and further specified; specified condition fully met. The previous trigger was general and was specified to include implementation of actions in the government's strategy to enhance equitable access to education; and to support further development of the future reform agenda for the sector. Significant actions have been taken to enhance equitable access for children from poor households and ethnic minorities. First, the National Assembly approved a program – to be implemented in the 2005/06 school year – to provide free textbooks, introduce school feeding, and provide transportation to primary school children in remote rural villages. Second, legislation was enacted to introduce a new cash allowance program for first graders from low income families. Third, the government has adopted a decree establishing a funding mechanism to support the implementation of its strategy and action plan (also adopted under PAL-3) to integrate children from ethnic minorities into the school system. In addition, other sub-sectoral programs supporting the implementation of the National Program as adopted by the Council of Economic Policy – such as the strategy for introducing information and communication technology in schools – were approved by Parliament and are being implemented.</p>	<p><i>Implementation of actions to promote equitable access to quality education for children from poor households and ethnic minorities, and adoption by the Council of Economic Policy of a National Program for the Modernization of Education, identifying changes needed to improve the quality, structure, management, and financing of the education system</i></p>
<p><i>Implementation of the action plan for the hospital restructuring strategy</i></p>	<p>Trigger retained and further specified; specified condition met. The previous trigger was general and was specified to include the</p>	<p><i>Improve hospital management, productivity, and efficiency through (i) expansion of output</i></p>

PAL-3 Triggers as approved by the Board in the May 4, 2004 Board PAL-2 Program Document	Status/Comments	Related Proposed PAL-3 Condition of Board Presentation
<p><i>Enactment of legislation setting out a fixed contribution rate and detailed benefit and contribution base indexation rules for the first pillar, and three to five year schedule of contribution increases to the second pillar</i></p>	<p>expansion of output based financing mechanisms to increase incentives for rationalization of the sub-sector and to support the launch of actual restructuring. With regard to the latter, hospital restructuring has been launched, with the actual piloting of restructuring in 2 hospitals, and restructuring of municipal hospitals in 3 regions on the way, following the development of a detailed updated National Health Map to guide future adjustments.</p> <p>Trigger retained and met. The language of the trigger was clarified.</p>	<p><i>based payment for inpatient care services to cover more than 50% of all hospital expenditures in 2005, providing incentives for the rationalization of services; and (ii) launch of restructuring in Ministry of Health and municipal hospitals and the development of a National Health Map to guide future restructuring</i></p>
<p><i>Enactment of legislation setting out a fixed contribution rate and detailed benefit and contribution base indexation rules for the first pillar, and three to five year schedule of contribution increases to the second pillar</i></p>		<p><i>To ensure stability and robustness of pension system, enactment of amendments to the social insurance code setting out: (i) the benefits indexation formula, including maximum and minimum benefits; (ii) contribution rates including time-table of establishing a 50/50 split of employer/employee contributions and the timetable of increasing second pillar contributions</i></p>

Implementation and Monitoring

112. **The government has taken a number of steps to put in place the appropriate institutional arrangements and structures to ensure the successful implementation of the PAL program.** The Council for Economic Policy⁶² (formerly the Council for Structural Policy) under the Council of Ministers, chaired by the Deputy Prime Minister and Minister for Economy has undertaken the overall management and coordination of the government program. It receives well-organized and effective support from the Directorate for European Integration and Relations with IFIs of the Council of Ministers. The Council for State Administration Modernization set up by the Council of Ministers under PAL-2, has continued to function effectively during PAL-3, and has been supported by the very active and effective Directorate for State Administration of the Council of Ministers. The Anticorruption Commission, chaired by the Minister for Justice, with the Minister for State Administration as the Deputy Chair, is supported by a very small but dynamic Anticorruption Coordination Commission Secretariat. Institutional development plans for several of the newly established independent regulatory agencies and commissions are being implemented. The government is also considering how to upgrade its communications strategy, including making greater provision for private sector participation, NGOs and service users in the design and implementation of government policies and reforms. A number of other bodies and inter-agency working groups are focusing on specific components of the reform.

113. **The government has also developed mechanisms for the participation of stakeholders in the design and implementation of the reform program.** The current legislation requires public consultation before making legislative proposals, for all sectors, and work is underway to further define the general procedures, principles and mechanisms for consultation with stakeholders. Several forums have been established with both private and public sector memberships to facilitate dialogue on thematic issues, notably the Council on Economic Growth and the Tax Council. There are regular consultations with established private sector organizations such as the Chamber of Commerce and Industry, the Industrial Association, the Employers' Association, the Associations of Commercial Banks and the Bulgarian Association of the Supplementary Pension Insurance Companies. In the health sector, discussions on legislative issues and annual budgets include the main nongovernmental stakeholders, most notably the organizations of medical professionals and dentists, and recently, of users of health services. The governance of NSSI is tripartite with a significant participation of the social partners. In education, the new reform directions are becoming increasingly subject to consultations with political parties, the teachers' unions, associations of parents, the Rector's Council, the academic community and civil society at large. To enhance inclusion of vulnerable groups in the policy decision-making process, the government is holding consultations with the Economic and Social Council, the National Council on Rehabilitation and Social Integration, the newly established National Council on Inter-ethnic Cooperation and Demographic Development and the commissions for child protection.

114. **The medium term program implementation plan includes several feedback mechanisms to enable the government to track progress towards the desired outcomes.** A baseline Administrative and Regulatory Cost Survey (ARCS) was completed under PAL-1, the first repeat survey was undertaken under PAL-2, and a follow up will take place under PAL-3 in spring 2005. A living standards survey was carried out in 2003. To assess changes in the public

⁶² It includes as members the Deputy Prime Minister and Minister of Transport, the Minister of Labor and Social Policy, the Minister of Regional Development and Public Works, the Minister of Finance, the Minister of Agriculture and Forestry, the Minister of State Administration, the Minister of Energy and Energy Resources, the Minister of Education and Science, the Minister of Environment and Waters, the Minister of Health, two Deputy Ministers of Economy determined by the Minister of Economy, and a Deputy Minister of Finance determined by the Minister of Finance.

perception of the judicial system, a survey was implemented in 2004. A repeat public officials and pay and benefits surveys will be run under PAL-3, together with a number of service delivery surveys. NGO anticorruption surveys and NGO monitoring of access to information will continue to provide important monitoring data. *Progress measured against the desired outcomes is documented in detail in the Matrix of Performance Benchmarks attached as Annex 6A to this Program Document.*

Poverty and Social Impacts

115. **Bulgaria has a comprehensive social protection system which effectively reduces the negative social impacts of restructuring.** First, Bulgaria has a strong social safety net: the social protection system includes social insurance programs (including unemployment insurance), social assistance programs, as well as a variety of active labor market programs (ALMPS) and employment services. The PAL program, including this loan, has supported continuous strengthening of the effectiveness of these programs through Pillars V (social assistance) and II (labor market and employment programs). The falling unemployment and poverty in the context of continued restructuring of the economy are testimony to the effectiveness of these programs. Program improvements under the PALs have been informed by analytical work including the Poverty Assessment and the Public Expenditure Review (both completed in 2002), a review of Active Labor Market Programs (ALMPs) in Bulgaria in 2001⁶³, as well as other recent evaluations commissioned by the government including with the support of PHRD grants under the PALs. Ongoing evaluations (including the net impact evaluation of the major ALMP) are expected to inform future adjustments. A recent update on the effectiveness of social assistance programs shows that some of the Bulgarian programs – particularly the GMI and energy benefits programs – rank among the best targeted programs in the world⁶⁴. Second, specific interventions under PAL-3 as well as previous PALs have been accompanied by social protection measures. For example, the energy tariff increases have been structured to minimize the impact on the poor – through the creation of a first block of (“social”) tariffs, while an annual program of adjustments to the winter energy benefits program has been implemented, including under PAL-3 to accompany the tariff increases. Similarly, most privatization transactions include social provisions. For example, provisions accompanying the privatization of the electricity distribution companies provide incentives to keep lay offs at optimal levels, while those accompanying the privatization of BTC include special severance and training packages. Finally, under the PAL program, and with the support of an IDF grant, the government has significantly enhanced its own capacity for poverty and social impact analysis and this analysis is increasingly informing its strategies.

Environmental Aspects

116. **The Bank has reviewed the potential environmental issues in line with OP/BP 8.60 as a matter of good practice, although the timing of the operation precedes formal requirements for this screening under current Bank policy.** This screening identified the primary environment linkages of the operation with the need to comply with the EU Large Combustion Plants Directives (LCP) for energy facilities and the need to ensure the adequate treatment of potential environmental liability issues in the process of privatization and liquidation of state owned property. The Implementation Plans agreed with the EU in the negotiations of the

⁶³ Walsh, K; Kotzeva, M.; Dulle, E; and R. Dorenbos, 2001. “Evaluation of the Net Impact of Active Labor Market Programs in Bulgaria,” Ministry of Labor and Social Policy of Bulgaria, Rotterdam. The study showed generally positive results for the evaluation of ALMPs in Bulgaria, comparing favorably with the findings in other countries in Central and Eastern Europe and Western Europe.

⁶⁴ Tesliuc, Cornelia (2004), “Social Protection and Poverty Reduction in Bulgaria – an Update,” mimeo. The World Bank.

environment chapter 22 for EU accession, have explicitly taken into account compliance with the LCP Directive including which energy facilities require the privatization process to address the requirements of the Directive. The Bank has previously assisted the government in establishing a process for the clarification of environmental liabilities through a Bulgaria Environmental Remediation Pilot Project; followed by a Bulgaria Environmental and Privatization Support Adjustment Loan operation. Both operations were successfully implemented, and have helped to establish Bulgaria's current system of pre-privatization environmental audits, compliance plans, and remediation agreements linked to and enforced through Sales Purchase Agreements in the privatization process. Legislative changes and capacity built through piloting and ongoing implementation of these now well established programs reflect best international practices and provide a systematic, comprehensive, and long term program to address and clarify environmental liabilities. The Environmental Impact Assessment process of Bulgaria was also integrated with the environmental liabilities legislation as a mechanism for further addressing social impacts and involving the public in proposed privatization sales agreements. The comprehensive approach of Bulgaria, and their foresight to introduce these systems early in the EU accession and privatization process has helped to bring more responsible investors into Bulgaria, facilitate better transaction prices; and ensure private capital flows into the retrofitting/refurbishing of industrial enterprises to cleaner technologies. Bulgaria's best practice model makes them a leader, including amongst existing EU member countries who will be required to more comprehensively adopt similar systems under recently adopted EU environmental liability legislation which goes into effect in early 2007.

Fiduciary arrangements

Disbursement and auditing

117. **Borrower and Loan Amount.** The proposed PAL-3 loan amount is EURO 116.1 million (US\$150 million equivalent). The borrower is the government of Bulgaria, represented by the MOF. The proposed PAL-3 is the third of the three planned adjustment loans totaling up to US\$450 million equivalent as provided for in the CAS.

118. **Disbursement.** Satisfactory progress in the reforms set forth in the loan will trigger disbursement of funds. Disbursement arrangements will reflect the February 1, 1996 Operational Directive on the Simplification of Disbursement Rules under Structural Adjustment and Sectoral Adjustment Loans. Disbursements will not be linked to specific purchases, thus evidence will not be needed to support disbursements, nor will procurement requirements be necessary. Upon approval of the loan and notification by Bank of loan effectiveness, the government will submit a withdrawal application. At the request of the Government, IBRD will disburse the loan and the proceeds of the loan will be deposited in the Treasury's EURO account in the Bulgarian National Bank (BNB), this account being available for budget financing. The loan proceeds will not be converted into BGN. Prior to that, the Bank will withdraw from the Loan Account a front end fee equal to 1 percent of the amount of the Loan, subject to any waiver of a portion of such fee as may be determined by the Bank from time to time. If after the loan proceeds are deposited in the Treasury's account at the BNB, the proceeds are used for ineligible purposes as defined in the loan agreement, IBRD will require the borrower to either: (a) return that amount to the Treasury's account at the BNB available to finance budget expenditure for eligible purposes or (b) refund the amount directly to IBRD.

119. **Accounts, Auditing and Closing Date.** The government should maintain the account and records, or should 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 compliant with the BNB's accounting legislation which is acceptable to the Bank. The Bank had chosen to exercise its prerogative to audit the deposit account under PAL-1

and PAL-2, and the audits were unqualified and acceptable to the Bank. The IMF conducted a safeguards assessment of the BNB in 2002 and found that safeguards are generally adequate. Recommendations by the IMF were promptly addressed by the BNB. Past audits and the positive assessment by the IMF provide significant assurance that the loan will not be inappropriately used. As a result of the above, no audit will be necessary under PAL-3. The PAL-3 closing date has been determined as March 31, 2006.

Procurement and Financial Management

120. A Country Procurement Assessment (CPAR) was submitted to the Government in July 2004 and has informed PAL-3 preparation. Specifically the regulatory framework for public procurement is being improved under PAL-3, and the government has made good progress in the initial implementation of the CPAR action plan.

121. The Bank has extended knowledge of the country's Public Financial Management (PFM) and fiduciary risk is considered low. A Country Financial Management Assessment (CFAA) was prepared in 2003. The CFAA highlighted strong features and significant achievements in Public Financial Management (PFM), including: (i) a well developed system; (ii) a sound legislation and functioning external oversight institutions (namely the National Audit Office and the Parliament); (iii) enhanced budget process and comprehensiveness – the latter through a significant reduction of the number of extra budgetary funds; (iv) the beginning of a pilot programmatic approach in three ministries; (v) the development of a Treasury Single Account (TSA) to service all budgetary institutions; (vi) improved realism of budget estimates; (vii) the restructuring of the capital expenditure function; (viii) strengthened cash management; and (ix) an adequate internal control framework. In 2003, fiscal transparency was considered high. While the overall financial management risk to Bank funds was deemed low, the CFAA made important recommendations – notably in the areas of controls – that the Government implemented, including under PAL-2 and PAL-3, and with continued technical assistance from the donor community.

122. Under PAL-2, the government developed a comprehensive program for strengthening public expenditure management. This included actions designed to increase allocative efficiency and transparency in budget formulation; and to strengthen the budget execution system and processes. The government also strengthened the effectiveness of internal and external accountability arrangements. Capital expenditure management processes and systems were aligned with European Union standards. The government also under PAL-2 moved forward with the implementation of the new Financial Management Information System (GMIS) with the long-term aim to expand the GMIS to all spending entities in government.

123. The government under PAL-3 is pursuing the reforms achieved under PAL-2, notably through (i) improving its internal and external audit practices; (ii) introducing performance standards and reporting on performance for services provided by the public sector; (iii) improving public expenditure management processes, including introduction of a medium term fiscal framework; (iv) expanding budgeting program in nearly half the ministries; (v) introducing accountability for results; and (vi) improving further the management of capital expenditures. Under PAL-3, the government is also deepening civil service reforms and strengthening accountability of the administrative judiciary system.

124. The government under PAL-3 is continuing the reform agenda, notably through (i) introducing performance standards and reporting on performance for services provided by the public sector, and development and publication of client charters in various national and 3 sub-national administrations; (ii) improved public expenditure management processes, including introduction of a medium term fiscal framework, expansion of program budgeting in nearly half

of all the ministries, introduction of accountability for results, and improved management of capital expenditures. Under PAL-3, the government has also deepened civil service reforms, notably by strengthening competitiveness and de-politicization of the civil service, enhancing accountability and transparency in civil service, increasing the efficiency of resolution of commercial disputes, and strengthening the administrative justice system.

125. **Compliance with Bank Policies.** The loan complies with all applicable Bank policies.

Benefits and Risks

126. **Benefits.** There are five distinct but complementary benefits. First, PAL-3 provides continuing technical advice as well as financial assistance to help the government achieve the key goals of its medium term economic program: to achieve sustained growth and reduce poverty and unemployment while progressing towards EU accession. Second, the loan supports the strengthening of the institutional arrangements required to ensure successful implementation, coordination, monitoring, and evaluation of ongoing and future medium term programs. Third, PAL-3 lays the groundwork for possible further future Development Policy Loans through identifying specific outcomes to be achieved over the period 2005-07 and preparing and indicating medium term directions of reform. Fourth, PAL-3 complements the government's ongoing investment projects by establishing the enabling policy framework. Fifth, the program supported by the loan complements and reinforces the IMF program to keep Bulgaria on its macroeconomic stabilization path.

127. **Risks.** There are three main risks:

- *Political risk remains high, but is mitigated by the maturity of the reform agenda.* With the outcome of the forthcoming Parliamentary elections as yet uncertain, this presents risks for completing the envisioned legislative changes. Mechanisms established or being established for stakeholder consultation are expected to strengthen support for completing the reforms and could mitigate this to some extent. There are also moderate risks regarding the continuity of reforms in the medium term. The latter risks are mitigated to a significant degree by the strong support from all political parties for Bulgaria's EU accession, which helps to provide an anchor for the remaining structural, institutional and social reforms – and particularly the reforms to public administration and the judiciary. The risks to reforms beyond PAL-3 are further mitigated by the advanced stage of implementation of several of the structural reforms, for which the foundation was established under earlier PALs. Finally, accompanying social protection measures have further mitigated the risks for these reforms.
- *Implementation risks from weak capacity remain* for completing the PAL-3 reforms but also for continuing reforms beyond the PALs. The institutional capacity is uneven across government agencies and the impact of the institutional reforms supported by the PALs is only beginning to be felt. The track record under the PAL program to date, however, bodes well for completing and continuing the ongoing reforms. The risk is further mitigated by implementation support for ongoing investment projects, from the Bank and other donors, in key areas of the reform program.
- *The economy faces risks and vulnerabilities.* Bulgaria faces several potential risks. The economy is vulnerable to several parameters including further increases in oil prices, higher interest rates, lower than expected FDI flows, and a weaker than expected growth in EU economies (the destination of over 50 percent of Bulgarian exports and the origin of more than half of the FDI inflows.) Domestic vulnerabilities include the degree of effectiveness of measures undertaken to address the rapid growth of credit to the non-government sector, the

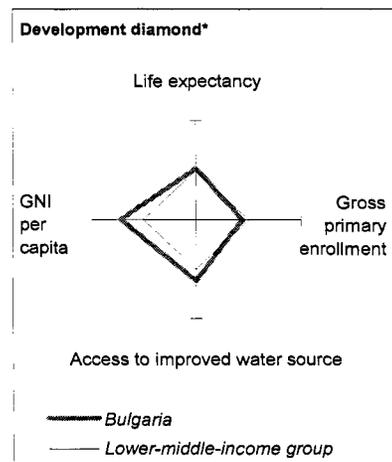
failure to enhance domestic market flexibility consistent with the CBA, and the electoral cycle's potential pressures on the budget. However, Bulgaria's sustained track record to date, its better than expected performance in 2004, and its active management of its external debt, continuation of prudent fiscal policies, and solid growth performance reduce the scope of these vulnerabilities. The mitigation of these risks is predicated on the continued maintenance of strict discipline in macroeconomic policies and the measures in place to respond to potential risks if these were to materialize.

Bulgaria at a glance

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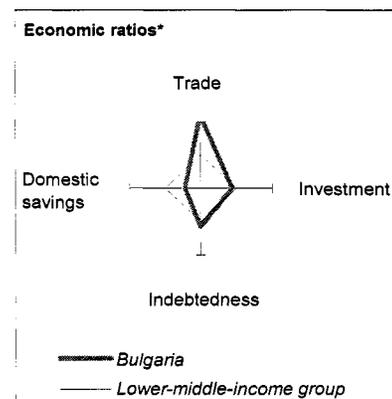
POVERTY and SOCIAL

	Bulgaria	Europe & Central Asia	Lower-middle-income
2003			
Population, mid-year (millions)	7.8	473	2,655
GNI per capita (Atlas method, US\$)	2,130	2,570	1,480
GNI (Atlas method, US\$ billions)	16.6	1,217	3,934
Average annual growth, 1997-03			
Population (%)	-1.0	0.0	0.9
Labor force (%)	-0.8	0.2	1.2
Most recent estimate (latest year available, 1997-03)			
Poverty (% of population below national poverty line)	13	..	..
Urban population (% of total population)	70	63	50
Life expectancy at birth (years)	72	69	69
Infant mortality (per 1,000 live births)	14	31	32
Child malnutrition (% of children under 5)	..	..	11
Access to an improved water source (% of population)	100	91	81
Illiteracy (% of population age 15+)	1	3	10
Gross primary enrollment (% of school-age population)	99	103	112
Male	101	104	113
Female	98	102	111



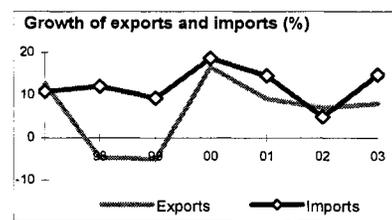
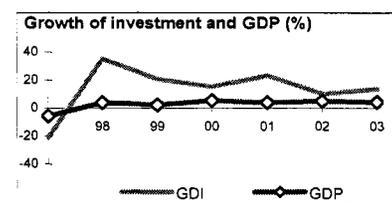
KEY ECONOMIC RATIOS and LONG-TERM TRENDS

	1983	1993	2002	2003
GDP (US\$ billions)	17.0	10.8	15.6	19.9
Gross domestic investment/GDP	32.9	15.3	19.8	21.7
Exports of goods and services/GDP	37.1	38.2	53.1	53.2
Gross domestic savings/GDP	33.1	7.7	13.2	12.0
Gross national savings/GDP	..	5.9	14.9	12.9
Current account balance/GDP	0.2	-10.1	-5.3	-8.4
Interest payments/GDP	0.6	1.7	2.0	2.0
Total debt/GDP	10.3	112.4	72.2	66.7
Total debt service/exports	3.0	6.2	13.4	11.4
Present value of debt/GDP	..	..	69.1	..
Present value of debt/exports	..	..	128.5	..
	1983-93	1993-03	2002	2003
(average annual growth)				
GDP	-0.4	1.0	4.9	5.3
GDP per capita	0.2	1.9	5.5	4.9
Exports of goods and services	-20.7	7.3	7.0	8.0



STRUCTURE of the ECONOMY

	1983	1993	2002	2003
(% of GDP)				
Agriculture	14.5	9.9	10.7	10.0
Industry	60.3	32.7	25.6	26.2
Manufacturing	..	..	15.4	16.0
Services	25.2	57.4	63.7	63.8
Private consumption	50.9	73.5	68.8	69.0
General government consumption	15.5	18.9	18.0	19.0
Imports of goods and services	36.9	45.8	59.8	63.0
	1983-93	1993-03	2002	2003
(average annual growth)				
Agriculture	-3.9	6.3	5.5	-1.3
Industry	-1.5	-0.8	4.6	7.1
Manufacturing	..	4.8	6.5	11.2
Services	0.6	-0.8	5.1	3.5
Private consumption	-0.9	1.3	3.6	6.4
General government consumption	-0.4	-0.8	4.9	7.2
Gross domestic investment ¹	-5.1	8.2	10.3	13.8
Imports of goods and services	-23.1	10.3	4.9	14.8



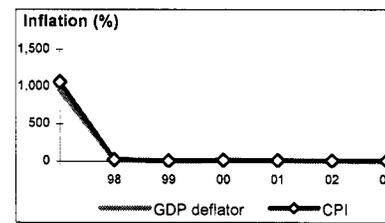
Note: 2003 data are preliminary estimates.

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

1. Refers to gross domestic fixed investment.

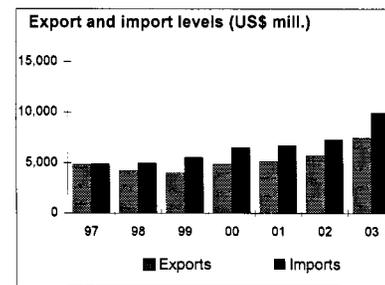
PRICES and GOVERNMENT FINANCE

	1983	1993	2002	2003
Domestic prices				
(% change)				
Consumer prices	..	72.8	5.8	2.3
Implicit GDP deflator	-0.6	51.1	3.8	2.1
Government finance				
(% of GDP, includes current grants)				
Current revenue	..	39.4	38.4	40.2
Current budget balance	..	-9.3	2.3	2.6
Overall surplus/deficit	..	-11.3	-0.6	0.0



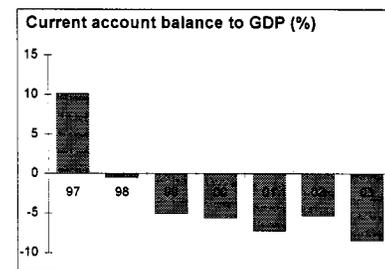
TRADE

	1983	1993	2002	2003
(US\$ millions)				
Total exports (fob)	..	3,726	5,692	7,445
Consumer goods	2,002	2,725
Investment goods	753	1,018
Manufactures
Total imports (cif)	..	4,981	7,287	9,923
Food	218	237
Fuel and energy	1,451	1,745
Capital goods	..	1,333	1,823	2,546
Export price index (1995=100)	..	93	82	92
Import price index (1995=100)	..	95	76	86
Terms of trade (1995=100)	..	99	108	107



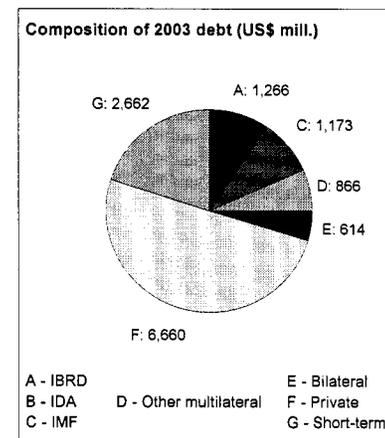
BALANCE of PAYMENTS

	1983	1993	2002	2003
(US\$ millions)				
Exports of goods and services	9,885	4,898	8,057	10,609
Imports of goods and services	9,829	5,841	9,170	12,487
Resource balance	56	-943	-1,113	-1,878
Net income	-127	-192	-261	-489
Net current transfers	109	37	547	692
Current account balance	38	-1,098	-827	-1,676
Financing items (net)	164	808	1,555	2,572
Changes in net reserves	-202	290	-729	-896
Memo:				
Reserves including gold (US\$ millions)	..	960	4,747	6,705
Conversion rate (DEC, local/US\$)	0.002	0.0276	2.1	1.7



EXTERNAL DEBT and RESOURCE FLOWS

	1983	1993	2002	2003
(US\$ millions)				
Total debt outstanding and disbursed	1,739	12,178	11,245	13,241
IBRD	..	158	958	1,266
IDA	..	0	0	0
Total debt service	300	309	1,121	1,248
IBRD	..	12	78	93
IDA	..	0	0	0
Composition of net resource flows				
Official grants	..	0	142	142
Official creditors	..	242	-129	-9
Private creditors	..	-34	483	642
Foreign direct investment	..	40	600	1,153
Portfolio equity	..	0	-23	-2
World Bank program				
Commitments	..	178	50	218
Disbursements	..	3	39	185
Principal repayments	..	0	37	50
Net flows	..	3	2	135
Interest payments	..	12	41	42
Net transfers	..	-9	-39	92



Bulgaria Social Indicators

	Latest single year			Same region/income group	
	1970-75	1980-85	1997-03	Europe & Central Asia	Lower-middle-income
POPULATION					
Total population, mid-year (<i>millions</i>)	8.7	8.9	7.8	472.7	2,655.2
Growth rate (% <i>annual average for period</i>)	0.5	0.2	-1.0	0.0	0.9
Urban population (% <i>of population</i>)	57.5	64.5	69.8	62.6	49.7
Total fertility rate (<i>births per woman</i>)	2.2	2.0	1.3	1.6	2.1
POVERTY					
<i>(% of population)</i>					
National headcount index	..	..	12.8	..	..
Urban headcount index	..	..	..	..	..
Rural headcount index	..	..	..	..	..
INCOME					
GNI per capita (<i>US\$</i>)	..	1,980	2,130	2,570	1,480
Consumer price index (<i>1995=100</i>)	..	..	4,008	..	..
Food price index (<i>1995=100</i>)	..	..	..	..	..
INCOME/CONSUMPTION DISTRIBUTION					
Gini index	..	..	31.9	..	..
Lowest quintile (% <i>of income or consumption</i>)	..	..	6.7	..	..
Highest quintile (% <i>of income or consumption</i>)	..	..	38.9	..	..
SOCIAL INDICATORS					
Public expenditure					
Health (% <i>of GDP</i>)	..	..	3.9	4.3	2.6
Education (% <i>of GNI</i>)	..	..	..	4.3	4.0
Social security and welfare (% <i>of GDP</i>)	..	..	13.6	..	..
Net primary school enrollment rate					
<i>(% of age group)</i>					
Total	96	96	90	..	91
Male	96	96	91	..	92
Female	97	96	90	..	91
Access to an improved water source					
<i>(% of population)</i>					
Total	..	..	100	91	81
Urban	..	..	100	96	94
Rural	..	..	100	82	70
Immunization rate					
<i>(% of children ages 12-23 months)</i>					
Measles	..	99	90	93	78
DPT	..	99	94	92	84
Child malnutrition (% <i>under 5 years</i>)	..	..	..	..	11
Life expectancy at birth					
<i>(years)</i>					
Total	71	71	72	69	69
Male	69	68	69	64	67
Female	74	75	75	73	71
Mortality					
Infant (<i>per 1,000 live births</i>)	28	20	14	31	32
Under 5 (<i>per 1,000</i>)	32	24	16	37	40
Adult (15-59)					
Male (<i>per 1,000 population</i>)	172	190	239	317	214
Female (<i>per 1,000 population</i>)	106	106	103	137	135
Maternal (<i>per 100,000 live births</i>)	..	..	32	..	..
Births attended by skilled health staff (%)	..	..	99	..	..

CAS Annex B5. This table was produced from the CMU LDB system.

11/29/04

Note: 0 or 0.0 means zero or less than half the unit shown. Net enrollment rate: break in series between 1997 and 1998 due to change from ISCED76 to ISCED97. Immunization: refers to children ages 12-23 months who received vaccinations before one year of age.

Bulgaria - Selected Indicators Table

Base-case (most likely) projection

	<i>Actual</i>			<i>Estimate</i>		<i>Projection</i>			
	1999	2000	2001	2002	2003	2004	2005	2006	2007
Part A: Main Macro Aggregates									
<i>Annual growth rates, calculated from constant 2002 price data</i>									
GDP (mp) per capita	2.9	5.9	7.5	5.5	4.9	6.2	5.9	5.9	5.9
Total consumption per capita	9.4	6.3	7.8	4.1	7.2	5.3	4.6	4.6	4.6
GDP at market prices	2.3	5.4	4.1	4.9	4.3	5.7	5.5	5.5	5.5
Total consumption	8.8	5.7	4.4	3.5	6.6	4.7	4.2	4.2	4.2
Private consumption	9.6	4.4	5.6	3.6	6.4	4.5	4.6	5.9	4.3
Gross domestic investment (GDI)	10.5	13.1	20.2	4.5	16.3	15.9	10.3	11.5	12.1
Gross dom. fixed investment (GDFI)	20.8	15.4	23.3	8.5	13.8	13.5	13.0	15.7	16.4
Exports (GNFS)	-5.0	16.6	10.0	7.0	8.0	10.6	12.2	12.2	12.4
of which Goods	-4.5	20.4	10.6	9.4	18.0	8.5	12.8	12.8	12.0
Imports (GNFS)	9.3	18.6	14.8	4.9	14.8	12.0	11.2	11.2	11.2
of which Goods	11.2	17.9	17.7	6.4	22.3	11.4	11.5	10.6	12.7
<i>Savings-investment balances, as percentage of GDP</i>									
Gross Domestic investment	17.9	18.3	20.7	19.8	21.7	23.2	24.7	24.4	25.5
of which Government investment	4.8	4.2	4.0	3.2	3.5	3.9	4.5	4.5	6.0
Foreign savings	5.0	5.6	7.2	5.3	9.3	7.5	7.6	6.9	6.7
Gross national savings	12.9	12.7	13.4	14.5	12.4	15.7	17.1	17.5	18.8
Government savings	4.4	3.2	3.2	2.3	2.6	5.6	5.5	5.0	5.4
Non government savings	8.4	9.5	10.2	12.2	9.7	10.1	11.6	12.6	13.4
Gross domestic savings	12.1	12.9	13.1	13.2	12.0	13.0	14.3	14.6	15.3
<i>Other</i>									
GDP inflation	3.7	6.7	6.7	3.8	2.1	5.1	3.1	3.2	3.2
Annual average exchange rate (LCU/US\$)	1.8	2.1	2.2	2.1	1.7	1.6	1.5	1.5	1.5
Index real average exchange rate (2002=100)	63.3	66.0	..	..	..	..	..	..	..
Terms of trade index (2002=100)	98.6	98.5	108.0	107.5	106.9	109.2	108.0	106.9	106.2
Incremental capital-output ratio (GDI based)	6.5	3.0	4.2	4.1	4.6	3.9	4.4	4.6	4.9
Import elasticity with respect to GDP	4.9	3.3	4.3	1.3	5.2	2.0	2.1	1.9	2.3
Money growth	13.4	30.8	25.8	11.7	19.6	21.6	21.3	18.1	18.1

Bulgaria - Selected Indicators Table (Continued)

Base-case (most likely) projection

	<i>Actual</i>		<i>Estimate</i>			<i>Projection</i>			
	1999	2000	2001	2002	2003	2004	2005	2006	2007
Part B: Government Finance Indicators									
<i>Percentage of GDP</i>									
Total revenues, of which	38.5	38.8	37.6	36.5	38.4	39.0	38.6	38.1	40.2
Tax revenues	29.2	29.9	28.7	27.4	29.8	31.0	30.7	30.6	30.4
Total expenditures, of which	38.3	39.4	38.2	37.1	38.4	37.3	37.6	37.6	40.8
Consumption	16.2	15.7	13.8	14.3	14.7	14.6	13.8	13.8	13.8
Deficit(-)/Surplus(+)	0.2	-0.6	-0.6	-0.6	0.0	1.8	1.0	0.5	-0.6
Financing:	-0.2	0.6	0.6	0.6	0.0	-1.8	-1.0	-0.5	0.6
Foreign	1.2	-1.5	-0.3	1.5	0.0	-1.6	-5.0	-0.6	-2.3
Monetary sector	-2.5	1.2	-1.7	-1.5	-0.7	-3.2	-0.3	-1.6	2.9
Other domestic	1.1	0.9	2.6	0.6	0.7	3.1	4.3	1.7	0.0
Total Debt/GDPmp	84.7	80.5	69.8	60.3	48.3	40.7	33.0	30.9	26.8
Total interest payments/Tax revenues	13.0	13.4	12.9	8.0	7.0	5.9	5.5	5.1	5.1
Part C: Debt & Liquidity Indicators									
<i>Total DOD and TDS</i>									
DOD (US\$ millions)	11552	10952	10681	10141	12009	15368	16226	17731	18546
DOD / GDPmp ratio	89.2	86.9	78.6	65.1	60.5	63.3	57.2	56.9	54.8
TDS (US\$ millions)	936	990	1306	1121	1248	2103	1607	1842	2299
TDS / exports (XGS) ratio	15.4	13.5	17.2	13.4	10.6	13.8	8.3	8.7	10.1
Total gross reserves (months' imports G&S)	5.5	5.0	4.7	5.8	5.9	6.4	5.3	5.4	5.2
Part D: External Financing Plan									
<i>(US\$, millions)</i>									
Official capital grants	-2	25	0	0	0	0	0	0	0
Private investment (net)	602	820	886	799	1857	1164	1188	2344	1352
Net Long term borrowing excl IMF	325	109	-54	136	255	1414	654	278	-469
Adjustments to scheduled debt service	0	0	0	0	0	0	0	0	0
All other capital flows	92	24	597	620	637	1087	1169	974	2037
Financing Requirements (incl IMF)	1017	977	1428	1555	2749	3665	3011	3596	2919
of which current account deficit	652	704	984	827	1856	1813	2166	2136	2253

Bulgaria - Key Exposure Indicators

Indicator	Actual			Estimate			Projected		
	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total debt outstanding and disbursed (TDO) (US\$m) ^a	11552	10952	10681	10141	12009	15368	16226	17731	18546
Net disbursements (US\$m) ^a	666	492	123	375	1960	1623	259	394	303
Total debt service (TDS) (US\$m) ^a	936	990	1306	1121	1248	2103	1607	1842	2299
Debt and debt service indicators (%)									
TDO/XGS ^b	190.6	149.6	140.8	121.1	102.4	100.7	84.1	83.5	81.3
TDO/GDP	89.2	86.9	78.6	65.1	60.5	63.3	57.2	56.9	54.8
TDS/XGS	15.4	13.5	17.2	13.4	10.6	13.8	8.3	8.7	10.1
Concessional/TDO	1.9	3.3	3.2	0.0	0.0	0.0	0.0	0.0	0.0
IBRD exposure indicators (%)									
IBRD DS/public DS	7.6	8.4	6.8	8.5	11.2	7.0	6.3	11.1	9.5
Preferred creditor DS/public DS (%) ^c	34.9	40.2	50.8	51.3	51.7	23.2	29.8	60.2	45.9
IBRD DS/XGS	1.1	1.0	1.1	0.9	0.8	0.7	0.6	0.6	0.7
IBRD TDO (US\$m) ^d	829	824	844	958	1266	1498	1601	1663	1754
Of which present value of guarantees (US\$m)									
Share of IBRD portfolio (%)	0.7	0.7	0.7	0.8	1.1	1.3	1.5	1.5	1.6
IDA TDO (US\$m) ^d	0	0	0	0	0	0	0	0	0
IFC (US\$m)									
Loans									
Equity and quasi-equity /c									
MIGA									
MIGA guarantees (US\$m)									

a. Includes public and publicly guaranteed debt, private nonguaranteed, use of IMF credits and net short-term capital.

b. "XGS" denotes exports of goods and services, including workers' remittances.

c. Preferred creditors are defined as IBRD, IDA, the regional multilateral development banks, the IMF, and the Bank for International Settlements.

d. Includes present value of guarantees.

e. Includes equity and quasi-equity types of both loan and equity instruments.

BULGARIA: THIRD PROGRAMMATIC ADJUSTMENT LOAN (PAL-3)
LETTER OF DEVELOPMENT POLICY

May 3, 2005

Mr. James D. Wolfensohn
President
International Bank for Reconstruction and Development
Washington D.C.

Dear Mr. Wolfensohn:

1. We appreciate this opportunity to request continuing support from the World Bank for the implementation of our medium term reform strategy, and, on behalf of the Government of Bulgaria, we request a Third Programmatic Adjustment Loan (PAL-3) for US \$150 million equivalent to complete the series of three annual programmatic loans. We continue to believe that the Programmatic Adjustment Loans (PALs) provide the appropriate vehicle for Bank support in addressing our medium term policy and institutional reform agenda.

2. Building on the reforms of the previous four years, our medium term program between 2002 and 2005 has aimed to sustain economic growth and further reduce poverty while moving us towards EU accession. We are generally on track in terms of meeting our program targets established in PAL-1: the achievement of average annual growth rates of 4.5-5.0 percent during 2002-05, the reduction of the unemployment rate from 18.1 percent in 2001 to 12-14 percent by end-2005, and the reduction of the poverty rate by 50 percent by end-2005 compared to the level at end-2001. Our strategy for growth and poverty reduction continues to revolve around two major themes:

- *Creating an investment climate* that promotes private sector investment, restructuring, and productivity leading to growth, and
- *Empowering the population*, especially the poor, to participate in economic growth.

3. To implement our growth and poverty-reduction strategy, we continue to base our medium term reform program on five pillars:

- *Sustaining structural reforms* in the enterprise sector, focusing on the completion of privatization and the restructuring of the energy, railway, telecommunications, and water sectors;
- *Establishing a market-friendly business environment*, focusing on reducing entry constraints, accelerating exits, securing deregulation and reducing regulatory costs, improving the delivery of public services to business, improving the competitive environment, and improving labor market policies;
- *Deepening the financial system*, improving the legal framework for lending, completing banking reform, and developing financial markets;
- *Improving public sector governance*, strengthening the public administration capacity, improving service delivery, reducing corruption, strengthening accountability and transparency, strengthening public expenditure management, and increasing the efficiency and effectiveness of the judicial system; and

- *Investing in human capital and strengthening social protection*, improving quality, access and efficiency in education and health, continuing pension reforms, increasing social assistance effectiveness, providing for better integration of the disabled, and reducing the institutionalization of children.

4. With the support of the PALs, we have made substantial progress towards meeting or exceeding the objectives of our medium term structural reform program. We have maintained average annual growth rates during 2002-05 at 5.1 percent and have reduced unemployment dramatically. Poverty is also falling and living standards are gradually improving. We have completed the European Union (EU) accession negotiations. We signed the accession treaty on April 25 2005, and we expect to join the union in 2007, as planned.

5. We have maintained macroeconomic stability as a precondition for the effectiveness and sustainability of the above program. We will maintain the Currency Board Arrangement (CBA) until accession to the European Monetary Union (EMU). 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. We will continue to implement a cautious and flexible fiscal policy, which is a key to safeguarding external viability under the CBA. We have aimed to reach, and then maintain, a broadly balanced fiscal stance in the medium term, remaining prepared to adjust our fiscal policy in case of further widening of the external current account deficit.

6. On August 6, 2004 the IMF Board approved a 25-month precautionary Stand-By Arrangement (SBA), equivalent to SDR100 million to support the government's economic program for 2004-06. For 2005, we have made a commitment to run an overall fiscal surplus of at least 1 percent of GDP while maintaining the flexibility of 1 percent of GDP if external current account deficits should widen beyond, or FDI flows fall short of those expected in our program, or if tighter fiscal policy should be required by such domestic developments as further acceleration of inflation. The Bulgarian National Bank has also taken actions in the banking sector to control the rapid credit growth.

7. In the course of preparing the Third Programmatic Adjustment Loan (PAL-3), we have further developed and implemented various components of our reform program as initially defined during the preparation of the first two PALs. The final design of PAL-3 has benefited from a strong monitoring and evaluation system, implemented in coordination with the Bank. This has enabled us to take actions necessary to ensure the sustained implementation of policies and the successful outcomes of institution-building efforts. The programmatic approach has provided us with the flexibility to make sound adjustments in our program and to build on new information and additional experience in institutional design and implementation in moving towards the successful achievement of our strategic objectives and program outcomes.

8. This Letter of Development Policy summarizes the elements of our program supported by PAL-3 in completing the program as envisioned, 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. We believe that the key policy anchors for Bulgaria will continue to be firmly in place beyond the forthcoming elections, including Bulgaria's accession to the EU by January 2007, and the CBA, which has broad political support, and we anticipate that Bulgaria will continue to sustain and build on the achievements of the three PALs, beyond our own political mandate, which ends in June.

Pillar I: Sustaining Structural Reforms.

9. With PAL-3 we have nearly completed our reform agenda for Pillar I and have exceeded many targets, especially in privatization. We have nearly completed our privatization program, which has focused on infrastructure State Owned Enterprises (SOEs). We have completed our envisioned plans to fundamentally overhaul the energy sector through completing our tariff adjustment program as envisioned, and have exceeded our targets for private sector entry in the energy and telecommunications sectors. We have continued to undertake actions to improve the fiscal sustainability of railways.

10. Bulgaria's medium term focus will be on addressing infrastructure bottlenecks, particularly in water and in transport. In the water sector, we recognize an apparent contradiction between our strategy to promote public-private ventures and our efforts to effectively absorb EU grant funds. We are urgently committed to resolving this dilemma.

Pillar II: Establishing a Market-friendly Business Environment

11. While the liquidation of loss-making SOEs and the implementation of the privatization program have increased productivity, we are aware that future growth requires the continued implementation of reforms aimed at establishing a business environment that is conducive to the emergence and growth of dynamic private sector enterprises. We have made considerable progress under the PAL program and PAL-3 in improving the business environment, in particular through deregulation and improvements in the efficiency of front line government services to businesses – including customs offices and services for foreign investors. It is important to note that, under PAL-3, we have taken significant steps to improve the conditions for the entry of new firms.

12. Bulgaria's medium term focus will continue to include actions that will improve the business climate for the entry, exit and operation of new firms. In particular, we are committed to completing the reforms in business entry initiated under PAL-3, and will enact during the last quarter of 2005, the legislation needed to transfer business registration from the courts and judges to a non-judicial administrative process.

Pillar III: Deepening the Financial System

13. In order to focus Bank assistance on other more pressing areas, we did not request support under PAL-3 on this pillar of our program. We have now fully developed our institutional framework for the Banking sector, as we move forward, financial sector reforms will focus mainly on non-banks.

Pillar IV: Improving Public Sector Governance

14. Under PAL-3, we have begun to implement the broad program to improve public sector governance that we developed in the earlier PALs. We have made particularly important strides in professionalizing our civil service. All newly recruited civil servants (at the national and regional levels) were recruited through external competitive recruitment in 2004. We have also increased the competitiveness of civil service pay and have implemented performance rewards throughout our civil service. In addition, we have significantly increased accountability and

transparency in the civil service and under PAL-3 we have adopted a code of ethics that will improve administrative procedures, reduce inappropriate discretion on the part of the civil service, and clarify accountability arrangements. Under PAL-3, we have also taken important steps to further improve the transparency and accountability of the judiciary, as well as to significantly increase the efficiency of dispute adjudication processes through promoting alternative dispute resolution mechanisms, expanding the administrative courts system, and enhancing the quality of legal services.

15. Notwithstanding these achievements – which provide a good platform for continuing the significant institution and capacity building agenda that is ahead of us as we prepare for successful integration into the EU – we acknowledge that we are still only about a year and a half into what is typically at least a four or five year reform agenda. We realize that the numerous legislative changes adopted in the past two years will require serious implementation efforts in order to bring about visible improvements in the functioning of our public services and our courts system. We are fully committed to pressing ahead with our efforts in governance reforms, including depoliticizing the civil service, reducing corruption, rationalizing and reorganizing our government structures and improving public service delivery at the central and local levels, improving the effectiveness of public expenditure management, and moving forward aggressively with establishing a more accountable and independent judiciary.

Pillar V: Investing in Human Capital and Strengthening Social Protection

16. Under PAL-3 we have completed the implementation of our action plan for pension reform defined in PAL-1, and have increased the stability and robustness of our pension system. It is important to note that we have launched significant reforms in health and education. In education, we have taken significant steps to increase the integration of children from ethnic minorities into schools, and to reduce incentives for dropping out of primary education. In health care, we have focused our efforts especially in the hospital sector, making significant advances in improving financing mechanisms and in launching the restructuring of hospitals to align services with the health care needs of the population. We have also strengthened the institutional structures and capacity to improve public health outcomes and reduce the incidence of tobacco-related health risks. Finally, we have made important strides to address social inclusion through our reforms in the area of disability and child protection.

17. EU accession brings with it the need for Bulgaria to position itself to compete in a global marketplace, to develop human capital capable of adapting to an increasingly dynamic work environment, and to increase social inclusion and reduce disparities. We are aware that we have a large agenda ahead to fully implement the reforms that we have initiated in order to improve the quality of our health and education services while improving their efficiency and fiscal sustainability, and that visible improvements will need persistent efforts over several years. In the case of education and training, we will press ahead with our strategy to increase the relevance of the skills of current and future entrants into the labor force while aligning our governance and financing structures to support these objectives. In the case of health care, we will complete the restructuring of our hospital sector to improve quality and fiscal sustainability. The future reform agenda will also need to aggressively address issues of access, informal payments and corrupt practices, and to define future directions for health insurance to improve its financial sustainability. We expect to revise our legislation to support these strategic directions in health and education in the coming year. Finally, we will fully implement the reforms that we have

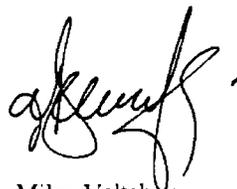
started to date – to reduce the social exclusion of minorities, to integrate the disabled into the labor force, and to reduce the institutionalization of children and other vulnerable groups.

18. We would like to reiterate that the Bulgarian Government is committed to accelerating reforms and, in particular, to sustaining and continuing the reform agenda needed for the EU accession as defined above. A new government program will further define the specific actions in the months ahead. We look forward to the World Bank's supporting Bulgaria in its development program including through development policy loans focusing on the future reform agenda for successful integration into the EU.

Sincerely yours,



Milko Kovachev
Minister of Economy



Milen Velchev
Minister of Finance

Sofia, Bulgaria
May 3, 2005

**BULGARIA: THIRD PROGRAMMATIC ADJUSTMENT LOAN (PAL-3)
PERFORMANCE BENCHMARKS (APRIL 22, 2005 VERSION)**

Goals	PAL-1	PAL-2	PAL-3	Desired Outcomes	Status of Desired Outcomes
	PILLAR I: SUSTAINING STRUCTURAL REFORMS				
Rationalizing of the role of the State by privatizing activities that can be performed by the private sector	<ul style="list-style-type: none"> Enactment of a new <i>Law on Privatization and Post Privatization Control</i> <i>Privatization of Biochim and DZI</i> 	<ul style="list-style-type: none"> <i>Privatization or liquidation of the large SOEs listed in Annex 6B</i> Privatization or liquidation of 50% of remaining small SOEs as of September 30, 2002 	<ul style="list-style-type: none"> <i>Privatization or liquidation of the large SOEs listed in Annex 6B</i> Privatization or liquidation of 80% of the remaining small SOEs as of September 30, 2002 	By end-2005, the only remaining SOEs would be those listed in Annex 6A	Privatization program near completion. Private sector share of GDP in 2002: 70%; 2003: 75%, mid-2004: 75% (EBRD); Process is under way for most of the few remaining large deals; As of February 2005 there are only 90 unsold enterprises - (majority packages) compared to total number of the enterprises already privatized of 2883; 1225 minority packages sold between January 1 2004 and February 28, 2005.
Improving in efficiency of energy services and preparing energy sector for EU accession	<ul style="list-style-type: none"> Enactment of amendments to the <i>Energy and Energy Efficiency Act (EEEA)</i> Establishment of electricity distribution, generation and transmission companies as separate legal entities Adoption by the Council of Ministers (CoM) of key regulations on electricity pricing and contracting of power by eligible consumers 	<ul style="list-style-type: none"> <i>Enactment of energy legislation consistent with EU Electricity & Gas Directives</i> Adoption of additional regulations to support electricity market opening including pricing methodology for access to transmission, dispatch and other system services Satisfactory implementation of the electricity tariff adjustment program Continued satisfactory implementation of the heating component of the Energy Strategy approved by the COM on May 11, 2002 Government launch of a strategy for private sector participation in the power generation sector Approval of a restructuring plan defining NEK's prospective role in the electricity market structure Preparation by State Energy 	<ul style="list-style-type: none"> Continued satisfactory implementation of the electricity tariff adjustment program Continued satisfactory implementation of district heating component of the Energy Strategy approved by the COM on May 11, 2002 Government launch of a strategy for private sector participation in the power generation sector Approval of a restructuring plan defining NEK's prospective role in the electricity market structure Preparation by State Energy 	In 2005, energy intensity of GDP would reduce by 15% compared to the level in 2001	Energy intensity of GDP fell by 9% between 2001 and 2003; forecasted decline in 2004 is 11%. (in tons of oil equivalent per thousand 1995 US\$).

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**BULGARIA: THIRD PROGRAMMATIC ADJUSTMENT LOAN (PAL-3)
PERFORMANCE BENCHMARKS (APRIL 22, 2005 VERSION)**

Goals	PAL-1	PAL-2	PAL-3	Desired Outcomes	Status of Desired Outcomes
Improving efficiency of the railway sector resulting in a decrease in railway subsidies	<ul style="list-style-type: none"> Implementation of an average price increase of 20 percent for household electricity prices in the second half of 2002 and approval of an indicative timetable for their adjustment to cost-recovery levels Satisfactory implementation of the district heating component of the Energy Strategy approved by the COM on May 11, 2002 SERC development of a strategy for issuing tenders to develop the low-pressure gas market 	Strategy approved by the COM on May 11, 2002	Regulatory Commission of a schedule for the (i) phasing out of the cross subsidy (the lower first block) in the electricity and heat tariffs for households; and (ii) related adjustment of the energy subsidy program to provide adequate protection for the affected low-income households	By end-2005, decrease in operating subsidies (excluding funds for investment) from 0.5% of GDP in 2000 to 0.2% of GDP	Operating subsidies have fallen from 0.5% of GDP in 2000 to 0.2% of GDP in 2004
	<ul style="list-style-type: none"> Creation of new railway operating company as joint stock company which has commercial objectives and autonomous decision making Creation of new railway infrastructure company as an independent public agency required to comply with 	<ul style="list-style-type: none"> Adoption by the railway operating company of a long term development strategy and formulation by the infrastructure company of a long term business plan ; recruitment by the railway operating company of a consultant for assisting in the preparation of a sound medium term business plan, including optimization of services 	<ul style="list-style-type: none"> Implementation of actions to improve financial sustainability of railways including (i) adoption and initial implementation of CoM decision to terminate services on and close 250 km of uneconomic lines; (ii) termination of 9% of passenger services; and (iii) continued staff reductions bringing cumulative total to 13% as of end-2004 	<p>By end-2005, increase in overall railway labor productivity by 16% compared to the level at end-2001</p> <p>By end-2005, achievement of financial working ratios of: 95% by the railway freight</p>	<p>Overall railway labor productivity increased by 12% by end-2004 compared to 2001</p> <p>Working ratios as of end 2004:</p> <ul style="list-style-type: none"> Freight services – 101%

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**BULGARIA: THIRD PROGRAMMATIC ADJUSTMENT LOAN (PAL-3)
PERFORMANCE BENCHMARKS (APRIL 22, 2005 VERSION)**

Goals	PAL-1	PAL-2	PAL-3	Desired Outcomes	Status of Desired Outcomes
	<p>minimum economic criteria for its expenditures</p> <ul style="list-style-type: none"> Issuance by the Ministry of Transport and Communications of regulations that (i) ensure that any willing and competent railway service supplier may be licensed; (ii) provide fair and transparent rules for track access; and (iii) keep transaction costs low for any prospective service supplier Preparation of sound plan of action for rationalization of rail network and operations 	<ul style="list-style-type: none"> Adoption of plans for accounting and organizational separation between the freight and passenger parts of the railway operating company Increase in the cost recovery level of intercity passenger services to at least 70% Framework contract between the government and the operating company for non-commercial services that will be subject to PSO finalized and being processed for government approval Formulation by the railway infrastructure company of improved systems and procedures for planning/budgeting expenses Termination of 199 km of loss-making services Reduction of railway labor force by around 10% compared to the level at end of 2001 	<p>compared to end-2001; resulting in achievement of subsidy of 0.2% of GDP and financial working ratio of 100% in 2004.</p> <ul style="list-style-type: none"> Railway operating companies given full freedom to set passenger fares and freight tariffs in accordance with sound commercial principles (except in cases of public service contracts) Track access charges set using common tariff framework for both passenger and freight operating companies to remove cross subsidization, effective as of October 1, 2004 Preparation of an overall transportation policy, clarifying the role of the state in railway and road infrastructure investments Signing of the contract between the Ministry of Transport and Communications, and the operating company for all non-commercial passenger services that will be subject to Public Service Contracts (PSC), effective as of January 1, 2005 Full accounting separation between the freight and passenger parts of the 	<p>services; 100% by the railway infrastructure company (without any government subsidies); and 100% by the railway passenger services (including full payment by the government for public service contracts)</p> <p>By end-2005, achievement by the railway freight operating company of a debt service ratio of 1.5 times</p>	<ul style="list-style-type: none"> Passenger services - 99% Railway operating company -- 100% <p>Debt Service Coverage Ratio for freight services as of end-2004: 2.9 times</p>

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**BULGARIA: THIRD PROGRAMMATIC ADJUSTMENT LOAN (PAL-3)
PERFORMANCE BENCHMARKS (APRIL 22, 2005 VERSION)**

Goals	PAL-1	PAL-2	PAL-3	Desired Outcomes	Status of Desired Outcomes
Liberalizing the telecommunications market	<ul style="list-style-type: none"> Implementation of Chapter 19 EU accession commitments Establishment of an independent, transparent, and accountable regulator for the telecommunications sector – the Communications Regulation Commission (CRC) <i>Issuance and implementation of a privatization strategy for BTC that ensures no extension of BTC exclusivities</i> Satisfactory progress in BTC tariff rebalancing Submission to National Assembly of draft New Telecommunications Law 	<ul style="list-style-type: none"> Preparation of analysis of competition in the market, including effective broadband access and competition, leased line access, carrier selection, indirect access, and provision of universal service Satisfactory progress on implementing EU accession commitments Enactment of New <i>Telecommunications Law</i> Decision to approve execution of BTC privatization transaction documents Adoption and satisfactory implementation of CRC institutional development plan, including its financial independence Satisfactory progress on promulgation of primary and secondary legislation ensuring the legal recognition of electronic contracts and personal data protection in electronic communications 	<p>railway operating company</p> <ul style="list-style-type: none"> Increase in cost recovery level of intercity passenger services to at least 80% including infrastructure charges based on full marginal cost. Continued satisfactory progress on implementing EU accession commitments COM approval of an updated sector policy and implementation action plan in accordance with <i>acquis</i> 2002 Continued satisfactory implementation of CRC institutional development plan 	<p>By end 2005, the degree of digitalization of transfer network will be 100%, of transit exchanges 82% and of fixed telephone network subscribers 46%; the number of households with telecommunications services allowing internet access will be 94%; telephone connection waiting time will not exceed one month.</p>	<p>In October 2004, degree of digitalization of:</p> <ul style="list-style-type: none"> Transfer network: 94% Exchanges: International: 100% Transit: 79% <p>Fixed network subscribers 32.74%</p> <p>In 2004, 94 % of households had access to telecommunications services allowing internet access</p> <p>In end-2004, telephone connection waiting time for new applications is about 65 days</p>

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**BULGARIA: THIRD PROGRAMMATIC ADJUSTMENT LOAN (PAL-3)
PERFORMANCE BENCHMARKS (APRIL 22, 2005 VERSION)**

Goals	PAL-1	PAL-2	PAL-3	Desired Outcomes	Status of Desired Outcomes
Modernizing the water sector	<ul style="list-style-type: none"> Submission to National Assembly of amendments to the <i>Water Law</i> supporting the restructuring and decentralization of the Regional Water Companies 	<ul style="list-style-type: none"> COM approval of a Water Sector Strategy COM approval and submission to National Assembly of <i>Water Regulatory Law</i> to provide appropriate regulatory framework for the water sector COM approval to approach for securing private sector involvement in the management of water companies in Varna and Shumen 	<ul style="list-style-type: none"> Enactment of <i>Water Regulatory Law</i> 	By end-2005, reduction of the operating ratios (operating costs including depreciation to total revenues) of water companies to 86%	In 2004, operating ratio of water companies is 88%, reflecting improved efficiency since 2002 when they were 90% (107 % in 1996)
Mitigating environmental risks	<ul style="list-style-type: none"> <i>Enactment of a new Environment Protection Act</i> Enactment of <i>Biodiversity Law</i> 	<ul style="list-style-type: none"> Satisfactory implementation of environmental policies on SOEs to be privatized Development and issuance of regulation on Environmental Impact Assessment Development of a system of issuance and control of Integrated Pollution and Control Permits (IPPC) 	<ul style="list-style-type: none"> By end-2005, issuance of 20 integrated environmental permits under the IPPC directive By end-2007, issuance of permits to all enterprises covered by the IPPC directive 	7 integrated environmental permits had been issued by November 10, 2004, applications for issuing 90 have been submitted (Approximately 225 permits will be needed to cover all enterprises, depending on the number of functioning enterprises)	
Reducing entry constraints and regulatory costs	<ul style="list-style-type: none"> <i>Submission to National Assembly of a draft Law on Administrative Regulation and Administrative Control on</i> 	<ul style="list-style-type: none"> Enactment of the <i>Law on Administrative Regulation and Administrative Control on Economic Activities</i> Development by the COM of guidelines to 	<ul style="list-style-type: none"> Elimination or modification of licensing, permit and registration requirements to complete 83% of the program approved by the CoM on June 7, 2002 Approval by the Council for 	<ul style="list-style-type: none"> During 2002-05, FDI inflows of US\$1.0 billion per year By 2005, increase in share of SMEs in valued added and employment to at least 50% 	<ul style="list-style-type: none"> Average FDI inflows of about US\$1.6 billion a year between 2001-04; estimated at US\$2.5 billion in 2004 SME share in

PILLAR II: ESTABLISHING A MARKET-FRIENDLY BUSINESS ENVIRONMENT

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PERFORMANCE BENCHMARKS (APRIL 22, 2005 VERSION)**

Goals	PAL-1	PAL-2	PAL-3	Desired Outcomes	Status of Desired Outcomes
	<p>Economic Activities</p> <ul style="list-style-type: none"> CoM approval of a program for eliminating and restructuring regulatory regimes Development by a working group of a plan for integrating the Bulstat, tax, and social security registration of companies Completion of the baseline Administrative and Regulatory Cost Survey (ARCS) 	<p>central administrative bodies on the design of proposed new regulatory regimes</p> <ul style="list-style-type: none"> <i>Elimination of 40 and modification of 50 regulatory regimes based on program approved by the COM on June 7, 2002</i> Establishment of a comprehensive public registry of regulatory regimes Drafting of the <i>Law on the Bulstat Register</i>, regulating the uniform registration for the purposes of the National Statistical Institute, the Tax Administration, and the National Social Security Institute 	<p>Economic Policy of guidelines to central and municipal administrative bodies on the design of proposed new regulatory regimes, broad dissemination of the guidelines</p> <ul style="list-style-type: none"> <i>Implementation of business registration reform, through (i) enactment of the Law on Bulstat Register introducing single identification number; and (ii) approval by the CoM of a strategy to transfer business registration from the courts and judges into a non-judicial administrative process; and (iii) establishment of a working group including business representatives to draft necessary legislation for the implementation of the strategy</i> 	<p>During 2002-05, total factor productivity increase of 2.5% annually</p> <p>By 2005, private sector share of GDP at least 70 %</p> <p>By end-2005, elimination or modification of at least 50% of regulatory regimes (issued by central administration) existing at mid-2002</p> <p>By end-2006, considerable decrease in the number of procedures and time required for business registration from the present 11 procedures and 32 days to 6 procedures and 10 days.</p> <p>By end-2006, reduced time in resolving commercial disputes from 440 days in January 2004, resulting from the freeing of judges time from business registration routines</p> <p>By 2005, significant reduction of regulatory compliance costs as measured by management time spent on regulatory compliance in the annual ARCS (from 25% in 2002)</p>	<p>employment is increasing continuously: 2000: 50.6% 2001: 51.6% 2002: 53.8% 2003: 56.7%</p> <p>SME share in value added is increasing continuously: 2000: 29.5% 2001: 31.2% 2002: 34.2% 2003: 36.2%</p> <p>Private sector share of GDP has increased from nearly 70% in 2001 to 75% in mid-2004</p> <p>By March 2005, approximately 44% of regulatory regimes (issued by central administrations) existing at mid-2002, have been eliminated or modified.</p> <p>Management time spent on regulatory compliance remained at 25% in 2003</p>
Improving business service delivery by government offices	<ul style="list-style-type: none"> Establishment of a Tax Council to include representatives from the private sector 	<ul style="list-style-type: none"> Introduction of measures for simplification of administrative procedures for regulatory regimes in the construction, tourism 	<ul style="list-style-type: none"> Introduction of measures for simplification of administrative procedures for regulatory regimes: (i) enactment of <i>Health Act</i>, 	<p>Customs revenue increased by 55% by 2005 in comparison with 2001</p> <p>Reduction of processing time</p>	<p>Customs revenue increased by 66% in 2004 compared to 2001 (by 47% in real terms)</p>

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**BULGARIA: THIRD PROGRAMMATIC ADJUSTMENT LOAN (PAL-3)
PERFORMANCE BENCHMARKS (APRIL 22, 2005 VERSION)**

Goals	PAL-1	PAL-2	PAL-3	Desired Outcomes	Status of Desired Outcomes
	<ul style="list-style-type: none"> Implementation of Customs reform in three pilot locations Development of a plan for piloting a system of monitoring service standards in the Directorate for National Building Control at the Ministry of Regional Development and Public Works and the Labor Inspectorate at the Ministry of Labor and Social Policy COM decision to establish a National Revenue Agency 	<ul style="list-style-type: none"> and food processing sectors Implementation of the measures adopted at the TTSE pilot sites also at other border crossing points and internal customs offices in line with the action plan agreed with the government Introduction of a system of monitoring service standards in the Directorate for National Building Control at the Ministry of Regional Development and Public Works and the Labor Inspectorate at the Ministry of Labor and Social Policy Establishment of a National Revenue Agency 	<ul style="list-style-type: none"> (ii) satisfactory progress with development of the strategy and action plan for optimization of the most burdensome regulatory regimes as defined by business Satisfactory progress with introduction of the measures adopted at the TTSE pilot sites at other agreed border crossing points and internal customs offices in line with the action plan agreed with the government Introduction of "one-stop shop" contact support for significant new FDI Satisfactory progress with the implementation of a Revenue Management System for the NRA 	<p>at all participating border crossing points by 20% in 2005</p>	<p>By 2004, processing time for imports in the 3 pilot sites was reduced by between 26-38% compared to 2001 and for exports by between 2.5-56% (the lower values of 26% and 2.5% are reported for 2003 for Guechevo which is undergoing construction since 2004).</p>
Ensuring competition and functioning markets	<ul style="list-style-type: none"> Enactment of the Law on State Aid Submission of amendments to the Law on the Protection of Competition 	<ul style="list-style-type: none"> Adoption by the COM of Regulations for Implementation of the Law on State Aid Implementation of an action plan to upgrade the institutional capacity of the Commission for the Protection of Competition 	<ul style="list-style-type: none"> Enactment of Rules for Implementation of the Law on State Aid Satisfactory progress with implementation of program for improving competitive environment Satisfactory progress with the establishment of legislation aimed at changing the status of the State Reserves to an institution, subject to full public disclosure 	<p>By end-2005, BEEPS survey evidence of increased competitiveness in private sector compared to position in 2002</p> <p>State reserves to act in a transparent manner and in the long run to stop interventions in the grain market, with eventual interventions to be carried out only in connection with EU accession requirements through an EU</p>	<p>Bulgaria closed EU chapter on competition in mid-June 2004</p> <p>Amendments to the State Reserves Act and Grain Storage and Trade Act are submitted to Parliament</p>

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**BULGARIA: THIRD PROGRAMMATIC ADJUSTMENT LOAN (PAL-3)
PERFORMANCE BENCHMARKS (APRIL 22, 2005 VERSION)**

Goals	PAL-1	PAL-2	PAL-3	Desired Outcomes	Status of Desired Outcomes
<p>Promoting flexibility in the labor market</p>	<ul style="list-style-type: none"> Initiation of actions implementing the Social Policy Strategy and Strategic Note on Labor Market Reforms Development of a set of indicators on labor market flexibility and ALMP impact 	<ul style="list-style-type: none"> <i>Approval by CoM and submission to National Assembly of amendments to the Labor Code agreed with Bank (including specific anti-discrimination provisions); enactment of Anti-discrimination Law</i> COM approval of regulation to secure improved representation of employers and employees in tri-partite arrangements Elimination of regulatory and bureaucratic barriers to private provision of employment services through amendment to <i>Employment Promotion Act</i> 	<ul style="list-style-type: none"> Implementation of measures to increase labor market flexibility including legislative provisions to reduce incidence and incentives for abuse of sick leave, and encouragement of discussion and dialogue between social partners to increase flexibility of working time regulations and to improve the adaptability of wages Satisfactory progress towards completing the first Net Impact Evaluation of the "From Social Benefits to Securing Employment" program and MOLSP adoption of action plan to complete net impact evaluation of all ALMPS by 2005 Continued implementation of actions to improve the effectiveness of active labor market programs including (i) shifting proportional composition of number of participants in ALMPs towards programs with higher net impact; and (ii) adjusting criteria for selection of providers of employment services to increase private sector participation Implementation of the new 	<p>style intervention agency</p> <p>By end-2005, reduction in unemployment, share of long-term unemployed, and youth unemployment rate; and increase in employment rate (based on labor force surveys)</p>	<p>Unemployment rate reduced from 19.8% in 2001 to 12% in 2004 against 8% in EU-15 in 2004</p> <p>Employment rate increased from 50.9% in September 2001 to 56.5% in September 2004 against 64.8 in EU-15 in 2003</p> <p>Share of long term unemployment reduced from 63.7% in 2001 to 59.3% in 2004 against 43.4 in EU-15 in 2003</p> <p>Youth unemployment rate reduced from 38.4% in June 2001 to 25.8% in 2004, against 14.7% in EU-15 in 2003</p>

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**BULGARIA: THIRD PROGRAMMATIC ADJUSTMENT LOAN (PAL-3)
PERFORMANCE BENCHMARKS (APRIL 22, 2005 VERSION)**

Goals	PAL-1	PAL-2	PAL-3	Desired Outcomes	Status of Desired Outcomes
Improving the efficiency of the insolvency regime	<ul style="list-style-type: none"> • Submission to National Assembly of proposed amendments to Part IV of the Commercial Code • Approval by Ministry of Justice of a plan to improve the selection and monitoring of bankruptcy trustees 	<ul style="list-style-type: none"> • Enactment of amendments to Part IV of the <i>Commercial Code</i> to accelerate resolution of insolvency cases • Implementation of plan to improve selection and monitoring of bankruptcy trustees • Implementation of a program for overhauling the <i>Civil Procedure Code</i> 	<p>"one-stop shop" processing model in at least 6 labor bureaus</p> <ul style="list-style-type: none"> • Implementation of monitoring system covering insolvency cases • Satisfactory progress in the preparation of legislative amendments to the <i>Commercial Code</i> to improve the insolvency regime and accelerate resolution of insolvency cases 	By end-2005, demonstrated reduction in average time period to reach resolution of insolvency cases from 3.8 years in 2003 towards levels in other advanced transition economies	The average time period to reach resolution of insolvency cases reduced to 3.3 years in 2004
PILLAR III: DEEPENING THE FINANCIAL SYSTEM					
Improving the legal framework for lending	<ul style="list-style-type: none"> • Submission to National Assembly of draft amendments to the <i>Law on Registered Pledges</i> • Enactment of amendments to the foreclosures provisions of the <i>Civil Procedure Code</i> • Enactment of the <i>Accountancy Act</i> and the <i>Independent Financial Audit Act</i> • Submission to National Assembly of a draft <i>Law on Measures Against Terrorist Financing</i> • Submission to National Assembly of 	<ul style="list-style-type: none"> • Enactment of amendments to the <i>Law on Registered Pledges</i> • Implementation of international standards in accounting and auditing • Enactment of the <i>Law on Measures Against Terrorist Financing</i> • Enactment of amendments to the <i>Law on Measures Against Money Laundering</i> 	By end-2005, increase in financial intermediation to support private sector investment, while maintaining capital adequacy and liquidity standards; increase in M2 to GDP from 42% in end-2001 and 43% in 2002; increase in private sector loans to GDP from 15% at end-2001, and to ensure that the quality of banks' portfolios is preserved in the face of rapid credit expansion.	<p>M2 to GDP increased to 47.8% of GDP in 2003, and to an estimated 53% of GDP in December-2004</p> <p>Real credit to private sector increased annually by close to 40% in 2003 and 43% in 2004</p> <p>Credit to private sector increased from 19% of GDP in 2002, to 26% of GDP in 2003, and to an estimated 36.9% of GDP in 2004</p>	

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**BULGARIA: THIRD PROGRAMMATIC ADJUSTMENT LOAN (PAL-3)
PERFORMANCE BENCHMARKS (APRIL 22, 2005 VERSION)**

Goals	PAL-1	PAL-2	PAL-3	Desired Outcomes	Status of Desired Outcomes
Completing banking reform	<ul style="list-style-type: none"> draft amendments to the <i>Law on Measures Against Money Laundering</i> Enactment of <i>Bankruptcy Law</i> Enactment of amendments to the <i>Banking Law</i> providing broader powers to the BNB to investigate and identify direct and indirect ownership of banks 	<ul style="list-style-type: none"> Establishment of mechanism for consultation of the BNB and other financial regulatory agencies with regard to drafts of laws and regulations relevant to the financial sector 		By end-2003, private sector share of banking assets reaches about 98%	Private sector share of banking assets at close to 98% by end-2004
Developing financial markets and improving supervision coordination; improving the sustainability, regulation and governance of private pension funds	<ul style="list-style-type: none"> Issuance of regulations for foreign investments of private pension funds Adoption of an institutional development plan for the State Insurance Supervisory Agency (SISA) Adoption of an institutional development plan for Insurance Supervisory Agency (ISA) Enactment of the <i>Mortgage Bond Law</i> Enactment of amendments to the <i>Law on Public Offering of Securities</i> 	<ul style="list-style-type: none"> <i>Enactment of the Social Security Code consolidating the Mandatory Social Insurance Code and the Voluntary Supplementary Pensions Insurance Act and strengthening of the governance of the private pension funds and the supervision capacity of the Financial Supervision Commission (FSC) and introduction of a general prohibition of related party activities</i> Unification of supervision of non-bank financial institutions (NBFIs) Enactment of amendments to the <i>Commercial Code</i> to 	<ul style="list-style-type: none"> Progress towards establishment of an Early Warning System to monitor vulnerability of financial sector Establishment of a working group including representation from FSC, National Bank, and custodian banks, to discuss and determine whether and which medium term regulatory and institutional changes are necessary and feasible for (i) expanding custodian banks' responsibilities to include transaction controls based on broader fiduciary powers and asset valuation, and (ii) defining custodians' liability commensurate with their extended powers and 	<p>By end-2004, the value of the combined pension fund portfolio approximates 2% of GDP</p> <p>By end-2005, improved custodianship rules effective</p>	<p>By end-2003, combined pension fund portfolio reached 1.5% of GDP; by end 2004, combined pension fund portfolio reached 2 % of GDP.</p> <p>Improved custody services for pension funds (single custodian) in place.</p>

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PERFORMANCE BENCHMARKS (APRIL 22, 2005 VERSION)**

Goals	PAL-1	PAL-2	PAL-3	Desired Outcomes	Status of Desired Outcomes
	<ul style="list-style-type: none"> • Submission to National Assembly of amendments to the <i>Commercial Code</i> to strengthen corporate governance • Enactment of amendments to the <i>Insurance Act</i> to harmonize with EU directives and strengthen ISA • Elimination of monopolies in certain segments of the insurance market • Establishment of a Financial Supervision Advisory Council for coordination and review of systemic vulnerabilities 	<ul style="list-style-type: none"> • strengthen corporate governance provisions • Enactment of <i>Law on Financial Supervision Commission</i> 	<p>responsibilities; and to discuss and determine whether the agreed changes require any changes in the competences of the different supervisory bodies</p>		
<p>PILLAR IV: IMPROVING PUBLIC SECTOR GOVERNANCE</p>					
<p>Strengthening public administration capacity, improving public sector service delivery, reducing corruption, strengthening public expenditure management and reforming the judiciary</p>					
<p>Strengthening public administration capacity:</p> <p>(i) Strengthening public administration reform program management capacity</p>	<ul style="list-style-type: none"> • <i>Approval of a Strategy for State Administration, and Modernization, and a program for its implementation agreed with the Bank</i> • Development of monitoring indicators 	<ul style="list-style-type: none"> • <i>Approval by the COM of an updated medium term public administration reform strategy and action plan to secure merit and depoliticization; provide incentives for performance and service optimization; lead to government structures; and strengthen accountability and</i> 	<ul style="list-style-type: none"> • Council of Ministers capacity to manage and monitor public sector reform strengthened in line with SIGMA recommendations; capacity created in COM Directorate for State Administration to manage the human resource development system and to provide methodological guidance and directives to inspectors with respect to the procedures and the 	<p>By end-2006, evidence of improved capacity in COM to develop and manage public administration and civil service policy and reform</p> <p>By end-2006, evidence of progress with public administration and civil service reforms, through development of key policy frameworks, legislation and implementation frameworks – especially related to</p>	<p>Extra 84 civil servants in Political Cabinet of Minister responsible for Public Administration and Civil Service and in regional administrations; COM capacity enhanced through training.</p> <p>Key policy frameworks developed for functional reviews and depoliticization and merit. Strategy for Modernizing</p>

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**BULGARIA: THIRD PROGRAMMATIC ADJUSTMENT LOAN (PAL-3)
PERFORMANCE BENCHMARKS (APRIL 22, 2005 VERSION)**

Goals	PAL-1	PAL-2	PAL-3	Desired Outcomes	Status of Desired Outcomes
		<p><i>transparency in service delivery</i></p> <ul style="list-style-type: none"> Council for State Administration Modernization implements a rigorous public administration reform monitoring system to track reform outcomes versus targets, with annual reporting on progress from the Council for State Administration Modernization to the CoM 	<p>methodology for the implementation of functional reviews</p> <ul style="list-style-type: none"> In advance of the fourth annual report on functioning of the public administration, COM Directorate for State Administration submits Action Plan to Implement the Strategy for Modernizing State Administration, including data to be used for comprehensive monitoring of reform outcomes Preparation of decree requiring that all legislative proposals be accompanied by an impact assessment and a summary of public consultation undertaken. 	depoliticization	State Administration developed and being implemented. Merit based recruitment and remuneration being implemented since 2004 with 100% of civil service affected by merit-based policies in some way
(ii) Strengthening merit and depoliticization		<ul style="list-style-type: none"> <i>Approval by National Assembly of amendments to Civil Service Law and by COM of related secondary legislation to take effect from 1 January 2004 to make open competition mandatory for all external recruitment to career civil servant positions; to provide for filling of vacancies to be filled through internal recruitment to be based on credible merit-based procedures; and to establish clear criteria</i> 	<ul style="list-style-type: none"> <i>Majority of vacancies for civil service positions in 2004 being filled through external competitive recruitment</i> First Reading by National Assembly of <i>Law on State Administration</i> to require Ministries to set strategic objectives (linked to program budgets); to strengthen Ministry-level strategic planning and policy development processes; to provide clear definition of role of Secretary Generals; and to provide for depoliticization 	By end-2006, all recruitment exercises (central government, regional administrations, local governments) filled through competitive/performance-based recruitment or advancement (<i>merit</i>)	100% of new recruitment exercises for civil servants in 2004 were conducted through external recruitment processes, in accordance with new requirements, compared with 10% of such exercises in the previous year.

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**BULGARIA: THIRD PROGRAMMATIC ADJUSTMENT LOAN (PAL-3)
PERFORMANCE BENCHMARKS (APRIL 22, 2005 VERSION)**

Goals	PAL-1	PAL-2	PAL-3	Desired Outcomes	Status of Desired Outcomes
(iii) Increasing competitiveness of civil service pay compared to private sector	<ul style="list-style-type: none"> Completion of a Pay and Benefits Survey in the public sector 	<p><i>for determining which posts are to be advertised on an internal and external basis, and which only on an internal basis</i></p> <ul style="list-style-type: none"> Conversion of all posts in Human Resource and Budget Departments in line ministries to civil service status by 1 January 2004 through initial implementation of the <i>Classifier of Civil Service Positions</i> Development of amendments to <i>Law on State Administration</i> agreed with the Bank to provide for clear specification of the role and function of political cabinets of ministers; and to provide strengthened guarantees for merit-based appointments of nominated directors of agencies 	<p>with respect to appointment and tenure of senior civil servants</p> <ul style="list-style-type: none"> Preparation of COM decision to establish a Commission for holding appointment competitions for senior civil servants, which is to include independent experts. 	<p>By end-2006, evidence of</p> <ul style="list-style-type: none"> (i) increases in public sector pay for benchmark grades compared to private sector pay for equivalent positions (ii) increase in decompression ratio (Junior Expert to Secretary General) (Annual) (<i>pay reform</i>) 	<ul style="list-style-type: none"> (i) in July 2004 pay increases across Government averaged 8.5%; exceeding inflation and private sector average—narrowing gap between public and private sector. (ii) 2004 pay increase averages exceeding 10% for higher echelons of
	<ul style="list-style-type: none"> Development and approval of relative pay position for civil service sector and for internal pay decompression, with particular emphasis on areas of recruitment and retention difficulty Performance appraisal system put in place and first performance 	<ul style="list-style-type: none"> Satisfactory progress in achieving higher competitiveness of civil service pay in areas of senior civil servants recruitment and retention difficulties Performance related pay and career advancement introduced across all ministries and pay increases for the year 2005 based on 			

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**BULGARIA: THIRD PROGRAMMATIC ADJUSTMENT LOAN (PAL-3)
PERFORMANCE BENCHMARKS (APRIL 22, 2005 VERSION)**

Goals	PAL-1	PAL-2	PAL-3	Desired Outcomes	Status of Desired Outcomes
(iv) Rationalizing government structures		<p>appraisal round completed in all ministries by the end of 2003; approval of legislative framework for the introduction of performance related pay and career advancement</p> <ul style="list-style-type: none"> Functional reviews of three pilot central state administration structures (Ministries/agencies) completed, designed to align Ministry/agency structures and staffing with those required to deliver key government work program priorities and put in place administrative capacity to meet requirements of EU accession 	<p>outcomes of performance appraisal</p> <ul style="list-style-type: none"> Government optimization and rationalization under way through completion of 13 functional reviews and surveys, report identifying reorganization opportunities, reorganization action plans to implement functional review recommendations, and evidence of reorganization in pilot areas 	<p>By end-2006, evidence of adjustments in government structures, functions, staffing levels and skills appropriate for effective delivery of priority government work program objectives and requirements of EU integration</p>	<p>civil service</p> <p>Government adjustments initiated through extended functional reviews in 7 ministries and 6 regional administrations, with implementation action plans for change; survey reviews in all other central administrative structures</p>
(v) Improving service delivery		<p>Performance standards for service delivery approved by COM together with timetable of implementation for all Ministries and Agencies of specific performance standards, together with provisions at ministry/agency level for obtaining feedback from service users, and for gathering Internet-based self-assessment by service providers</p>	<ul style="list-style-type: none"> Implementation of "one-stop shops" in a majority of local administrations; approval by Council for State Administration Modernization of approach to integrating service-specific one-stop shops to create integrated one-stops shops at level of municipalities Implementation of Client Charters setting out services provided, service standards, service levels achieved, contacts, charges, timescales, appeals and 	<p>By end-2006, evidence of increased number of e-services delivered to citizens and businesses and in the associated volumes of services/transactions completed/number of hits on key government service websites.</p> <p>By end-2006, evidence of increase on perceptions of civil servants as to degree of performance orientation in civil service.</p> <p>By end-2007, evidence of</p>	<p>Client Charters of various national and 3 sub-national administrations posted on Internet portal of State Administration.</p> <p>Various service areas (notary publics, construction supervisors, local water and garbage collection) subject to competitive processes, with over another 60 administrative services to be subject to competitive processes before January 2007.</p>

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**BULGARIA: THIRD PROGRAMMATIC ADJUSTMENT LOAN (PAL-3)
PERFORMANCE BENCHMARKS (APRIL 22, 2005 VERSION)**

Goals	PAL-1	PAL-2	PAL-3	Desired Outcomes	Status of Desired Outcomes
(vi) Increasing accountability and transparency	<ul style="list-style-type: none"> Establishment of Inter-ministerial Committee for Implementing the Anti-Corruption Strategy and Action Plan <i>Development of an anti-corruption strategy and action plan agreed with the Bank</i> 	<ul style="list-style-type: none"> <i>First annual progress report on implementation of the government's Anticorruption Program approved by COM and widely disseminated with partnerships established with business and investor associations and NGOs; COM approval of Anticorruption Program for period 2004 to 2005, including sectoral anticorruption strategies for education and health and linked to anticorruption program for judiciary approved by Supreme Judicial</i> 	<p>sanctions in three municipalities and identification of methodology and time-frame for their roll out to all municipalities</p> <ul style="list-style-type: none"> Approval by COM of an updated Strategy and Action Plan for the Modernization of the State Administration including consultations with service users and stakeholders, and drafting by Council for State Administration and Modernization of general principles, procedures and mechanisms for consultation with service users and stakeholders 	<p>significant increase in the extent to which administrative services subject to formal competitive processes; and of outsourcing of services and analysis of savings generated</p>	
			<ul style="list-style-type: none"> Evidence of progress in achieving detailed objectives of ministry and agency-specific anti-corruption action plans, including for the Ministry of Interior, the Tax and Customs Administrations; as well as for the judiciary Evidence of wide spread public awareness and education campaigns; and of effective partnerships with business and investor associations in developing codes of ethics for the private sector Inspectorates formally allocated responsibility for 	<p>By end-2006, levels of state capture and administrative corruption reduced compared to 2001; and public administration displaying a stronger external accountability and transparency and providing for wide-ranging participation in formation of "rules of the game", demonstrated through:</p> <p>NGO surveys show decline in number of transactions involving corruption; decline in perceptions of corruption in key areas such as tax, customs and judiciary; BEEPS III (2005) shows decline in</p>	<p>Corruption felt to be a significant problem affecting the performance of government institutions by 50% of public officials (2001 baseline Public Officials Survey)</p> <p>Anticorruption public councils created in 21 (out of 28) regional administrations</p> <p>213% increase in applications to government bodies for access to public information in 2003 compared to 2002 (39%</p>

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**BULGARIA: THIRD PROGRAMMATIC ADJUSTMENT LOAN (PAL-3)
PERFORMANCE BENCHMARKS (APRIL 22, 2005 VERSION)**

Goals	PAL-1	PAL-2	PAL-3	Desired Outcomes	Status of Desired Outcomes
Strengthening public expenditure management (i) Increasing allocative efficiency and transparency in budget formulation		<ul style="list-style-type: none"> Council (SJC) Conflict of interest and asset declaration regime strengthened (including monitoring and sanctions) 	<ul style="list-style-type: none"> controlling corruption in ministries Codes of ethics approved for civil service Implementation of legal provisions of <i>the Access to Public Information and the Protection of Classified Information Acts</i> to provide for more timely access to information by the public and streamlined and transparent appeals mechanism, and through declassification of documents which are than to be available to the public 	<p>perceptions of state capture and of administrative corruption compared to BEEPS II (2002). Repeat Public Officials Survey (2004) shows decline in perceived instances of administrative corruption compared to baseline survey (2001) (<i>reducing corruption</i>)</p> <p>Increase in number of requests by public for official information; monitoring of % provided; % refused; number of appeals when refused; % of appeals successful; % unsuccessful (partly to be based on feedback and analyses to be provided by NGOs) (<i>transparency</i>)</p> <p>100% compliance by public officials with asset and earnings declaration and disclosure requirements</p>	<p>increase from 2001 to 2002) from 21.649 to 67.712 requests. 315 of these requests turned down in 2003 with 38 appeals against refusals</p> <p>Many ministries have declassified documents to be available to public under freedom of information regulations: MoF, MoE, MoFA/MoEUI, MLSP, MoEER, MRDPW, MoA, MoH, MoES, MoC, MoJ, and MoD (champion with 52,298 declassified documents).</p>
		<ul style="list-style-type: none"> Program budgets for existing and new pilot ministries (Ministry of Environment and Waters, Ministry of Transport and Communications, and Ministry of Labor and Social Policy) prepared and included in 2004 budget Medium-term capital investment targets and prioritized program for 	<ul style="list-style-type: none"> For 2005 budget process, MTFE includes sectoral and sub-national disaggregation; and MTFE subject to National Assembly scrutiny Program budgets for existing and four new pilot ministries (Ministry of Education and three others, making seven in all) and including performance indicators and targets prepared and included in 	<p>By 2007, evidence of improved performance focus in entire budget, through program orientation across government and publishing of all first level spending unit goals and objectives in budget; and accountability for results as reflected in active audits of programs</p> <p>By 2006 (for 2007 budget preparation cycle), public</p>	<p>7 out of 17 FLSUs have program budget documents in appendix to 2005 budget; one audit of program budget sent to Parliament; MOF report on budget includes (for first time) list of all FLSU goals and objectives.</p> <p>2005 budget based on three year fiscal</p>

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PERFORMANCE BENCHMARKS (APRIL 22, 2005 VERSION)**

Goals	PAL-1	PAL-2	PAL-3	Desired Outcomes	Status of Desired Outcomes
		<p>EU pre-accession funds agreed and incorporated in 2004 budget; expenditure equivalent to 3-4% of GDP allocated to capital expenditures and 6-7% allocated to operations and maintenance</p> <ul style="list-style-type: none"> Central system in place and functional within Ministry of Finance to record and monitor government capital investment expenditures and to generate reports on such expenditures; National Investment Division established in Ministry of Finance as sole agency responsible for coordination of national investment policy 	<p><i>2005 budget, and organizational objectives for all first level spending units published in 2005 budget</i></p> <ul style="list-style-type: none"> Ministry of Environment and Waters Program Budget Report for 2003 published and MOEW Program Budget presented to Parliament in 2005 budget 2005 budget preparation includes full integration of capital with recurrent expenditure; and analysis and prioritization of capital investment projects based on explicit and appropriate criteria for capital investment decision; 2005 budget reflects upward trend in capital expenditures Investment monitoring system providing evidence of appropriate consideration being given to provision for maintenance expenditures and medium-term planning horizon 	<p>expenditure management system based on medium-term MTFF</p> <p>By 2006, evidence of improved focus on investment expenditures and investment expenditure management, evidenced through improved allocations to investment and maintenance items and more active management of these items.</p>	<p>framework.</p> <p>Capital expenditures declined to 3.5% of GDP in 2002 compared to 4.8% in 1999; preliminary estimate for 2004 is 3.9 percent of GDP and projection for 2005 is 4.5 percent of GDP.</p>
(ii) Strengthening procurement and financial accountability mechanisms		<ul style="list-style-type: none"> GFMS operational for five modules (Financial Accounting, Funds Management, Cash Management, Fixed Assets and Material Management) in two pilot second-level spending units (SLSUs) of the Ministry of Finance 	<ul style="list-style-type: none"> Satisfactory progress with implementation of improved regulatory framework for procurement consistent with 2004 CPAR action plan Pilot program and performance audit undertaken by NAO for Ministry of Environment and Waters 	<p>By end-2005, evidence of more robust procurement system including: (i) functional arbitration court for public procurement; (ii) fully functional and complete Public Procurement Register.</p> <p>By end-2005, evidence that PIFCA reports leading to</p>	<p>New procurement framework introduced</p> <p>Public Internal Financial Control Agency (PIFCA) had as at September 2004, covered all central and local entities with either delegated audit teams or other internal audit</p>

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PERFORMANCE BENCHMARKS (APRIL 22, 2005 VERSION)**

Goals	PAL-1	PAL-2	PAL-3	Desired Outcomes	Status of Desired Outcomes
		<p>(Ministry of Finance and General Tax Directorate)</p> <ul style="list-style-type: none"> Internal audit teams delegated to all line ministries, 109 municipalities, the National Social Security Institute and the National Health Insurance Fund and Executive Agencies; internal auditors delegated to the larger second-level spending units on a risk assessment basis; other spending units also audited on a risk assessment basis Internal audits being undertaken on the basis of the Regulations on the rules and procedures for the carrying out of internal control by PIFCA bodies, the Handbook on the exercise of control in the field of public procurement, the Regulations on the activity of delegated internal auditors, the Ethical Code, and the Charter of internal audit 	<ul style="list-style-type: none"> NAO operating multi-year rolling strategy of audit of financial and operational performance of government ministries and agencies Internal audits carried out in all government entities (as per the Law on the Public Internal Financial Control) Annual reports of the activities of the delegated internal PIFCA audit teams presented to the PIFCA Director and consolidated in the annual PIFCA report presented to the COM by the Minister of Finance; audit reports for each PIFCA executed audit delivered to the respective spending unit and to PIFCA on a timely basis 	<p>appropriate action by Ministry of Finance (remedial, system and process improvements)</p>	<p>arrangements</p>
(iii) Strengthening system of intergovernmental finance and municipal service		<ul style="list-style-type: none"> Government reaches agreement with National Association of Municipalities to liquidate outstanding arrears (any 	<ul style="list-style-type: none"> Government to fully fund delegated functions in 2005 budget based on agreed expenditure standards Government to fully fund 	<p>Increased predictability and transparency in allocation of Government transfers to municipalities</p>	<p>2005 budget provides for all centrally mandated local government expenditures to be fully funded—according to</p>

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PERFORMANCE BENCHMARKS (APRIL 22, 2005 VERSION)**

Goals	PAL-1	PAL-2	PAL-3	Desired Outcomes	Status of Desired Outcomes
delivery		<p>government funding for arrears reduction to be allocated on the basis of a transparent formula and to cover substantially less than 100% of the outstanding stock)</p> <ul style="list-style-type: none"> Government to fully fund delegated functions in 2003 and in 2004 budget, based on agreed expenditure standards Government to adopt transparent formula for allocating revenue equalization grant and fully fund grant in 2004 budget 	<p>equalization transfer in 2005 budget based upon agreed formula</p>		legislated approach
Increasing the accountability, efficiency and effectiveness of the judicial system	<ul style="list-style-type: none"> <i>Approval of a program and action plan for judicial reform including a National Anti-Corruption Component for the Judiciary</i> Preparation by Supreme Judicial Council (SJC) of uniform standards of service for the administrative staff Submission to National Assembly of amendments to the <i>Judicial Act</i> incorporating adoption of uniform criteria for the 	<ul style="list-style-type: none"> <i>Adoption of a legal framework governing the accountability framework for judges (immunity, tenure, mandate)</i> Establishment of a specialized commercial college at Supreme Court of Cassation and of specialized commercial sections at remaining courts of law (with heaviest commercial case load) Regulatory action in place for the selection of magistrates; for establishing criteria for the performance appraisal, promotion and demotion of magistrates; 	<ul style="list-style-type: none"> Approval by SJC of first annual monitoring report focusing on outcomes of judicial reform program (including implementation of new accountability framework for judges) Adoption of <i>Attorney's Act</i>, approval of regulations on qualification exams and preparation for Attorneys' Code of Ethics SJC approval of anticorruption program for the judiciary Submission of <i>Administrative Procedural Code</i> to the Parliament and initiation of development of a comprehensive plan for establishment of specialized 	<p>By end-2005, increase in accountability, efficiency and effectiveness of judicial system demonstrated through : the improved structure and capacity of the SJC, monitoring of case load per judge, and a reduction in complaints and disciplinary measures against judges, and improved perceptions of judges' ethics.</p> <p>By mid-2005, a new and improved legislative framework for providing legal services by attorneys, improved quality of legal services and better enforcement of ethical rules</p>	<p>Strategic and policy framework for judicial reform established by Ministry of Justice and Supreme Judicial Council in 2002; Legislative framework to provide for appropriate and strengthened accountability framework for magistrates established in 2003 as well as for their selection, performance appraisal, promotion and demotion with effect from early 2004.</p> <p>Setting up of an internal unit (standing commission) within SJC</p>

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PERFORMANCE BENCHMARKS (APRIL 22, 2005 VERSION)**

Goals	PAL-1	PAL-2	PAL-3	Desired Outcomes	Status of Desired Outcomes
	<p>selection of magistrates and the evaluation of their performance</p> <ul style="list-style-type: none"> Introduction of compulsory training for magistrates 	<p>for establishing a national training system for magistrates in the areas of international business transactions and European law; and for establishing an internal unit within the SJC to address issues of corruption within the judiciary</p>	<p>administrative courts</p> <ul style="list-style-type: none"> Adoption of a <i>Mediation Law</i> and initiation of preparation of training standards, procedural and ethical rules of behavior, and unified register of mediators Establishment of a working group under SJC and development of interim performance appraisal rules for magistrates 	<p>By end-2005, registration/accreditation process for mediators will be in place, and by mid-2006 there will be an increase in the number of cases handled through mediation</p> <p>By end-2006, at least 50% of specialized administrative courts will be operational.</p>	<p>to address issues of corruption within Judiciary according to a national Anti-corruption Strategy and Action Plan approved by the SJC. Anti-corruption hotlink in place since end-2004.</p>
PILLAR V: INVESTING IN HUMAN CAPITAL AND STRENGTHENING SOCIAL PROTECTION					
Improving the governance and efficiency of the educational system	<ul style="list-style-type: none"> Preparation of a plan for phased staff reduction and other efficiency measures in the education system agreed with Bank 	<ul style="list-style-type: none"> Update of COM resolution on per capita financing to municipalities with incentives for increasing efficiency in staffing in grades 9-12 in municipal secondary schools 	<ul style="list-style-type: none"> Development and initial implementation of an action plan for reform of tertiary financing and governance to improve the efficiency and relevance of the tertiary education system Establishment of a database providing detailed information on physical and human infrastructure in secondary schools to guide decisions on efficient use of staff and facilities 	<p>By end-2007, continued gradual improvement in student-teacher ratio towards OECD levels particularly in higher education</p> <p>By end-2007, greater autonomy and accountability in management of higher education institutions , in particular through considerable representation of external stakeholders on university governing councils and professionalization of the position of the rector to assure independence from the governing body.</p>	<p>Student-teacher ratio for grades 1-4 was 16.9 in 2002-03 against 17.7 for OECD levels and 16.7 for EU countries average.</p> <p>Student-teacher ratio in grades 5-8 was 12.2 in 2002-03 against 15.0 for OECD and 12.6 for EU countries average.</p> <p>Student-teacher ratio in grades 9-13 in 2002-03 was 11.0 against 13.9 for OECD and 12.9 for EU countries average.</p> <p>In 2003-04, student: staff ratio in Bulgarian higher education system is about 10:1, compared to average student :staff ratio for the OECD of 16.4:1</p>

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PERFORMANCE BENCHMARKS (APRIL 22, 2005 VERSION)**

Goals	PAL-1	PAL-2	PAL-3	Desired Outcomes	Status of Desired Outcomes
<p>Improving quality and equity of education at all levels</p>	<ul style="list-style-type: none"> • <i>Submission to Council for Economic Policy of concept for education reform strategy and initial action plan designed to improve quality of learning and teaching while strengthening equity; and to improve resource management and fiscal efficiency</i> • Approval by COM of an <i>Action Plan for Protection Against Discrimination Against Minorities</i> in the education system • Obligatory pre-school year to enable equal access of ethnic minority children to regular schools launched • Ministry of Education and Science legislation aligned with the <i>Child Protection Act</i> • Approval by COM of <i>Plan for Integration of Children with Special Educational Needs</i> into mainstream school system and for securing reduction in the number of children in Ministry of Education and Science managed institutions 	<ul style="list-style-type: none"> • <i>Implementation of actions to promote equitable access to quality education for children from poor households and ethnic minorities, and adoption by the Council of Economic Policy of a National Program for the Modernization of Education, identifying changes needed to improve the quality, structure, management, and financing of the education system</i> • Implementation of National Plan for Integration of Children with Special Educational Needs and/or chronic diseases in the system of public education (including de-institutionalization of children in Ministry of Education and Science managed residential care) • Satisfactory implementation of the strategy for introducing information and communications technologies in secondary schools. • To ensure quality and transferability of tertiary education, at least 50% of higher education institutions will have set up internal university system for quality assurance 	<p>By end-2007, public expenditures on education as a percentage of GDP are closer to OECD levels (5.6%).</p> <p>Reduction in the gap in participation, enrollment, and attendance rates for minorities and families in poverty as compared with the general population.</p> <p>By end-2007, 40% of Roma students integrated into mainstream schools</p> <p>By end-2007, increase in number of children with special education needs integrated into mainstream kindergartens and schools; and in the number of schools and kindergartens adapted to receive and educate children with special education needs</p> <p>By end-2007, gradual reversal in the present trend of declining performance of the system as measured by national and international assessments.</p>	<p>2002: 4.1% of GDP 2003: 4.1%; 2004 and 2005 (programmed): 4.4%</p> <p>Non-enrollment rates among 7-18 year olds fell between 2001 and 2003, with largest absolute decline (20 percentage points) among children from poorest quintile</p> <p>Legal and regulatory changes in place to promote integrated teaching for children with special education needs.</p> <p>130 resource teachers appointed in 2004-05 school year to tutor 675 children and students with special educational needs. 10 schools for children with special needs started teaching the regular curriculum.</p>	

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PERFORMANCE BENCHMARKS (APRIL 22, 2005 VERSION)**

Goals	PAL-1	PAL-2	PAL-3	Desired Outcomes	Status of Desired Outcomes
Improving the governance and financial sustainability of the health system	<ul style="list-style-type: none"> Agreement among the MOF, MOH, and the NHIF on a long term funding approach for hospital services 	<ul style="list-style-type: none"> Development of a positive drug list by MOH 	<ul style="list-style-type: none"> Procedures in place to implement EU Bologna agreement, and regulations adopted for internal and external certification and distance learning Approval of a national strategy for adult and continuing education and related action plan. Satisfactory progress towards development of a strategy with realistic revenue and expenditure projections (premium rate, package of services with or without co-payments) to ensure long-term financial sustainability of NHIF Approval and implementation of a unified national policy, strategy and action plan for pharmaceuticals Preparation of standards for capital investment in specialized medical equipment Implementation of a new cycle of accreditation of healthcare facilities, including the strengthening of the institutional capacity for accreditation of healthcare facilities 	<p>By 2005, NHIF administrative costs kept at less than 3% of total expenditures</p> <p>By 2006, financing of all hospitals becomes the responsibility of the NHIF</p> <p>By 2007, NHIF will have a balanced annual budget between its revenues and expenditures, and will cease to supplement it from its reserve funds</p> <p>By end-2005, completion of new cycle of accreditation of inpatient medical care facilities (will also form new baseline)</p>	<p>Administrative costs in 2004 at 3%, as per NHIF end-year report</p> <p>Budgeted admin costs in 2005 – less than 3% inclusive of capital expenditures.</p> <p>NHIF budget allocated to inpatient care increased by 53% from 2003 to 2004; and by 20% in 2005, accounting for 50% of all inpatient expenditures including reserve</p> <p>Gradual deficit increase was expected in the period 2004-06, before achieving balanced budget in 2007. Deficit in 2003: 0.7%; 2004: planned deficit around 6.7%, but in effect ended up with a small surplus due to improved collection;</p> <p>2005 – 11% planned deficit</p>

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PERFORMANCE BENCHMARKS (APRIL 22, 2005 VERSION)**

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<p>Enhancing access to and quality of healthcare services and promoting multi-sectoral interventions for effective public health actions</p>	<ul style="list-style-type: none"> Approval by the COM of a strategy for hospital restructuring, including financing plan 	<ul style="list-style-type: none"> Development of a concrete short-term action plan for implementing the hospital restructuring strategy Design and implementation of a mechanism for funding national health programs (e.g., Tobacco control, Immunization, HIV/AIDS, Tuberculosis) Submission to National Assembly of amendments to the <i>Health Act</i> that allows earmarking 1% of the excise tax collected from tobacco and tobacco products to fund the national tobacco control program Submission to National Assembly of <i>Law on Tobacco and Tobacco Products</i> together with proposals for completion of the harmonization of the tobacco control legislation and regulations with the relevant EU Directives 	<ul style="list-style-type: none"> <i>Improve hospital management, productivity, and efficiency through (i) expansion of output based payment for inpatient care services to cover more than 50% of all hospital expenditures in 2005, providing incentives for the rationalization of services; and (ii) launch of restructuring in Ministry of Health and municipal hospitals and the development of a National Health Map to guide future restructuring</i> Increase in proportional allocation to national public health programs in MOH operating budget for 2005 Enactment by National Assembly of amendments to the <i>Health Act</i> that allows earmarking 1% of the excise tax collected from tobacco and tobacco products to fund the national tobacco control program Enactment by National Assembly of <i>Law on Tobacco and Tobacco Products</i> together with proposals for completion of the harmonization of the tobacco control legislation and regulations with the relevant EU Directives 	<p>By end-2005, the average occupancy ratio in acute care hospitals will reach 85%</p> <p>By the end-2005, the average length of stay (ALOS) in days in acute care hospitals will be reduced from 11.5 in 2000 towards the EU average of 8.2 days</p> <p>By end-2005, there will be a system in place for periodic monitoring and evaluation of immunization, tuberculosis case detection and treatment/cure, HIV prevalence rates</p> <p>By end-2007, increase in immunization coverage and reduction in the incidence of infectious diseases including tuberculosis.</p> <p>By 2010, gradual increase of excise duty on tobacco products towards harmonization as per the EU directive (to be assessed on a yearly basis)</p>	<p>Occupancy rate in acute care hospitals (supervised by MOH) was 66% in 2001, 75% in 2002 and 79% in 2003</p> <p>The ALOS for acute care hospitals (supervised by MH) was 11 days in 2001 and 9 days in 2002, and 8.8 days in 2003.</p> <p>2004 budget provided for 1% of the excise tax to be applied to financing tobacco, alcohol and drug control programs. Excise duty on tobacco products is gradually being increased on an annual basis to reach the EU level in 2010.</p> <p>New cases of tuberculosis fell from 48 per 100,000 in 2001 to 41.7 in 2003. Polio immunization rate for children under 2 years rose from 94.4 % in 2000 to 96% in 2003</p> <p>Share of MOH central procurement budget for National Health Programs increased from 18.6% in 2002, to 19% in 2003, 26 % in 2004, and 29% in 2005 (2004 and 2005 figures are budget estimates)</p>

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**BULGARIA: THIRD PROGRAMMATIC ADJUSTMENT LOAN (PAL-3)
PERFORMANCE BENCHMARKS (APRIL 22, 2005 VERSION)**

Goals	PAL-1	PAL-2	PAL-3	Desired Outcomes	Status of Desired Outcomes
<p>Improving the administration and targeting of disability benefits and empowering the disabled to integrate fully into society</p>		<ul style="list-style-type: none"> • Approval by COM of a <i>Strategy for Equal Opportunity for the Disabled</i> and a consolidated draft <i>Act on Integration of People with Disabilities</i> • Approval by COM of draft amendments to the <i>Health Act</i> to provide for adequate representation of NSSI in the Disability Assessment Committee (TELK) 	<ul style="list-style-type: none"> • Enactment of amendments to the <i>Social Insurance Code</i> disallowing people over retirement age to claim disability thus bringing disability pension policy in line with international practice and reducing incentives for misuse of disability benefits • Enactment of the consolidated <i>Act on Integration of People with Disabilities</i> to provide the basis for improved needs assessment of the disabled • Review of all disability benefits and adoption of measures to consolidate those that are not disability related with social assistance or to eliminate • Development and adoption by the Government of secondary legislation relating to the new disability law to put in place needs assessment to facilitate integration into labor force and society • Enactment of amendments to the <i>Health Act</i> to provide for adequate representation of NSSI in the disability assessment commissions, to ensure that NSSI has access to medical records of disability pensioners, and to provide for penalties to medical practitioners for disability and sick leave fraud 	<p>From 2005, no new disability pensions awarded to people above retirement age</p> <p>Improved control over disability uptake and fraud by end-2006</p> <p>By end-2006, needs (social) assessment regulations are in place and are applied to the disabled</p>	<p>Legislation prohibits awarding disability pension to people already receiving old age pensions.</p> <p>Legislation provides for improved control by NSSI over the disability assessment process</p> <p>Legislation introduces notion of social assessment</p>

Note: This annex is the agreed PAL Program medium term performance matrix and is an attachment to the Government's Letter of Development Policy.

**BULGARIA: THIRD PROGRAMMATIC ADJUSTMENT LOAN (PAL-3)
PERFORMANCE BENCHMARKS (APRIL 22, 2005 VERSION)**

Goals	PAL-1	PAL-2	PAL-3	Desired Outcomes	Status of Desired Outcomes
Ensuring the successful implementation of pension reform	<ul style="list-style-type: none"> Introduction of the second pillar of the pension reform with a two percent contribution rate Adoption of regulations to transfer contributions to pension funds in a prompt and transparent manner Initiation of implementation of an action plan to improve and strengthen the pension reform program 	<ul style="list-style-type: none"> Enactment of a consolidated <i>Social Insurance Code</i> to create a conducive framework for the further development of the multi-pillar pension system Approval of NSSI budget for 2004 with 3% contribution to the second pillar 	<ul style="list-style-type: none"> To ensure stability and robustness of pension system, enactment of amendments to the social insurance code setting out: <ul style="list-style-type: none"> (i) the benefits indexation formula, including maximum and minimum benefits; and (ii) contribution rates including time-table of employer/employee contributions and the timetable of increasing second pillar contributions 	By 2005, stability achieved in benefit indexation, contribution base dynamics, and contribution rates	The <i>Social Insurance Code</i> (a) specifies the timetable for the change in the ratio of employer to employee contributions from 70:30 in 2005 to 50:50 in 2009 (b) sets benefit indexation at 75% CPI+25% wage growth,
Improving the effectiveness of social assistance programs	<ul style="list-style-type: none"> Introduction of targeting of child allowances Adoption of an adjusted energy subsidy program in view of announced tariff increases Establishment of a poverty monitoring unit in MOLSP Approval by COM of amendments to the <i>Social Assistance Act</i> opening social services provision for private and NGO providers. 	<ul style="list-style-type: none"> Implementation of measures to improve coverage and efficiency of social assistance programs (including <i>Guaranteed Minimum Income, energy benefits and child allowance</i>) Development of minimum standards for social services and replacement of licensing with registration (except for child care services) Enactment of the <i>Anti-Discrimination Act</i> 	<ul style="list-style-type: none"> Further implementation of measures to improve effectiveness of all social assistance programs, including the GMI, child allowance benefits and energy benefits Development of minimum standards for social services Capacity for poverty and policy analysis and monitoring strengthened as demonstrated through updated poverty analysis and inclusion of such analysis in strategic documents. 	<p>Increased effectiveness of GMI</p> <p>Increase in share of poorest quintile among beneficiaries of child allowance program and reduced leakage to richest 2 quintiles.</p> <p>Increased school attendance for children from poor households.</p> <p>Improved targeting of energy benefit payments</p>	<p>Coverage of GMI increased 2.7 times between 2001 and 2003, and of energy benefits 2.5 times.</p> <p>Share of funds channeled to poorest quintile increased from 60% to 75% for GMI, from 20% to 35% for child allowances, from 47% to 54% for energy benefits. Share of funds to richest two quintiles fell from 40% to 23% for child allowances program.</p> <p>School drop-out rates fell between 2001 and 2003, with largest absolute</p>

Note: This annex is the agreed PAL Program medium term performance matrix and is an attachment to the Government's Letter of Development Policy.

**BULGARIA: THIRD PROGRAMMATIC ADJUSTMENT LOAN (PAL-3)
PERFORMANCE BENCHMARKS (APRIL 22, 2005 VERSION)**

Goals	PAL-1	PAL-2	PAL-3	Desired Outcomes	Status of Desired Outcomes
Reducing institutionalization of children through helping families and fostering community based alternatives to institutional care		<ul style="list-style-type: none"> • Harmonization of the <i>Family Code</i> with the new <i>Child Protection Act</i> • Approval by COM of plan for reducing the number of children in specialized institutions • Introduction of new criteria and standards for child care services, including foster care 	<ul style="list-style-type: none"> • Harmonization of all primary and secondary legislation with the <i>Child Protection Act</i> • Implementation of the plan for reducing the number of children placed in specialized institutions; and for restructuring existing child care institutions 	<p>By 2007, decline in number of children in specialized institutions by 10%</p> <p>By 2007, increase in the number of restructured childcare institutions</p> <p>By 2007, increase in the number of care providers subject to transparent, modern licensing procedures</p> <p>By 2007, increase in number of non-governmental alternative child care providers and in community based child welfare services</p>	<p>decline (20%) among children from poorest quintile</p> <p>The number of institutions has decreased from 316 in 2001 to 305 in 2003, or by 3.5%. The number of children placed in institutions has decreased from 30,751 to 27,828, or by 9.5%. The rate of institutionalization has decreased from 1.913% in 2001, to 1.825 of the child population</p> <p>Restructuring plans at advanced stage but restructuring to begin in 2005</p> <p>There were 12 licensed non-governmental child care providers in mid-2004</p>

Note: This annex is the agreed PAL Program medium term performance matrix and is an attachment to the Government's Letter of Development Policy.

List of Companies Not Included in the Privatization Program

II. Ministry of Transport and Communications

LIST OF COMPANIES WITH MORE THAN 50 PER CENT OF STATE PARTICIPATION IN THE EQUITY OR DETACHED PARTS THEREOF (from updated Annex to Article 3, paragraph 1 of the Law on Privatization and Postprivatization Control)

I. Ministry of Regional and Urban Development

1. Water Supply and Sewerage EOOD - Blagoevgrad
2. Water Supply and Sewerage EAD - Bourgas
3. Water Supply and Sewerage OOD - Varna
4. Water Supply and Sewerage Yovkovitsi OOD - Veliko Tarnovo
5. Water Supply and Sewerage EOOD - Vidin
6. Water Supply and Sewerage OOD - Vratsa
7. Water Supply and Sewerage OOD - Gabrovo
8. Water Supply and Sewerage EOOD - Dobrich
9. Water Supply and Sewerage OOD - Karjali
10. Water Supply and Sewerage OOD - Kyustendil
11. Water Supply and Sewerage OOD - Lovech
12. Water Supply and Sewerage OOD - Montana
13. Water Supply and Sewerage EOD - Pazardjik
14. Water Supply and Sewerage OOD - Pernik
15. Water Supply and Sewerage EOD - Pleven
16. Water Supply and Sewerage EOOD - Plovdiv
17. Water Supply and Sewerage OOD - Isperih
18. Water Supply Dounav EOOD - Razgrad
19. Water Supply and Sewerage OOD - Rousse
20. Water Supply and Sewerage OOD - Silistra
21. Water Supply and Sewerage OOD - Sliven
22. Water Supply and Sewerage EOOD - Smolyan
23. Water Supply and Sewerage EOOD - Stara Zagora
24. Water Supply and Sewerage OOD - Targovishte
25. Water Supply and Sewerage OOD Dimitrograd
26. Water Supply and Sewerage EOOD - Haskovo
27. Water Supply and Sewerage OOD - Shoumen
28. Water Supply and Sewerage OOD - Yambol
29. Water Supply and Sewerage EOOD - Sofia
30. Geoprotection EOOD - Varna
31. Geoprotection EOOD - Pernik
32. Geoprotection Pleven EOOD - Pleven
33. National regional development Center EAD - Sofia
34. Research Construction Institute – NISI - Sofia
35. Technoexportstroy EAD - Sofia
36. Metal Structures Holding EAD - Sofia
37. Industrial Construction Holding EAD - Sofia
38. Installations - Sofia
39. Expressways EAD (amended, the "State Gazette", No. 20/04.03.2003)
40. Ceoplanproject EAD (amended, the "State Gazette", No. 31/04.04.2003)
41. Geodetics EAD (amended, the "State Gazette", No. 31/04.04.2003)
42. Geodetics and Photogrammetrics Scientific Research EOOD (amended, the "State Gazette", No. 31/04.04.2003)
43. National Cadastre Center EOOD (amended, the "State Gazette", No. 31/04.04.2003)
44. Cartography EOOD (amended, the "State Gazette", No. 31/04.04.2003)
45. Construction Materials Scientific Research Institute EOOD (amended, the "State Gazette", No. 31/04.04.2003)

1. Bulgarian State Railways EAD - Sofia, which, according to the Transition and Final Provisions of the Act on Railway Transport, shall be terminated without liquidation on January 1, 2002, and its successors will be the Railway Infrastructure National Company and a sole-proprietor company that shall be established by the CoM by January 1, 2002 and shall perform the activity related to railway transport of passengers and cargo.

2. Sofia Airport EAD - Sofia
3. Varna Airport EAD - Varna
4. Bourgas Airport EAD - Bourgas
5. Gorna Oriahovitsa EAD - Gorna Oriahovitsa
6. Plovdiv Airport EAD - Plovdiv
7. Stara Zagora Airport EOOD - Stara Zagora
8. Rousse Airport EOOD - Rousse
9. Port Complex Rousse EAD - Rousse
10. Port Complex Lom EAD - Lom
11. Port of Vidin EOOD - Vidin
12. Port of Varna EAD - Varna
13. Port of Bourgas EAD - Bourgas
14. Lesport EAD - Varna
15. Bulgarian Posts EAD - Sofia

III. Ministry of Agriculture and Forestry

1. Irrigation Systems EAD - Sofia
2. Agrolesproekt EOOD - Sofia
3. St. Ivan Rilski EAD - Sofia
4. Hidromeloiracii – Sevlievo EAD - Sevlievo
5. Agrogrometer-Sofia EAD – Sofia
6. Vodproekt EAD - Sofia
7. Kabjulk EAD - Shumen
8. Khan Asparuh KZ EAD - Yasenovets
9. Stefan Karadjia EOOD - Balchik
10. Vrana EAD - Sofia

IV. Ministry of Defence

1. Terem EAD - Sofia
2. Military Publishing House EOOD - Sofia
3. Supply and Commerce MF EOOD - Sofia
4. Triamstroyinvest EOOD - Sofia
5. PRONO FOOD – Sofia
6. Logistic support EAD (amended, the "State Gazette", No. 31/04.04.2003)

V. Ministry of Education and Science

1. Student Canteens and Boarding Houses EAD - Sofia - social functions
2. Education and Science EAD - Sofia - social functions
3. AkademiKa 2000 - Sofia - social functions
4. Allians EOOD
5. Unique Appliances and Systems EOOD

List of Companies Not Included in the Privatization Program

- VI. Ministry of Culture**
1. Submarine Archaeology Center EOOD - Sozopol Restoration" EAD, Sofia (amended, the "State Gazette", No. 31/04.04.2003)
 2. Conservation and restoration of valuable pieces of art EOOD, Sofia (amended, the "State Gazette", No. 31/04.04.2003)
 3. Music EOOD, Bourgas (the "State Gazette", No. 31/04.04.2003)
 4. Music EOOD, Vratsa (the "State Gazette", No. 31/04.04.2003)
 5. Music EOOD, Plovdiv (the "State Gazette", No. 31/04.04.2003)
 6. Music EOOD, Pleven (the "State Gazette", No. 31/04.04.2003)
 7. Music EOOD, Varna (the "State Gazette", No. 31/04.04.2003)
 8. Music EOOD, Stara Zagora (the "State Gazette", No. 31/04.04.2003)
 9. Music EOOD, Rousse (the "State Gazette", No. 31/04.04.2003)
 10. Chamber Music EOOD, Sofia (the "State Gazette", No. 31/04.04.2003)
 11. Sofia Music Agency EOOD, Sofia (the "State Gazette", No. 31/04.04.2003)
 12. Audiovideo Orpheus EAD, Sofia ("State Gazette", No. 46/20.05.2003)
 13. Vreme Film studio, Sofia ("State Gazette", No. 46/20.05.2003)
- VII. Ministry of Health**
1. Specialized Rehabilitation Hospitals - National Complex EAD - Sofia
 2. Balneological Center - Kamena EAD – Velingrad
 3. BUL BJO – NCZPB EOOD, Sofia
 4. Specialized rehabilitation hospital – Kiten EAD, Kiten
- V. Ministry of Energy and Energy Resources**
1. Kozloduy nuclear power station EAD - Kozloduy
 2. Bulgargas EAD - Sofia
 3. Ecoingenering EOOD – Sofia
 4. NEC EAD
 5. Maritsa Iztok 2 Thermal Power Station "Maritsa Iztok 2" EAD , the village of Kovachevo (amended, the "State Gazette", No. 46/20.05.2003)
 6. Minproekt EAD
- IX. Ministry of Economy**
1. I. B Bulgarticum EAD Sofia
 2. Bulgarian Rose State Laboratory EOOD - Sofia
 3. Eco Elshitsa EOOD - village of Elshitsa
 4. Eco Medet EOOD - village of Panagyurski Kolonii
 5. International Economics Staff Training Center EOOD - Sofia
 6. Bulgarian Agency for Export Insurance AD – Sofia
 7. Plovdiv International fair AD, Plovdiv (amended, the "State Gazette", No. 78/13.08.2002)
- X. Ministry of Finance**
1. Tax Free Zone Bourgas AD - Bourgas
 2. Tax Free Zone Vidim AD - Vidim
 3. Tax Free Zone Rousse AD - Rousse
 4. Tax Free Zone Plovdiv AD – Plovdiv
 5. Tax Free Zone Svilengrad AD - Svilengrad
 6. Transit Commercial Zone AD - Varna
 7. Information Service AD - Sofia
 8. Formprint AD- Sofia
9. Promotion Bank AD - Sofia
10. Bulgarian Stock Exchange AD - Sofia
11. Central Depository AD - Sofia
12. Bank Consolidation Company AD - Sofia
- XI. State Agency for Youth and Sport**
1. National Sports Base EAD - Sofia
 2. Olympika EAD - Sofia

Large State-owned Enterprises/Banks to be Privatized or Liquidated

PAL-2 Board Conditions

1. Bulgartabak:

Approval by the government of a strategy for completing the privatization and restructuring of the Bulgartabak Holding which is satisfactory to the Bank; and which provides for proceeds from the sales of saleable entities to be applied to cover only the social costs of restructuring (redundancy payments, training, micro-credits)

Approval by the Bulgartabak Holding Supervisory Board of a timetable for completing privatization and restructuring of the Bulgartabak Holding which is satisfactory to the Bank.

Signing of the contract with the financial adviser as envisaged under the Bulgartabak privatization strategy

2. DSK (State Savings Bank)

3. Shipyard Varna

4.. Balkancar Holding under formal liquidation proceedings

5. Twenty out of 35 small Hydro Power Plants

PAL-2 Second Tranche Conditions

Bulgartabak :

Significant progress towards completion of privatization of Bulgartabak in line with the approved privatization strategy and timetable

Satisfactory progress in implementing the restructuring strategy to be approved by the Supervisory Board of the Holding

PAL-3 Board Conditions

1. The seven electricity distribution companies

2. Bulgarian Telecommunications Company (BTC)

3. Submission to National Assembly of privatization strategy for Bulgarian River Fleet, Rousse
4. Submission to National Assembly of privatization strategy for Bulgarian Commercial Fleet, Varna
5. Seven District Heating Companies

Bulgaria: IMF-World Bank Relations

A. Partnership in Bulgaria's Development Strategy

1. The government's economic program has been underpinned by a conservative fiscal policy and significant progress with structural reforms. So far Bulgaria has made substantial progress towards long-term macroeconomic stability—an important step along the way to its ultimate goals of improving living standards and accession to the EU. The wide-ranging reforms in the government's agenda hinge on the continuing challenge of macroeconomic stability in the context of the Currency Board Arrangement (CBA), sustaining structural reforms and establishing a business environment conducive to growth, together with improved governance, a deeper financial system, and investment in human capital and physical infrastructure.

2. The IMF has been leading in supporting Bulgaria's medium-term program in maintaining macroeconomic stability. Building on the achievements of the three-year Extended Fund Facility (EFF) arrangement with Bulgaria, in February 2002 the IMF Board approved a two-year Stand-By Arrangement (SBA) with Bulgaria. The SBA, with a reduced scope and detail of structural conditionality compared to the EFF, focused on medium-term fiscal challenges and structural reforms with significant macroeconomic, typically fiscal, implications. In August 2004, the IMF Board approved a 25-month precautionary SBA (ending September 2006) in an amount of SDR100 million.

3. The World Bank has been leading the policy dialogue in structural and institutional reforms aiming at (i) promoting competitive private sector-led growth; (ii) strengthening market institutions and improving both corporate and public sector governance; and (iii) mitigating the social impact of restructuring and delivering social services more effectively. In May 2002 the Board of Directors discussed the Country Assistance Strategy (CAS) of the Bank which outlined the roadmap for the Bank's country support for the period 2002–04. In addition to the Bank's ongoing lending operations in areas such as health, child welfare, water, trade and transport, environment, land registration and cadastre, the CAS includes a three-year programmatic adjustment lending (PAL) program of up to three PALs of up to US\$150 million each. In February 2003, the Board of Directors approved the first PAL operation—it aimed at advancing structural, regulatory, and institutional reforms in the real and financial sectors. In June 2004, the Board of Directors approved the second PAL (PAL-2), which aims at supporting improvements in public sector governance. The third PAL (PAL-3) is currently under preparation with expected Board approval in June 2005. The Bank continues to undertake substantive country diagnostics providing a solid base for policy dialogue and design and implementation of its lending operations in Bulgaria.

B. IMF-World Bank Collaboration in Specific Areas

4. In general, the Bank has the lead on the dialogue on the core structural aspects of the reforms while the Fund has the lead on the dialogue on the macroeconomic, typically fiscal, aspects of the reforms. There are a number of areas where the IMF leads and its analyses serve as inputs into World Bank policy formulation and advice, including policies to maintain macroeconomic stability, fiscal policies, income policies and external sector policies. There are other areas in which the Bank and the Fund share responsibility and are

coordinating closely their policy advice to the Bulgarian authorities such as in the financial sector, public expenditure management and budgeting, and tax administration. In some areas, the Bank has taken the lead but its analysis, country diagnostic work, and policy recommendations served as inputs into the Fund's policy advice on the fiscal front such as education, health care, pensions, social protection, energy, and railways. In areas such as private sector development, strengthening market institutions (including entry and exit policies, regulatory reform to enhance the business climate, judicial reform, labor market reform), and improving governance the Bank has the lead and there has been little conditionality under Fund programs. In addition to consultations early in the process of formulating and adjusting each institution's program with Bulgaria, the Bank and Fund staff teams interact extensively during the review of the progress achieved in the country and coordinate closely their policy advice to the Bulgarian authorities.

B.1. Areas where the IMF leads and its analyses serve as inputs into the World Bank policy formulation and advice.

5. To achieve the objectives of their economic program, the Bulgarian authorities are fully committed to maintain sound and flexible macroeconomic policies centered on a Currency Board Arrangement (CBA) and implement an ambitious reform agenda. In particular, the authorities have maintained a very tight fiscal policy since 1998, attaining a surplus of 1.8 percent of GDP in 2004. The aim is to have at least one percent surplus in 2005, conduct fiscal policy flexibly in the face of shocks, and maintain a high level of fiscal reserve assets. Given the constraints of the CBA, the authorities see labor market policies as another key component of the broad policy strategy. A strict incomes policy for the state enterprise sector is enforced and measures aimed at facilitating the adjustment of labor markets are being implemented. The structural and institutional reforms, which constitute the third pillar of the policy strategy, are focused on creating a fully functioning market economy that is competitive and can flexibly adjust to shocks.

6. In the context of a 25-month Stand-By Arrangement that was approved in August 2004, the IMF continued to lead in assisting Bulgaria in safeguarding macroeconomic stability and promoting structural reforms in areas that are macro-critical and fall within the Fund's core expertise. To safeguard the CBA and ensure that it can continue to serve as the macroeconomic policy anchor, the IMF set a floor on the size of the overall surplus of the general government and a ceiling on central government arrears. To prevent threats to the currency board and macroeconomic stability that could arise from a loss in competitiveness or excessive external financing requirements, Fund conditionality also included ceilings on the wage bill of those state enterprises that have the largest losses and arrears, are monopolies, and receive subsidies, and on the contracting and guaranteeing of public sector external debt.

B.2. Areas of shared responsibility.

7. **Financial Sector.** In late 2001, staff of the two institutions carried out a joint IMF-World Bank *Financial Sector Assessment Program* (FSAP) for Bulgaria, providing a shared perspective on the development agenda of the country and on the prioritization and sequencing of reforms in the financial sector. Key findings of the FSAP are conditionalities on financial sector policies under both the SBA and the PAL program. The IMF has

emphasized aspects related to the banking sector—mainly on policies under the mandate of BNB and supervisory agencies—while the World Bank is focusing on policies that affect market performance and development of the financial sector such as improving the legal and institutional framework for lending, restructuring of the banking sector, strengthening creditor rights, corporate insolvency and governance, and non-banking financial sector issues. A follow-up of the FSAP was undertaken by Fund staff in the context of the 2004 Article IV consultation mission in March–April 2004.

8. Since 1997, in the context of two Finance and Enterprise Adjustment Loans (FESALs), and now with the PAL program, the Bank has supported the government in sector restructuring of the financial sector. Privatization of commercial banks has been a major component of the FESALs, while the Fund provided support for the institution building efforts of the BNB and its Banking Supervision Department in particular. In the financial sector, the Bank has focused on banking, insurance, pension funds, and capital markets while the Fund has continued its focus on the BNB, banking supervision, and the payments system.

9. **Revenue Administration.** The IMF and the World Bank have been carrying out a joint effort since 1996 to assist Bulgaria in reforms aimed at the establishment of an efficient revenue collection agency. Diagnostics consistently pointed to revenue collection deficiencies including weak management, and problematic audit and enforcement of collection, which in turn facilitates low compliance. Supporting reform efforts, the World Bank implemented a project to modernize the Social Security Institute, including its revenue collection activities. The IMF provided a long-term advisor to the Ministry of Finance, and focused advisory services through consulting assignments. Joint World Bank-IMF efforts resulted in a proposal for “Implementing a Modern Revenue Collection Agency” in March 2000, which is now moving forward. The World Bank’s Board approved on June 5, 2003 the Revenue Administration Reform Project (RARP, €31.9 million), developed with technical assistance of the IMF, to support the establishment of the national revenue agency (NRA), which seeks to maximize the level of voluntary taxpayer compliance, promote effectiveness and efficiency, establish a professional workforce and approach to collection, and help reduce the scope for corruption. To support the reform of the revenue administration, the IMF included in the current SBA as prior actions the parliamentary approval of the Bulstat legislation, the approval on first reading of the Tax and Social Contributions Procedural Code to Parliament, and the submission to Parliament of a package of new tax laws (Personal Income Tax Law, Corporate Income Tax Law, VAT Law, and Excise Tax Law). The approval of the Code is structural performance criterion, while the approval of the four tax laws is a structural benchmark in the current SBA.

10. **Public Expenditure Management.** The Bank has taken the lead in the dialogue on the efficiency and effectiveness of public expenditures and has outlined policy directions in the context of the Public Expenditure and Institutional Review (PEIR)¹ which are being further supported by the PAL program. The PEIR has also been a useful input to the IMF program. The PEIR notes that notwithstanding progress to date, important challenges remain in: (i) improving management and accountability in the use of public resources; (ii) restructuring and rationalizing intersectoral public expenditure—particularly energy and railways, economic services, defense and security, and general services; (iii) reallocation of

¹ The PEIR is entitled *Bulgaria: Public Expenditure Issues and Directions for Reform*, August 2002, The World Bank, (Report No. 23979-BUL)

intrasectoral priorities—especially in health, education, and social protection; and (iv) higher investment requirements in many sectors—infrastructure and environment—some of which are priorities for EU accession, and some of which should involve the private sector. The PEIR notes that Bulgaria’s main fiscal challenges include working towards an improved allocation of expenditures, while gradually reducing the overall level of expenditures over the medium term in tandem with Bulgaria’s fiscal targets of easing the overall tax burden, especially payroll taxes.

11. The IMF has provided long-term technical assistance on budgeting and expenditure management. To ensure the fiscal discipline necessary to support the CBA, the government has already initiated a number of public expenditure management reforms. New budget procedures were introduced in early 2002 and were implemented for the 2003 budget. Despite this important progress, the PEIR notes that there is a need to continue and broaden the reform effort—capital expenditure proposals should be prepared under hard budget constraints and as an integral part of the medium-term budget frameworks; and the financial management at the local level should be strengthened. These reforms are also supported by the Bank through the PAL program.

B.3. Areas where the World Bank leads and its analyses serve as inputs into the IMF policy formulation and advice.

12. **Energy sector.** The Bank has played the lead role in assisting the government in the design of the reform program in the sector, and more importantly on its implementation. After the completion of the Energy Project at end-2000, the Bank has continued to support the developmental objectives of the sector to increase the energy efficiency. Under the PAL program, the government has strengthened the legal and regulatory framework, removed major price distortions and initiated steps to enable the private sector to assume an increasing share of commercial risks. Policy recommendations have been outlined in the Bank Energy and Environment Review completed in 2002, which aimed at also evaluating alternative strategies to balance the need for economic development and environmental protection. In June 2003 the Bank’s Board approved two district heating projects to support the rehabilitation of the Sofia and the Pernik District Heating Companies. The Fund’s and the Bank’s teams have worked collaboratively in close consultations with the government, and the previous SBA included a performance criterion focusing on implementation of the schedule for bringing electricity prices to full cost recovery level, and two benchmarks—one on implementation of the new regulatory pricing regime, and the other on preparing a new Energy Act to harmonize Bulgaria’s legislation with EU Directives.

13. **Railways.** The Bank has been the government’s main external partner in the transformation of the railway sector, particularly through the Railway Rehabilitation Project, which was completed in June 2002. This transformation is at present only half way achieved. Some essential measures have been implemented under the PAL program, especially the divestiture of all railway ancillary activities, securing a major staffing optimization, signing a Public Service Contract, and completing the institutional separation of the national company into two new infrastructure and rail services enterprises together with the opening of rail services to private operators. Key remaining steps include completion of the tariff reform, further staff optimization, and improved corporate governance. They were refined in the context of the recent PEIR and are being supported by the Bank through the PALs. Detailed

assistance with the design of these reforms will be further provided through transport sector work in the near future.

14. **Education.** The reform efforts in the education sector aim at improving expenditure management in view of the declining population, especially in school age, and at enhancing quality and access to education. The main priority in the education sector, including universities, is to reallocate expenditures from surplus capacity in teaching staff and underused facilities toward modernization and upgrading of curricula, textbooks, teaching materials, schools, and other quality-enhancing education inputs. The Bank has supported the government program in education through the Education Modernization Project loan (closed on March 31, 2004), the PALs, and the analytical work done for the Poverty Assessment, the PEIR, and the Inter-governmental Finance study². Under PAL-2 the government developed a concept for an education reform strategy and action plan, the implementation of which is being supported through PAL-3.

15. **Health care.** Key reform priorities in the health sector include addressing the concurrent problems of surplus capacity issues in health facilities, the serious deterioration in the quality of facilities and health services, and the inadequate modernization of equipment. At the same time, the government needs to ensure the financial integrity of the NHIF, which is the central point of the reforms in the sector. For a long time the Bank has been supporting the restructuring of the health sector through the Health Sector Restructuring Project which was closed at end-2001. The follow-up Health Sector Reform project approved in late 2000 is under implementation and focuses on the administrative and information systems of the NHIF, and supports the ambulatory care sector and the hospital sector. The reform agenda in the health sector has been supported through the PALs, with PAL-3 focusing on the implementation of the action plan for the hospital restructuring.

16. **Social protection programs.** Social protection programs—pensions, labor market programs, social assistance, and short-term and family benefits—have a wide coverage among the population. On pensions, one reform priority is to improve compliance with, and coverage of, the public pillar. Ensuring successful implementation of the pension reform has been supported through the PALs. During FY04, the preparation of a policy-oriented note has supported the pension policy dialogue. On labor market programs, there is a need to monitor these closely to improve their effectiveness and long-term impact in stimulating labor demand. Subject to progress in key reforms, consideration should be given to reduce the tax burden related to labor market policies in order to curtail labor costs.³ Some social assistance and benefit programs have become more pro-poor since the mid-1990s and are playing a major role in alleviating poverty. However, given the plethora of these programs, and the complexity of program design in many cases, a constant challenge of the social protection system as a whole is to consolidate the system driven by improving targeting of vulnerable groups, and engage in systematic monitoring of the programs, their costs and effectiveness to ensure fiscal sustainability.

² *Issues in Intergovernmental Relations*, the World Bank, January 27, 2004, Report No. 25821-BUL.

³ However, such fiscal adjustment requires increasing efficiency in public expenditures, and lowering public expenditures to GDP before implementing tax reductions.

17. The Bank has been the main partner of the government in its efforts to address poverty reduction and meet its social development objectives. The main findings of the Poverty Assessment and the PEIR contribute significantly to the enhanced policy dialogue with the government on its policy options to improve living standards in the country, and increase the effectiveness and adequacy of its social protection programs. The Bank is assisting these important reforms in the social protection system through providing grants amounting to US\$2.2 million. The latter focus on poverty monitoring and evaluation, integration of ethnic minorities, child development and building social capital in disadvantaged communities. A Bank-financed Child Welfare Reform project helps address the needs of children in public care, while a Bank-financed Social Investment and Employment Promotion (SIEP), which supports community and employment creation and strengthening of ALMPs, was approved in 2002. The IMF has been also monitoring the sustainability of the pension system and the advancing of the labor market reforms in terms of their relevance for the Fund's program objectives.

B.4. Areas where the World Bank leads and there is no direct IMF involvement.

18. **Private Sector Development.** Bulgaria has completed the divestiture of about 95 percent (based on value of assets) of its non-infrastructure state-owned enterprises (SOEs) since 1995. To encourage the entry of new firms and the expansion of existing ones, the business climate will have to continue to improve focusing on reducing barriers to entry, reducing compliance cost of the regulatory regime, developing a competitive environment, and establishing an efficient exit mechanism for non-viable enterprises. Under the PAL program, major changes in the basic legislation have been initiated - notably the Commercial Code, the Civil Procedure Code, and the Labor Code, and the passage of legislation on how the State will regulate economic activity to ensure stability and predictability of regulatory regimes.

19. **In the context of the two Finance and Enterprise Adjustment Loans (FESALs) and the PAL program, the Bank has supported the government in sector restructuring of the non-infrastructure enterprise sector.** Privatization of SOEs has been a major component of the FESALs. Under PAL-1 and PAL-2, the Bank has led the dialogue on reforms covering the regulatory regimes, the insolvency process, and competition.

20. **Public sector governance.** The government is pursuing a broad program to improve public sector governance including strengthening the capacity of the public administration, improving service delivery, reducing corruption, and reforming the judiciary. The support of this program has been the main focus of PAL-2. The policy, legal and institutional framework has been developed and put in place to strengthen merit and depolitization. Performance standards for service delivery have been developed and one-stop shop principles have been introduced in five central administrations and six regional administrations. The system of performance appraisal and professional development within the state administration has been enhanced. Concrete steps have been undertaken to increase accountability and transparency – the conflict of interest and asset declaration regime has been strengthened; a monitoring system to track progress in meeting the anti-corruption objectives has been designed; key ministries and agencies have prepared detailed and practical anticorruption action plans.

C. The World Bank Group Strategy and Lending Operations

21. **The Country Assistance Strategy (CAS) for Bulgaria⁴**, discussed by the Bank's Board on May 9, 2002, focuses on three main themes: (i) promotion of competitive private sector led growth, (ii) strengthening public administration reforms and anti-corruption initiatives, and (iii) mitigating the social impact of restructuring and delivering social services more effectively.

22. **Programmatic Adjustment Lending.** Up to three Programmatic Adjustment Loans (PALs), the first two, PAL-1 and PAL-2, were approved by the Board in February 2003 and June 2004, respectively, ⁵and the third one is under preparation. The PAL program supports the government's reforms aiming at: (a) completion of privatization and restructuring in energy and infrastructure; (b) improving the environment for private sector led growth; (c) deepening the financial sector; (d) reducing poverty and improving human capital, and better delivery of social services; and (e) support public administration reform and anti-corruption programs.

23. **The World Bank's assistance program in Bulgaria to date comprises 37 operations for a total original commitment of US\$1,987.2 million equivalent.** This includes eleven adjustment loans (US\$1,075.8 million), 19 investment projects (US\$750.7 million), one debt reduction loan (US\$125.0 million), four Bank-managed Global Environmental Fund (GEF) grants, and two Bank-managed Prototype Carbon Fund (PCF) operations. Of these 37 operations, 24 have been completed, of which ten have been partially cancelled during implementation, and thirteen operations are currently under implementation (see Table 1 below). In addition, a grant by the Institutional Development Fund, in the area of regulatory reforms in infrastructure, was approved in February 2005 in the amount of US\$381,000.

24. **IFC's Activities in Bulgaria comprise 25 projects (totaling US\$293 million) in the support of financial sector development, gas production, tourism and restructuring of post-privatized companies.** Of those, 20 projects were approved from 1999-on. In the financial sector, IFC has supported two specialized SME banks, established Bulgaria's first micro lending bank, and has invested in a leasing company and in a venture capital fund. Also, IFC has invested in a number of key manufacturing projects covering cement production, electronic assembly, pulp and paper mill, and copper processing. In FY04 alone, IFC has committed about US\$90 million to support post-privatization restructuring of a steel mill and glass processing plants.

25. **Economic and Sector Work.** The country diagnostic work recently completed includes: Country Financial Accountability Assessment, Survey on Rural Development Needs, Issues in Inter-governmental Relations, Environmental Sequencing Strategies for EU Accession, and the National Energy Efficiency Study. Other country diagnostic work being

⁴ *Memorandum of the President of the International Bank for Reconstruction and Development and the International Finance Corporation to the Executive Directors on a Country Assistance Strategy of the World Bank Group for Bulgaria, May 31, 2002.*

⁵ *Program Document for a Proposed Programmatic Adjustment Loan to the Republic of Bulgaria, The World Bank, January 23, 2003, Program Document for a Proposed Second Programmatic Adjustment Loan to the Republic of Bulgaria, The World Bank, May 4, 2004.*

completed includes an infrastructure and energy study, a roads study, and a Country Economic Memorandum focused on policy reforms for growth.

Table 1. Bulgaria: Active World Bank Operations (net of cancellations) ^{a/}

	Operation	US \$ million	Board Date
1.	Trade and Transport Facilitation in Southeast Europe	7.4	2000
2.	Health Sector Reform	63.3	2000
3.	Child Welfare Reform	8.0	2001
4.	Registration and Cadastre	30.0	2001
5.	Wetlands Restoration and Pollution Reduction (GEF Grant)	7.5	2002
6.	Social Investment and Employment Promotion	50.0	2002
7.	Revenue Administration Reform Project	34.2	2003
8.	District Heating Project	34.2	2003
9.	Wood Residue to Energy (PCF)	1.8	2003
10.	District Heating (PCF)	5.0	2004
11.	Energy Efficiency Fund (GEF)b/	10.0	2005
12.	Pomoriisko Lake (GEF)b/	0.9	2005

Notes: *a/* PAL-1 (US\$ 150 million) was approved by the Board on January 23, 2003, PAL-2 (equivalent to US\$125 million) was approved by the Board on May 4, 2004. PAL-3 is expected to reach the Board in June 2005. *b/* Not effective yet.

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