

**PROGRAM INFORMATION DOCUMENT (PID)
CONCEPT STAGE**

Report No.: .

31701

Operation Name	Third Programmatic Adjustment Loan (PAL 3)
Region	EUROPE AND CENTRAL ASIA
Sector	Gen pub admin sector (30%); Gen ind/trade sector (25%); Other social service (21%); Secondary education (12%); Health (12%)
Project ID	P078675
Borrower(s)	GOVERNMENT OF BULGARIA
Implementing Agency	MINISTRY OF FINANCE
Environment Assessment	OD 4.01 applies? [] Yes [X] No
Date PID Prepared	December 10, 2004
Estimated Date of Appraisal Authorization	January 20, 2005
Estimated Date of Board Approval	May 17, 2005

1. Key development issues and rationale for Bank involvement

Following the economic and financial crisis of 1996/97, Bulgaria had, at the start of the PAL program, achieved macroeconomic stability and implemented the first generation of structural reforms. Growth was restored and averaged 4 percent in 1998-2001, after cumulative decline of 14 percent in 1996-1997. Inflation was brought down from over 1000 percent in 1997 to 4.8 percent in end 2001. External and public and publicly guaranteed debt declined from over 100 percent of GDP in 1997 to 78 and 70 percent respectively. As a result of the structural changes, private sector share of GDP had reached nearly 70 percent in 2001 (from 60% in 1996), and the banking sector had been put on a sound footing. However, unemployment at 18% in 2001, was among the highest in the region. Poverty fell with the economic recovery but remained unacceptably high, while pockets of poverty persisted, with strong ethnic, regional or age dimensions.

Against this background, the government has followed a two-pronged strategy for sustaining growth and reducing poverty: (a) creating an investment climate for private sector led growth, and (b) empowering the population, especially the poor to participate in growth. This strategy builds on the gains made during the previous five years, but has represented a shift from the focus of the previous government from an agenda driven primarily by the depth of the economic and financial crisis of 1996/97: an agenda that had focused on macroeconomic stabilization, the establishment of a sound fiscal regime, accelerated implementation of structural reforms and the expansion of the social safety net to mitigate the impact of the transition.

Bulgaria has continued to make consistent progress in implementing its broad reform agenda and the PAL program has supported the momentum for reforms. The macroeconomic performance remains strong, and the country remains on track for EU accession planned in 2007. Economic growth has accelerated to 5.6 percent during the first half 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 (12-month inflation at 6.3% in September 2004). Strong GDP growth and active debt management have contributed to a reduction in consolidated government debt to 40.2% of GDP in August 2004, well below the Maastricht threshold of 60 percent. Fiscal policy has remained tight, with overall fiscal deficit declining from 0.9% of GDP in 2001 to 0.6 percent in 2002 and a balanced budget in 2003. FDI inflows have averaged 6% of GDP over 2001-03, while in January-July 2004 were estimated at \$1.6 billion, higher than the annual inflows in 2003. . As a result of continued structural reforms, the share of the private sector in GDP has expanded to 75 percent of GDP in 2003; and the share of the private sector in the banking system was 98% in 2003. All these achievements have resulted in increased investors' confidence and in the summer of 2004, Standards & Poor's and Fitch Ratings upgraded Bulgaria's

foreign currency long term sovereign debt from speculative to investment grade. Persistently high unemployment has finally started to decline as a result of accelerated growth, private sector job creation, and supported by active labor market policies. -Unemployment has declined dramatically from 18.1% in 2001 to 11.7% in September 2004, and per capita incomes in 2004 were 124% of the levels in 1997. Available evidence suggests that poverty has continued to fall, albeit slowly.

Despite these gains, challenges remain in maintaining stability, sustaining growth, and improving performance in the social sectors.. Notwithstanding the impressive progress to date, Bulgaria has one of the lowest per capita income levels compared to the EU average, and unemployment remains high compared to other countries in the region. The nature of poverty has evolved, as recent improvements in welfare have not been equally distributed across the population. “Pockets of poverty” persist among certain groups, particularly large families with many children, ethnic minorities most notably Roma, the less educated, and the unemployed. While participation in education has continued to increase, Bulgaria’s education system needs modernization to ensure it equips students with skills required in a competitive market economy. Moreover, gaps in access to health and education are real for vulnerable groups. Improving economic performance in a rules-based environment is central to continue to improve standards of living. Strengthening the macroeconomic framework requires efforts to improve efficiency of public expenditures to enable continued implementation of tax reform which aims at improving growth prospects. Improving growth prospects requires completion of PAL program reforms, particularly those in pillars 1 to 3 which aim at supporting economic restructuring and improved business environment. Completion of the public sector governance reform, where Bulgaria made important progress under PAL 2, is central to growth and investment, as well as efficiency in public sector service delivery.- Long term growth hinges on reforms to invest in human capital, particularly upgrading skills, improving the functioning of the labor market, completing health care and pension reforms, and strengthen efficiency and efficacy of the social safety net-

PAL3 is the third of three programmatic adjustment loans envisaged in the Country Assistance Strategy (CAS) discussed by the Board on May 9, 2002. The PALs support the government’s medium term reform agenda. The first, PAL 1, was approved by the Board of Directors of the Bank on February 20, 2003 (Report No. 25374-BUL). PAL 2 – structured as a two tranche operation – was approved on June 10, 2004 (Report No. 27473-BUL).

The external financing provided by the PALs, enables structural reforms to be phased in 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 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 provides fiscal and balance of payments support needed for the government to be able to implement a broad reform program.

2. Proposed objective(s)

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, while making 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 with reducing

social exclusion and increasing empowerment to ensure wide participation in growth. The program consists of five complementary pillars:

- *Sustaining structural reforms* in the enterprise sector with emphasis on completion of privatization and on 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, and improving the competitive environment, including through continuing labor market reform;
- *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 institutionalization of children.

3. Preliminary description

The PAL series has been designed as a comprehensive effort to support the components of the Government's medium-term program, focusing on the design and implementation of policies and sector programs, and the strengthening of markets and institutions. Each PAL intervention was intended to focus on specific themes, while at the same time sustaining reforms which began during previous PALs, and preparing reforms to be implemented in succeeding PALs. 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), PAL-2 initiated broad reforms in the area of *public sector governance* (Pillar IV) while continuing the reforms initiated under PAL-1. PAL-3 plays an important role in "completing" the current reform agenda as envisioned, while laying the foundation for a future reform program. It continues the unfinished reform agenda of the previous PALs, particularly in pillars I, II and IV, while it has a particular focus on reforms in the *social sectors* (Pillar V). Reforms in Pillar V support investments in human capital and strengthening of social protection through measures to improve the effectiveness and efficiency of health and education services, improve the effectiveness of disability benefits to facilitate integration of the disabled, implement pension reform, improve the effectiveness of social assistance, and reduce institutionalization of children. All interventions have been closely tied to the needs for preparing Bulgaria for EU accession

4. Environment Aspects

The PAL Program has a component that would further strengthen the design and implementation of environmental policies. This includes the passage of improved environmental legislation, in line with EU directives.

5. Tentative financing

Source:	(US\$m.)
BORROWER	0
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT	150
Total	150

6. Contact point

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