PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

Report No.: AB1434

Operation Name	PAL 3
Region	EUROPE AND CENTRAL ASIA
Sector	General public administration sector (30%);General industry and trade sector (25%);Other social services (21%);Secondary education (12%);Health (12%)
Project ID	P078675
Borrower(s)	GOVERNMENT OF BULGARIA
Implementing Agency	Ministry of Finance
Date PID Prepared	March 3, 2005
Date of Appraisal Authorization	March 15, 2005
Date of Board Approval	May 17, 2005

1. Country and Sector Background

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 5.7 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% in 2004). Strong GDP growth and active debt management have contributed to a reduction in consolidated government debt to 39.1% of GDP in November 2004, well below the Maastricht threshold of 60 percent. Fiscal performance continued to improve as a result of combination of tight expenditure policy and revenue overperformance – fiscal accounts ran a surplus of one percent in 2004 compared to a balanced budget in 2003. FDI inflows were estimated at $2.5 billion in 2004, the highest inflows recorded so far since the start of the transition. As a result of continued structural reforms, the share of the private sector in GDP has expanded to 75 percent of GDP in mid-2004; and the share of the private sector in the banking system is 98%. 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 12.7% in 2004, and per capita incomes in 2004 were 124% of the levels in 1997. Available evidence suggests that poverty has continued to fall.

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, and despite recent improvements, gaps in attendance rates in Bulgaria – between rich and poor – remain among the highest in the ECA region. 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).

2. Operation Objectives

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 increasing empowerment and reducing social exclusion and 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.

Progress towards the objectives of the program has been impressive: the average annual growth rate between 2002-05 has been 4.8 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, particularly in Pillars 1, 2, 4 and 5, with a focus on the *social sector agenda.*

3. Rationale for Bank Involvement

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 this broad reform program.

4. Financing

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

5. Institutional and Implementation Arrangements

The government has taken a number of steps to put in place appropriate institutional arrangements and structures to ensure the successful implementation of the PAL program. The Council for Economic Policy[1] (formerly the Council for Structural Policy) under the Council of Ministers, chaired by the Deputy Prime Minister and Minister for Economy, has undertaken 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 involvement of private sector participation, NGOs and service users in the design and implementation of government

[1] 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.

policies and reforms. A number of other bodies and inter-agency working groups focus on specific components of the reform.

The government has also developed mechanisms for participation by stakeholders in the design and implementation of the reform program. 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, and the Employers' Association.

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 public perception of the judicial system, a survey has been implemented in 2004. 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. *A consolidated matrix on Progress Against Desired Outcomes is attached as [Annex 6C] to this Program Document.*

6. Benefits and Risks

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 strengthening of 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 a future medium term reform program through identifying specific outcomes to be achieved over the period 2005-2007 and indicating medium term directions of reform. Fourth, PAL-3 complements 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.

There are three main risks:

- *Political risk remains high, but is mitigated by the maturity of the reform agenda***.** With the coalition government losing its parliamentary majority and the outcome of the upcoming Parliamentary elections as yet uncertain, this presents risks for completing envisioned legislative changes. Mechanisms established or being established for stakeholder consultation are expected to strengthen the support for completing the reforms and could mitigate this to some extent. There are also moderate risks about the continuity of reforms in the medium term. The latter risk is 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 remaining structural, institutional and social reforms – and particularly the reforms to public administration and the judiciary. The risks to reforms during and 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 PAL-3 reforms but also continuing reforms beyond the PALs. 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 implementation support in ongoing investment projects from the Bank and other donors in key areas of the reform program areas. Also important is the ongoing EU support to capacity building through PHARE and twinning arrangements. Nevertheless, risks remain and there is a significant unfinished agenda in institution and capacity building.

- *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 fifty percent of Bulgarian exports and the origin of more than half the FDI inflows.) 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. However, Bulgaria's sustained track record to date, the better than expected performance in 2004, and the active management of its external debt, continuation of prudent fiscal policies, and solid growth performance reduce the scope of these vulnerabilities. Mitigation of these risks are predicated on continued maintenance of strict discipline in macroeconomic policies and the measures in place to respond to potential risks if these were to materialize.

7. Poverty and Social Impacts and Environment Aspects

The Bank has reviewed the potential environmental issues related to this operation. It has dentified the primary linkages with the need to comply with the EU Large Combustion Plants Directives for energy facilities; and ensuring 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 European Union in the negotiations of the environment chapter for EU accession have explicitly taken into account which energy facilities require the privatization process to address Large Combustion Plant Directive requirements. The Bank has directly assisted the Government of Bulgaria on establishing a process for clarification of environmental liabilities through previous adjustment and sector loans, and the team is in the process of verifying that the privatization agency has fully adopted these practices.

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