



# **BULGARIA: PUBLIC EXPENDITURES FOR GROWTH AND COMPETITIVENESS**

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# **BULGARIA: PUBLIC EXPENDITURES FOR GROWTH AND COMPETITIVENESS**

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## Weights and Measures

Metric System

## ABBREVIATION AND ACRONYMS

<b>CAR</b>	Council for Administrative Reform
<b>CBA</b>	Cost-benefit analysis
<b>CGER</b>	Consultative Group on Exchange Rate Issues
<b>CPI</b>	Consumer price index
<b>EC</b>	European Commission
<b>ERMII</b>	Exchange Rate Mechanism II
<b>ESA95</b>	European System of Accounts 1995 revision
<b>EU</b>	European Union
<b>FDI</b>	Foreign direct investment
<b>GDP</b>	Gross domestic product
<b>MOE</b>	Ministry of Education
<b>MOF</b>	Ministry of Finance
<b>MTFF</b>	Medium-term fiscal framework
<b>NSI</b>	National Statistics Institute
<b>NRP</b>	National Reform Program
<b>PIM</b>	Public investment management
<b>PRP</b>	Performance-related pay
<b>PPS</b>	Purchasing power standard
<b>REER</b>	Real effective exchange rate
<b>SOE</b>	State-owned enterprise
<b>ULC</b>	Unit labor cost
<b>UPSCS</b>	Unified per student cost standard
<b>VAT</b>	Value added tax

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# Executive Summary

**1. Bulgaria's economy performed relatively well during the global crisis and the recovery is well along.** The large macroeconomic imbalances that emerged in 2005–08 were corrected by 2010. In late January 2011 the European Commission (EC) concluded that in 2010 Bulgaria had made significant fiscal consolidation that had reduced the excessive deficit and could be expected to exit excessive budget financing procedures in 2011 (EC 2010a). Driven by net exports, the economy is recovering, although investment and consumption are coming back more slowly.

**2. However, the emerging economic recovery faces several risks.** The legacy of non-government external debt of 91 percent of GDP as of 2010 implies there will be a period of deleveraging. Spurts in the gradual deleveraging may stress the banking system. In the medium term, domestic savings are expected to play a more important role than in the past in financing investment. This will represent one more step forward in Bulgaria's development, albeit it is challenging. Negative shocks to investment and growth would further stress finances of the corporate sector and may also require cuts in public spending to safeguard stability. Among other challenges are uncertainties about the sovereign debt situation in the euro area and the pace of recovery in European Union (EU) countries.

**3. To address these risks, the government has undertaken major economic and institutional reforms.** The reform agenda outlined in the Bulgaria National Reform Program (NRP), 2011–15 (anchored in the Europe 2020 Strategy) is designed for joining the Exchange Rate Mechanism II (ERMII), converging more closely to EU income levels, and enabling a gradual transition to an export-led growth model. To accomplish this, it emphasizes upgrading institutions, infrastructure, and labor force skills, and improving the business environment. At the core of the program is reform of the state: making public services more efficient and effective. The proposed reforms have three dimensions: policy changes, modernization of institutions, implementing the policies, and better management of public finances.

**4. This document was prepared to inform policy makers, the international community, and civil society about Bulgaria's recent economic performance and about public expenditure reforms to enhance competitiveness and export-led growth.** The report first summarizes Bulgaria's growth strategy and fiscal adjustment over the last several years and the medium-term challenges ahead. It then analyzes export performance to identify the comparative advantages of Bulgaria's exports and outlines policy options to enhance competitiveness in the medium term. Reforms to strengthen competitiveness should focus on making the public sector more productive so as to enhance service delivery, improve the business environment, and upgrade infrastructure. The report therefore targets two broad areas for reform: (i) the wage bill and public employment; and (ii) public investment management (PIM).

**5. If it is to enhance growth sustainably by relying increasingly on exports, Bulgaria needs to be more competitive.** Returning to sustainable growth is vital to accelerate the pace of convergence. Bulgaria's per capita income at purchasing power standards (PPS) is only about 44 percent of the EU27<sup>1</sup> average, and convergence slowed somewhat during the recession. Improving the growth differential with the rest of the EU will require that productivity growth and competitiveness intensify. Higher productivity is critical for sustainable growth, given Bulgaria's

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<sup>1</sup> EU27 refers to all 27 member states of the EU.

unfavorable demographic situation, and only significant improvements in competitiveness of Bulgaria's producers would allow a shift to export-led growth and make the economy more resilient to external shocks. The growth model of the past that relied solely on domestic demand was not sustainable as the economy overheated.

**6. Export-driven growth, however, is associated with lower tax revenues.** A high share of tax revenue comes from consumption taxes, value-added tax (VAT), and excises, mainly from imports. Higher exports mean higher VAT refunds and therefore less tax revenue. Bulgaria will therefore need to continue its fiscal consolidation if it is to reduce its deficit below the reference rate of 3 percent of GDP in 2011 (ESA95 definition) and reach the medium-term goal of a generally balanced budget by 2014 (-0.5 percent of GDP). In the medium term, Bulgaria aims to join the EMU and is committed to preserving the fixed exchange rate until it becomes a member of the euro area. Credible fiscal consolidation and sustainable convergence of price levels based on productivity increase will support Bulgaria's plan to join the EMU and consequently the euro area.

**7. Keeping the economy stable and fiscal policy and management sound are prerequisites for sustainable growth. The implications are that Bulgaria would need to**

- **Exit the excessive deficit procedure on schedule in 2011 and continue to reduce the deficit in the medium term.**<sup>2</sup> This should make fiscal policy more credible.
- **Resist political pressures for ad hoc spending increases.** Such increases have previously proved detrimental to fiscal discipline and create wrong incentives. Unplanned spending should be permitted only if there is a clear economic rationale and if savings have been achieved elsewhere.
- **Ensure that public investment projects are done effectively and efficiently.** Absorption of the close to €6 billion remaining in EU structural and cohesion funds will require substantial changes in the planning, monitoring, and completion of public investment projects.
- **Restructure spending to reallocate scarce public resources to productivity-enhancing activities.** This will require continuing reforms to improve access to and the quality of education and reforms in the health sector not only to address access and quality issues but also to deal with inefficiencies in spending. These reforms do not necessarily require higher spending but rather intra-sectoral reallocations to achieve better efficiency and effectiveness.

**8. Bulgaria has the potential to move gradually to the export-led growth path that is central to its economic recovery and convergence.** Different measures of real effective exchange rates (REERs) do not reveal significant exchange rate misalignments, although results are affected by the method and period of estimation. Over the last 10 years the accumulated appreciation of Bulgaria's currency as measured by REER based on unit labor costs (ULC) was in line with the appreciation registered in most EU10<sup>3</sup> countries. Shorter-term estimates, however, show an appreciation of 27 percent for 2006–08, influenced mainly by sizable foreign capital inflows, which are unlikely to return any time soon. Export performance indicators also show that since 2000 Bulgaria has become more competitive and has expanded its export capacity. Total exports of goods and services increased, in nominal terms, by 274 percent, from €7.6 billion in 2000 to

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<sup>2</sup> EPreliminary data based on national classification show that the fiscal deficit in 2011 was 2.1 percent of GDP.

<sup>3</sup> EU10 refers to the newer EU members: Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia.

€20.7 billion in 2010. Exports to highly competitive markets have steadily risen; currently the largest market for Bulgaria's merchandise exports is Germany, one of the most competitive and fastest-growing economies in the EU. The composition of Bulgaria's exports to EU markets is also changing for the better, with the share of capital-intensive and skilled-labor products rising, though still low. Diversification was a helpful buffer during the global crisis, though exports of natural resources were more resilient than other commodity groups. Similarly, trade in services helped cushion external imbalances. Bulgaria had a relatively large surplus in services, which almost quadrupled between 2000 and 2010. Services exports, which account for close to 14 percent of GDP, give Bulgaria an important comparative advantage.

**9. Nevertheless, exports of goods and services are below their potential.** Bulgaria's comparative advantage is mostly in natural resource-based and unskilled, labor-intensive commodity exports rather than in capital- and skilled-labor-intensive goods. Also, preliminary estimates indicate that producers in Bulgaria are only now beginning to build linkages with buyer- or producer-driven market networks. Buyer-driven networks are in industries in which large retailers, marketers, and branded manufacturers take the lead in setting up decentralized production networks in exporting countries. Some buyer-driven networks are labor-intensive, notably in such consumer goods as clothing, footwear, housewares, and consumer electronics. Producer-driven networks are typical in industries where large transnational manufacturers organize production networks both upstream and downstream. These networks tend to be in capital- and technology-intensive industries, such as automobiles, aircraft, computers, semiconductors, and heavy machinery. Only 41 percent of Bulgaria's exports to EU countries is linked to networks, whether buyer- or producer-driven. Networked Bulgarian exports are dominated by buyer-driven networks, which represent 50 percent of total exports of network products to the EU and tend to be associated primarily with labor-intensive products. Most buyer-driven network exports from Bulgaria are textiles and clothing, but these have been trending downward since 2000. Although exports of producer-driven network products have by contrast been expanding at a rate of 16 percent a year, they started from a base of less than 2 percent of Bulgaria's total exports. Problems with the business environment, deficiencies in infrastructure, inefficient and often non-transparent public administration, and high energy and resource intensity have limited the expansion of services exports, especially travel and transport services.

**10. Reforms are needed to strengthen Bulgaria's exports and competitiveness.** B National Reform Program 2011–2015 describes what the government plans to do to make Bulgaria more competitive. If the program is implemented as planned, competitiveness can improve in the medium term. Priority reforms to strengthen competitiveness would be to:

- **Improve the public services essential to compete in world markets**, by enhancing education to equip the labor force with needed skills; providing efficient and quality services to improve the health of the labor force; and financing research and development to help firms innovate and expand production. Currently Bulgaria fares worse than most other EU10 countries in terms of quality of and access to education, quality of health care, and capacity to produce high-tech products.
- **Streamline the business environment.** Burdensome regulation and inefficient administrative services limit business growth opportunities and stifle innovation and competitiveness. The government target is to reduce the administrative burden by 20 percent by the end of 2012, but this may not be sufficient to make it easier to do business. Currently Bulgaria's ease of doing business ranking is below the median for the EU10.

- **Upgrade basic infrastructure.** The quality of Bulgaria's road and rail infrastructure needs to be far better if its producers are to reach distant markets easily and at less cost. While some EU10 countries doubled and tripled the length of their motorways in 2000–09, Bulgaria has been slow to build highways, and existing roads have suffered from years of neglect. Provided reforms of railways are implemented, the railway sector could play an important role in supporting expansion of Bulgaria's trade in the region.
- **Improve labor market participation and labor force skills.** This is especially important considering that Bulgaria's population is aging and declining. Activity rates in Bulgaria declined more in 2009–10 than in other EU10 countries and are now among the lowest in the region.

**11. Initiating the reforms needed to become more competitive relies on a more productive public administration.** Optimizing public administration and adjusting the wage-setting policy would make it possible for Bulgaria to attract and retain more qualified staff. In response to the global crisis, the government took two major steps to contain growth in the public wage bill. First, it eliminated about 16 percent of central government positions. Second, it froze the central government wage bill. In addition, functions are being streamlined and administrative services simplified as part of the Public Administration Optimization Plan 2010–2011. In 2010 a new pay and grading system was introduced that streamlined wage-setting for all public employees. However, it is important at the same time to enhance employment and pay policies to ensure that the public sector attracts and retains high-caliber staff who can deliver on the ambitious reform program. To do this, it will be necessary to

- **Continue optimizing public administration staff and structures.** Bulgaria has about 30 public employees per 1,000 population, one of the highest proportion among EU10 countries. While this may reflect the broad scope of services provided by the Bulgarian public sector, it also indicates significant overstaffing. Plans for increasing the efficiency of administrative services and expanding e-government should permit a leaner administration in the future.
- **Be careful with the implementation of the PRP.** Introducing a performance element into remuneration should encourage productivity, but international experience has generally been disappointing: objectively measuring performance is difficult, and the impact of PRP on performance is limited and may even be negative. PRP systems are particularly difficult to implement where management is weak, because managers then tend to assign ratings on the basis of factors unrelated to performance, such as friendships or family connections. Therefore, rather than performance evaluations being used to determine annual salary increases, they should be used to evaluate staff for dismissal or promotion. Performance can be encouraged through other means, such as effective recruitment and competitive remuneration.
- **Maintain flexibility in setting public sector wages.** Wage bill freezes are risky as a longer-term strategy because they may make it difficult to attract and retain competent staff, especially once economic growth resumes. As the fiscal accounts improve, there may be a case for raising salaries. In the long term, one approach might be to index wages to inflation. To keep public wages competitive, some countries base wage increases on surveys of wages in the private sector to see if wages for equivalent positions may be rising.
- **Periodically review recruitment and retention policies.** This is particularly important in more competitive high-skilled jobs to ensure that wages for key positions are

high enough to attract and retain qualified staff. Assigning position-specific wage increases might be an option.

**12. Another effective way to increase public sector productivity is to enhance PIM.** Capital expenditures have been a large share of public expenditure, reaching 5.2 percent of GDP in 2010 (13.6 percent of the budget). Bulgaria's infrastructure needs are large. The lack of progress in upgrading basic infrastructure, particularly the long distance transport network, is undermining competitiveness. A large part of the EU funds finance infrastructure investments, and by 2013 Bulgaria plans to more than double execution of EU-funded projects over what was done in 2009. This will require much better PIM to assure that appropriate standards of project analysis and management are being met and that the government is obtaining value for money.

**13. PIM in Bulgaria seems to be lagging behind best practices among EU10 countries.** Planning and execution of public investments seem to be one of the least effective areas of budget planning and execution. Line ministries make capital investment decisions with little if any review and oversight by the Ministry of Finance (MOF). As long as the line ministry outlays remain below their capital ceilings, the ministries are free to set and meet their own investment priorities. This practice gives line ministries little incentive to improve investment proposals and project management, since there is no oversight of capital budget execution. As a result, while there may be capital priorities by sector, current practice in Bulgaria does not support setting national priorities or controlling the quality of investment proposals. Moreover, evaluation of project proposals is often understood to be simply engineering analysis; there is little capacity for assessing the economic and social benefits of proposals. Transparency and accountability for capital spending are minimal. Some projects have been underway for decades.

**14. To make Bulgaria's PIM more effective and deliver on its ambitious program for upgrading infrastructure, the following reform options might be considered:**

- **Strengthen strategic planning for projects.** This would require that long-term sector strategies are agreed with the MOF to ensure they are budgeted realistically. Bulgaria needs to better prioritize projects for the medium term and rationalize the size of its public investment portfolio by closing slow or low-yielding projects and redirecting resources to activities with more economic benefits. Criteria should be carefully considered on which projects to close; percentage of the project already completed, contract termination costs, and marginal economic benefits to completion could all be potential factors.
- **Enhance project appraisal and selection.** This might include establishing an institutional structure through which MOF can challenge line ministries on the economic benefits of a given investment. MOF could also consider tailoring the guidelines for investment project applications to specific sectors and to the complexity of each project. To improve the quality of the cost-benefit analysis and make it more useful for decision making, the government might consider training some public servants in project appraisal. As institutional capacity grows, other factors might be considered for project selection, such as risk adjustment, project management, or distributional considerations. Projects could be prescreened to encourage line ministries to do a comparative economic analysis of each.
- **Enhance medium-term budgeting and programming.** The medium-term fiscal framework (MTFF) could be used to anchor the financing of priority investments (such as major repairs to infrastructure) in a baseline budget and prevent crowding-out by po-

litically motivated projects. To enforce line ministry prioritization of projects, the budget planning horizon for public investment could be expanded to five to seven years; projects that cannot be done within this range could be either downsized or closed. Budget planning should also take into account the stream of future maintenance costs associated with infrastructure investments. The three-year MTEF horizon continues to be a realistic basis for budget planning overall, but some additional annex could be used to record the commitments that have already been entered into by the Government that extend beyond the three-year window. This reflects prudent long-term economic planning to assure that ministries are not taking on bigger commitments than the expected financial resources can bear.

- **Better monitor and evaluate projects.** Monitoring should provide early warning of any problems and be accompanied by formal procedures that ensure that problems are acted upon. MOF might consider initiating in-year monitoring and annual reviews of major projects to check progress against original budgeted costs and schedule and analyze reasons for any delays or overruns. During budget preparation MOF could list all projects, new and continuing, that are approved through the budget preparation process. Giving projects codes would make it easier to systematically record expenditure against individual projects.
- **Enhance transparency and accountability.** Performance-based budgeting implementation reports need to be strengthened to provide meaningful information on public investment projects. Ministries with major investment programs should be expected to account for how well they manage projects in terms of cost, time, and outcomes. Enhance policy dialogue and accountability at municipal level. As the highest income disparities lie in rural areas, proper streamlining of instruments and policy actions at municipal level would be crucial for faster growth.

# 1. Introduction

**1. Bulgaria's economy performed relatively well during the crisis and the economy is re-viving.** In comparison with other EU10 countries, for Bulgaria the drop in GDP growth was below the median, fiscal performance deteriorated less, and public debt stayed among the lowest in the entire EU. In late January 2011 the EC concluded that in 2010 Bulgaria had made significant progress in deficit reduction and is on track to exit the excessive deficit procedure in 2011. The large macroeconomic imbalances (high current account deficits and external debt ratios) observed in 2005–08 had been corrected by 2010 with relatively little negative impact on growth relative to other EU10 countries. Since late 2010 Bulgaria's recovery has been driven by net exports; investment and consumption are recovering more slowly. With sharp decline of foreign direct investments from abroad the current account turned into a surplus by 2011 and the external debt declined significantly, albeit still high.

**2. However, to move growth to a more sustainable path by relying on exports, Bulgaria needs to become more competitive.** Returning to a sustainable growth path is necessary to accelerate the pace of convergence. Bulgaria's per capita income at PPS is only about 44 percent of the EU average, and convergence slowed during the recession. Improving the growth differential with the rest of the EU would mean that Bulgarian producers would need to be both more productive and more competitive. Higher productivity is critical for sustainable growth, especially given Bulgaria's unfavorable demographic situation, and only significant improvements in competitiveness would support the shift to export-led growth and make the economy more resilient to external shocks. Export-driven growth, however, is associated with lower tax revenues. A high share of tax revenues come from consumption taxes, value-added taxes (VAT), and excises, mainly on imports. Higher exports mean higher VAT refunds and therefore lower tax revenues. This means that Bulgaria will need to continue its fiscal consolidation program if it is to reduce its deficit below the reference rate of 3 percent of GDP in 2011 (ESA95 definition) and reach its medium-term goal of a generally balanced budget (-0.5 percent of GDP) by 2014. In the medium term, Bulgaria aims to join the EMU and is committed to preserving the fixed exchange rate until it becomes a member of the euro area. Credible fiscal consolidation and sustainable convergence of price levels based on productivity increases will support those plans.

**3. In the current circumstances, public expenditures need to be reformed to safeguard stability and re-establish growth on a more balanced path.** Fiscal management is a cornerstone of Bulgaria's medium-term program. To keep public finances both stable and flexible, spending needs to be maintained at sustainable levels, and further reductions in public spending may be needed should economic recovery prove to be more protracted than expected or negative external shocks be realized. The central fiscal challenge is to restructure public expenditures to become more efficient (product or service delivery has lowest possible cost for a given level of quality) and effective (product or service delivery reaches intended beneficiaries). To support growth and improve productivity and competitiveness, producers in Bulgaria need efficient and reliable public services, solid public infrastructure, and an appropriately skilled labor force. These basic public goods are also important to potential foreign investors deciding in which country to invest. With about 40 percent of GDP in the command of the public sector, better managed public spending is central to stability and growth.

**4. This report is intended to inform policy makers, the international community, and civil society about Bulgaria's recent economic performance and its options for reforming public spending to enhance competitiveness and growth.** It first reviews Bulgaria's growth strategy and its fiscal adjustment over the last several years and the medium-term challenges it confronts. The report then analyzes Bulgaria's export performance to identify comparative advantages and outline policy options to enhance competitiveness in the medium term. Reforms should focus on improving the productivity of the public sector to enhance service delivery, improve the business environment, and upgrade infrastructure. The report identifies two general areas for reform: (i) the wage bill and public employment; and (ii) management of public investment.

**5. These two areas are not only responsible for a large proportion of public expenditures, they also have a significant impact on competitiveness and growth.** Together, the wage bill (19 percent), capital expenditures (14 percent), and operations and maintenance (17 percent) represented half of all public expenditures in 2010. Reforms of the wage bill and public employment will make public administration more productive. Better qualified and better paid public servants are necessary for advancing the agenda outlined in Bulgaria's National Reform Program (NRP), including modernization of basic infrastructure. A substantial part of the infrastructure upgrade is being financed by EU post-accession funds. In 2012 and 2013 Bulgaria plans to significantly accelerate absorption of EU funds to almost triple the amounts disbursed in 2009. This will demand considerable improvement in public investment management (PIM) policy and practices.

## 2. Bulgaria's Growth Strategy and Fiscal Adjustment

**6.** This section reviews Bulgaria's growth strategy during the last economic cycle, analyzing strengths and weaknesses in its adjustment, and identifies risks that may jeopardize the reform program going forward.

### Bulgaria's Growth Strategy in Comparative Perspective

**7. Over the last decade, Bulgaria performed comparatively well on a number of economic indicators.** Between 2000 and 2010 output expanded in real terms by close to 50 percent, 4.7 percent a year, which is comparable to the median growth for the EU10 (Figure 1A). Solid growth during most of the decade supported Bulgaria's convergence to EU average per capita income levels; by 2010 per capita income (in PPS terms) was already 44 percent of the EU average, up from 28 percent a decade before (Figure 1B). As in other EU10 countries robust domestic demand, mainly consumption, drove growth but investment played a relatively greater role in Bulgaria's economic development than in the rest of the EU10. Investment needs were financed from capital inflows, mostly in the form of foreign direct investment (FDI), which averaged 21 percent of GDP for 2005–08. Thus, Bulgaria's external current account expanded more than that of other EU10 countries (Figure 1C). Financing from foreign parents of Bulgarian banks also grew rapidly in 2005–08, boosted by expectations for high returns on investment when Bulgaria acceded to the EU. As a result, Bulgaria's gross external debt expanded to 103 percent of GDP (Figure 1D). However, the composition of external debt changed significantly: The public portion declined to just 8 percent of GDP in 2010, a drop of 58 percentage points of GDP compared to 2000. Intercompany debt, on the other hand, grew rapidly, from just 3 percent of GDP in 2000 to 41 percent in 2010, and together with bank borrowing (mostly from parent banks) accounted for 60 percent of GDP. The rest is debt of firms, households and NGOs (34 percent of GDP).

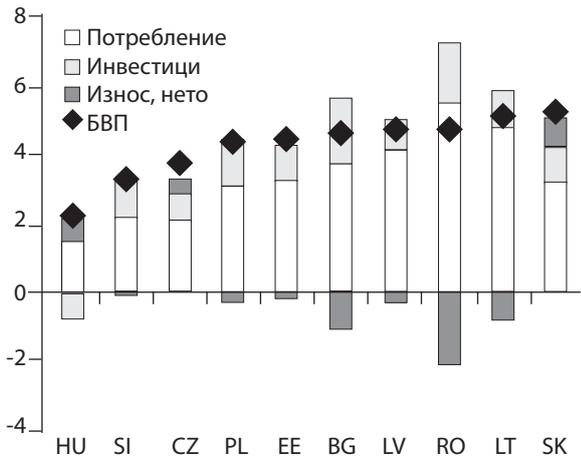
**8. Bulgaria's fiscal policy during the boom centered on accumulating surpluses in the face of expanding external current account deficits.** Between 2004 and 2008 Bulgaria averaged surpluses on a cash basis of 3 percent of GDP, largely because revenues improved. On an accrual basis (ESA95<sup>4</sup>), the surplus was somewhat lower but still represented the best fiscal performance among EU10 countries; only Bulgaria and Estonia accumulated surpluses when revenues were growing fast (Figure 1E). Prudent fiscal policy and active debt management during the boom helped reduce general government debt (ESA95) to among the lowest in the entire EU (Figure 1F).

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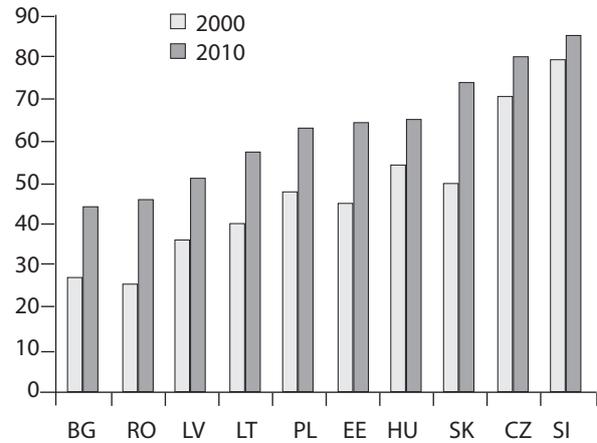
<sup>4</sup> ESA95: European System of Accounts 1995 revision.

**Figure 1. Bulgaria in Comparative Perspective**

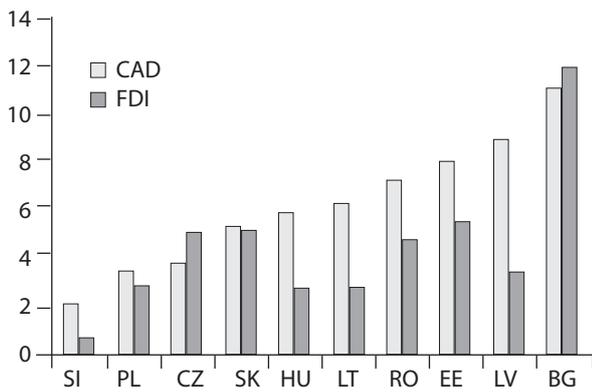
**A. Contribution to Growth, Average 2000–10 (Percent)**



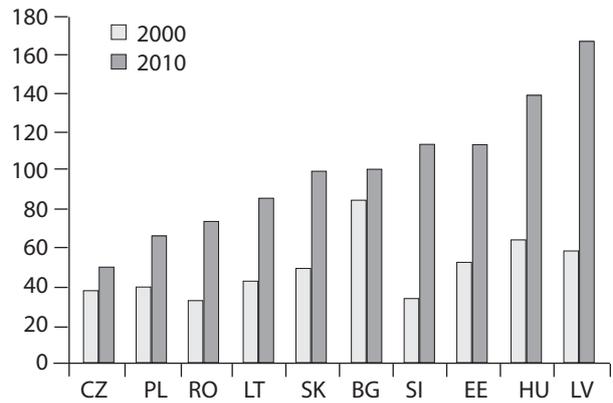
**B. GDP per Capita in PPS, 2000 and 2010 (Percent of EU27 average)**



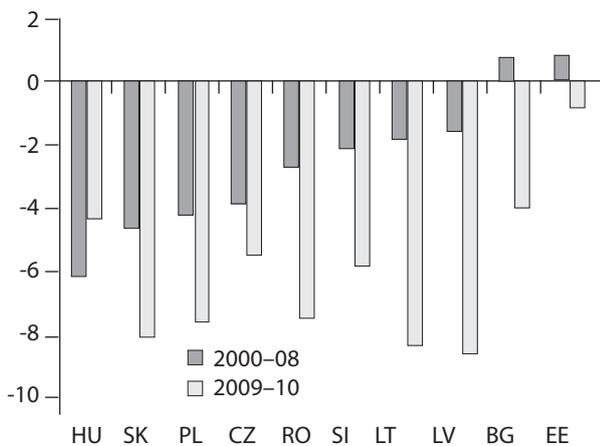
**C. Current Account Deficit and net FDI 2000–10 (Percent of GDP)**



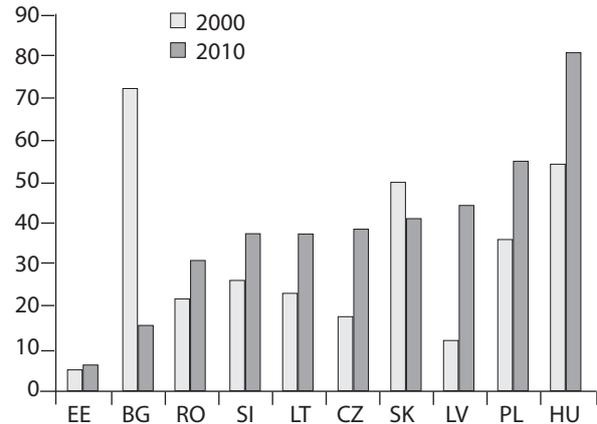
**D. Gross External Debt, 2000 and 2010 (Percent of GDP)**



**E. General Government Balance, 2000–10 (Percent of GDP)**



**F. Gross General Government Debt, 2000 and 2010**

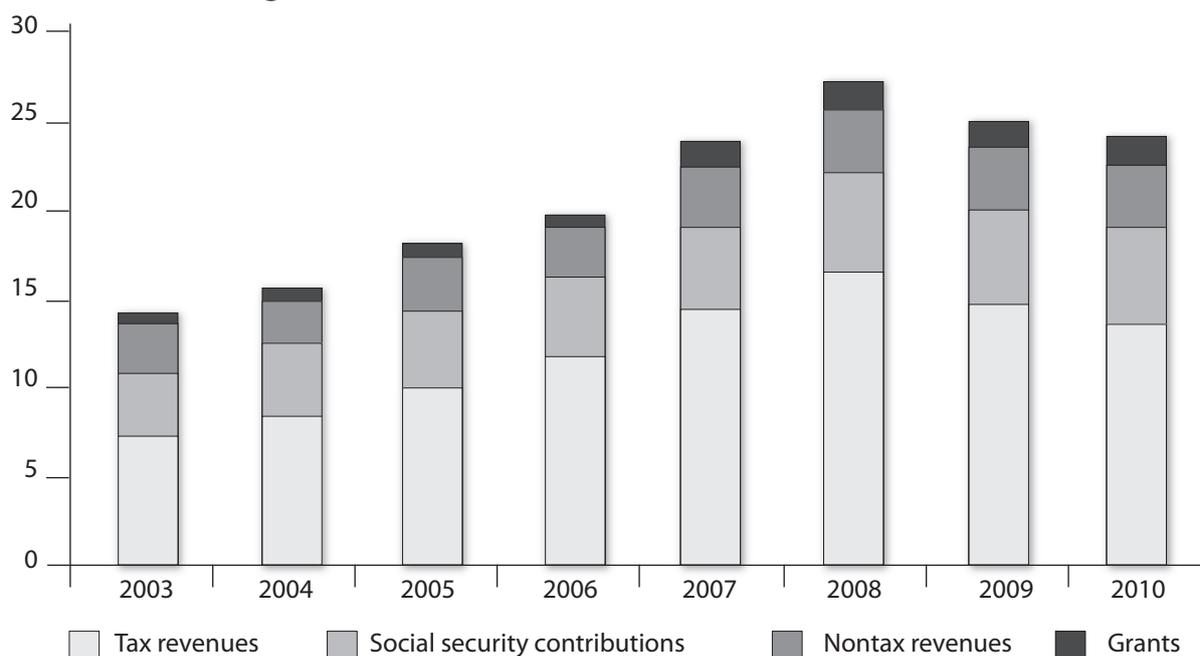


Source: Eurostat, central banks of EU10 countries, and World Bank staff estimates.  
 Note: General government balance and debt based on ESA95 definition.

## Fiscal Adjustment During the Boom and the Recession

**9. Bulgaria's revenues doubled between 2003 and 2008.** Tax revenues grew by 125 percent (Figure 2), buttressed by the growing economy and revenue administration reform. VAT revenues contributed most to buoying revenue performance – thanks also to substantial improvements in compliance rates, they grew by 2.1 percentage points of GDP between 2003 and 2008. Grants, mainly from EU pre- and post-accession funds, more than tripled, reflecting absorption of EU pre-accession funds before the end of the financial perspective and advance payments on post-accession funds.

**Figure 2. Consolidated Fiscal Revenues (BGN billions)**



Source: MOF.

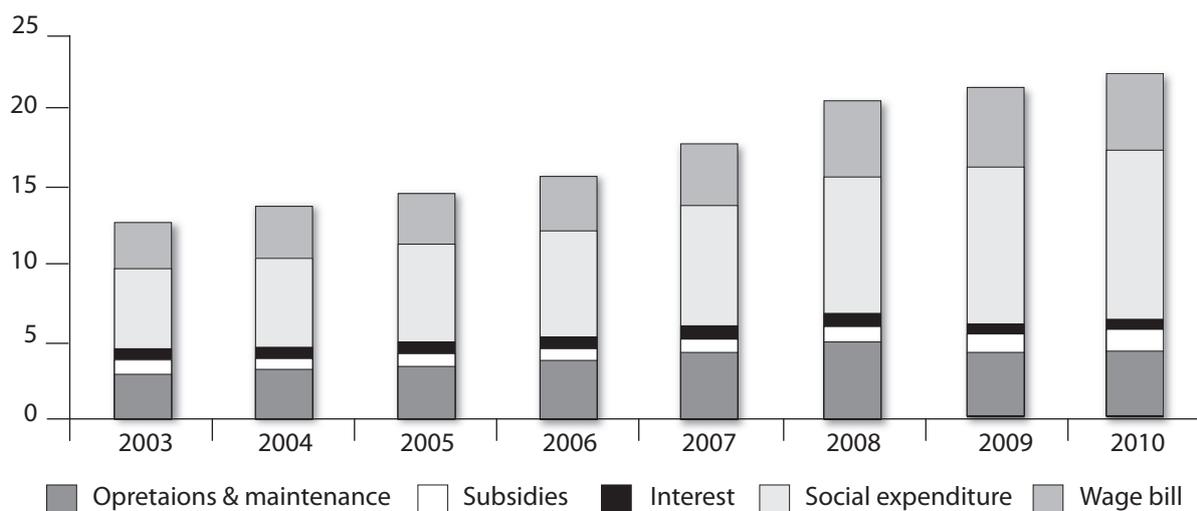
Note: National methodology on a cash basis.

**10. Tax revenue gains were used to lower corporate and personal income tax rates and help make Bulgaria's economy more competitive.** By 2008 Bulgaria had one of the lowest tax rates in the EU and achieved the highest revenue gain in the EU10. Between 2003 and 2008 tax revenues increased by 3.5 percentage points of GDP and by 2008 corporate and personal income tax rates had been reduced to 10 percent, corporate from 23.5 percent and personal from 29 percent (the highest bracket).

**11. Robust revenue made it possible to expand spending, which grew by close to 80 percent in 2008 compared to 2003.** Social and capital spending contributed most to the expenditure growth while wage bill and operations and maintenance spending grew much more slowly (Figure 3). Social spending, which represented close to 40 percent of government spending, expanded by over 70 percent, mainly because of increases in pensions, both planned and ad hoc. A decline in the number of beneficiaries during the boom kept increases in social assis-

tance spending relatively moderate. Capital spending more than tripled in nominal terms to take advantage of EU resources and make important investments that had been neglected in the first decade of transition. In 2007–08 public investment accounted for 6 percent of GDP compared to 3.8 percent in 2003. There is substantial scope (see Section 5) for the government to improve both selection of projects and their monitoring, especially for nationally financed projects where selection and monitoring are not as careful as for projects financed with EU funds. Spending on wages and salaries kept pace with expenditure growth generally, driven by the expansion of public administration and the rise in public wages in 2006–08. Enhancing the efficiency of the public wage bill and reforming public employment and pay is crucial for improving the productivity of the public sector (see Section 4).

**Figure 3. Consolidated Fiscal Spending (BGN billions)**



Source: MOF.

Note: National methodology on a cash basis.

**12. Fiscal adjustment patterns have changed dramatically since the global economic and financial crisis in late 2008.** Loss of revenue was significant because demand-driven tax revenues suffered from the plunge in external demand. Tax revenues declined by 14 percent between 2008 and 2010, mainly because VAT revenues and taxes on profit sank. The economic downturn worsened tax compliance, and tax arrears increased as firm profits deteriorated severely and access to credit became more difficult. Personal income tax and social security revenues seem to have been less affected by the recession – personal income tax revenues even rose slightly. Social security revenues, however, declined by 8 percent, which worsened the balance in the public pension fund even as pension spending was growing by 24 percent.

**13. While adjustment to lower revenues was quick, substantial fiscal consolidation was needed in 2009 to contain the budget deficit.** Growth projections for the 2009 budget had been unduly optimistic, envisaging revenue growth of more than BGN5.3 billion over 2008. Instead, revenues fell by more than BGN2.2 billion. At the same time planned spending went forward, including increases in pensions in January and July 2009, which significantly strained the budget. Fiscal consolidation after the parliamentary elections helped keep the deficit low despite rapid worsening of revenues. The consolidation included measures to (i) reduce inefficient and wasteful spending in the central budget by a 15 percent cut of non-interest spending au-

thorized by the Government Decree of August 2009; (ii) prioritize capital projects by reviewing large projects underway to identify savings and address any governance issues; (iii) optimize public administration structures and staff: two ministries were closed in 2009, a number of agencies were consolidated, and there were significant staff reductions in the Customs Agency, the MOF, the National Revenue Agency, and the Council of Ministers; and (iv) intensify the fight against tax fraud and avoidance. While some of the measures had a more medium- to longer-term impact, the 2009 budget ended in a small deficit of 0.9 percent of GDP on a cash basis but a larger one of 4.3 percent on an accrual basis as arrears accumulated on public investment contracts and hospitals.

**14. The economic downturn exposed deficiencies in public expenditure management.**

Previous revenue over-performance had to some extent altered the incentives for good management of the public finances. Expecting that money would become available at the end of the year, some budgetary units had been committing to expenditures that had not been budgeted. With the large revenue shortfall, however, these commitments could not be respected, considering that severe cuts in already budgeted spending had become necessary. This meant the gap between the accrual and cash deficits widened in 2009 (4.3 percent of GDP accrual vs. 0.9 percent cash). To remedy this, the government set out to tighten financial control regulations, procedures, and practices, and insisted that each ministry or agency adhere strictly to its budget limits.

**15. Containing the rise in the deficit in 2010 demanded additional spending restraint.**

In the first quarter, as fiscal revenues continued to deteriorate, it was already clear that the austerity measures planned—freezes on public wages and pensions—were not sufficient to reduce the deficit. A revised budget approved in mid-2010 cut spending by the central government by 20 percent and by municipalities by 15 percent. By year-end half the arrears accumulated in 2009 had been repaid, mainly those of the central government, which brought arrears down to 0.6 percent of GDP.

## Fiscal Policy in Support of Recovery and Competitiveness

**16. Bulgaria now must confront the dual challenges of fiscal consolidation and safeguarding growth.**

Fiscal adjustment is vital to avoid real exchange rate appreciation pressures and will have to rely heavily on reforming public spending while keeping economic recovery on a more balanced path with external current account deficits that are sustainable. To ensure that fiscal policy is supportive of growth and competitiveness, reforms in public spending should focus on cutting waste and inefficiencies and reallocating fiscal resources to productivity enhancing investments, rather than increase the spending envelope. For example, reducing administrative barriers to businesses would lower the costs to the budget for delivery of the services. Similarly, better efficiency of spending on health and education would make room for spending to improve quality of services.

**17. In the medium term, the government envisages reducing the fiscal deficit to below 3 percent of GDP in 2011 and achieving a generally balanced budget by 2014.**

The 2011 budget law targeted a deficit of 2.5 percent of GDP. Achieving the 2011 fiscal target depended not only on improved revenue performance – both tax revenues and increased absorption of EU funds – but also on continued spending restraint. As for spending, fiscal consolidation meas-

ures included containing the rise in wage and pension expenditure and better managing EU-funded projects and health care funding.

**18. Provided fiscal consolidation and structural reforms are implemented as planned, the medium-term outlook for Bulgaria is positive.** Growth is expected to accelerate in the medium term and output to expand in 2011 by close to 2 percent. Although the positive growth differential that Bulgaria had with the euro area dropped markedly in 2009 and 2010, it is expected to rebound in the medium term. Output growth is expected to be driven by exports and a gradual recovery of domestic demand. Current and planned reforms<sup>5</sup> are designed to improve the efficiency and effectiveness of public expenditures and boost the competitiveness of Bulgarian firms. Improving basic infrastructure, labor market participation and skills, and the business environment as the government program envisions could speed the expansion of the exportable base. Sustained improvements in exports would make it possible to ease labor and credit markets and thus stimulate the recovery of private consumption. Investment is likely to grow, though modestly; it will be constrained by slow capital inflows from abroad and tighter domestic lending conditions. Large investments already in the pipeline and planned upgrades in infrastructure, financed almost exclusively with EU structural funds, are likely to help private investment recover.

**19. Inflation is projected to hold at about 3 percent in the medium term.** Keeping inflation relatively low and improving product and labor markets would advance the government goal of entering ERMII in the medium term and then joining the euro area (exiting the currency board arrangement). Inflation hit 4 percent in the beginning of 2011, reflecting global food and energy price shocks, but subsided to 2.1 percent in the end of the year.

**20. Rapid correction of the external imbalances that started in 2009 is likely to slow as the economy catches up with the rest of Europe.** The current account is expected to be in surplus of around about 2 percent of GDP in 2011 and to turn into a small deficit in the medium term as capital flows from abroad gradually recover. FDI is expected to continue to be the primary source of balance of payments financing while funding from banks is still constrained by concerns about sovereign debt and financial stability in several euro area countries. Current and capital transfers from the EU are expected to increase as absorption of EU structural funds intensifies because of reforms to upgrade administrative capacity for project management and reduce barriers to getting projects done. Absorption should speed up significantly by 2013 when the current financial perspective ends (with the possibility of continuing to finance projects underway through 2015); otherwise there is a risk of losing grant funds. A large domestic savings cushion should support the emerging recovery over the medium term without significant recourse to external financing.

**21. The gross external debt to GDP ratio is expected to adjust from 103 percent in 2010 to some 80 percent by 2013.** Public and publicly guaranteed external debt is low—10.4 percent of GDP in November 2011 – and is expected to remain little changed through 2013 in line with the planned medium-term fiscal adjustment. General government debt (both external and domestic, ESA95 definition) has an adequate currency, interest, and maturity structure and is projected to be among the lowest in the EU in both 2011 and the medium term. Private external debt, which was 79.8 percent of GDP in November 2011, is expected to decline further as the

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<sup>5</sup> "Bulgaria: National Reform Program, 2011–2015." *In Implementation of Europe 2020 Strategy*, April 13, 2011, Sofia, Bulgaria.

uncertainty that exists in the Euro area and global financial markets is also serving to limit the debt-financing channels that were experienced in the pre-crisis period. Nearly two-thirds of private debt is either inter-company debt (47 percent) or debt to parent banks of Bulgarian subsidiaries (18 percent) mainly in the form of short-term deposits. The non-inter-company debt (debt of other sectors – firms, non-government organizations, and households) thus accounts for about 35 percent of total private debt or 31.4 percent of GDP as of end-November 2011.

**22. Economic recovery prospects, however, are not without downside risks.** For instance, economic recovery in Bulgaria's main trading and investment partners may be slower than expected. There may be unexpected new financial shocks which may push up interest rates and tighten global financial conditions and energy prices may again shoot up. There is also uncertainty about how sustainable the recovery is and about effectiveness of measures taken in the EU to support country financial sectors and contain contagion from euro area periphery. These measures can be expected to affect capital flows to Bulgaria from both parent banks and private investors. There are also domestic risks related to imbalances in the private sector: high corporate debt or a sudden deterioration in bank portfolios.

**23. However, there are factors mitigating the risks.** At the end of 2010 Bulgaria still had sizable fiscal reserves (9 percent of GDP), and gross international reserves of 36 percent of GDP. The Bulgarian authorities continue to regulate the banking sector conservatively. The sector is dominated by subsidiaries of foreign banks, mainly from EU countries<sup>6</sup>. Leverage is moderately high compared to other EU banking sectors, with a loan to deposit ratio of about 133 percent (excluding deposits of financial corporations) in 2009. To mitigate risks in the banking sector, the Bulgarian authorities have continued to take measures to maintain large capital and liquidity buffers and have heightened supervision. Capital adequacy in Bulgaria is 17.5 percent (Bulgaria requires 12 percent and most EU countries require 8 percent) and by December 2010 liquidity had risen to 24.4 percent. Bulgarians have confidence in the banking sector, as is illustrated by household deposits, which despite declining interest rates have increased every month, rising from €11.3 billion in December 2008 to €14.3 billion at the end of March 2011.

**24. Moving gradually to export-led growth is central to Bulgaria's economic recovery and convergence.** In the medium to long term Bulgaria will continue to need foreign savings to finance investment needs. FDI and other capital inflows are also helping to modernize the productive structure of the economy. To sustain this development path, Bulgaria needs to continuously expand its export capacity. Besides supporting macro-financial balances, an export-led growth path is usually accompanied by rapid increases in productivity induced by intense competition in international markets, and thus would support sustained recovery of domestic demand. These dynamic forces generate faster adaptation of new technologies, innovation, and higher turn-over of firms and jobs. Higher productivity is accompanied by higher wages and accelerated convergence. In the short term, making the economy more competitive will also stimulate the emerging recovery. Select dimensions of competitiveness are examined in the next chapter.

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<sup>6</sup> See IMF Article IV Consultation Staff Report and Selected Issues, July 2011.

## Reform Options

### **25. Keeping the economy stable and fiscal policy and management sound to support competitiveness and growth, it will be necessary to:**

- **Exit the excessive deficit procedure by 2011<sup>7</sup> as planned and continue to reduce the deficit in the medium term.** This would make fiscal policy more credible.
- **Resist political pressure for ad hoc spending increases.** Such increases have previously been detrimental to fiscal discipline and they create negative incentives. Spending should be increased only if there is a clear economic rationale and if savings to cover it have been achieved elsewhere.
- **Ensure that public investment projects are undertaken in an effective and efficient way.** There is still €6 billion in EU structural and cohesion funds to be absorbed. This will require substantial improvement in the planning, monitoring, and implementation of public investment projects.
- **Restructure spending to reallocate scarce public resources to productivity-enhancing activities.** To accomplish this it will be necessary to improve access to and the quality of education and to reform the health sector to address not only access and quality issues but also inefficiencies in spending.

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<sup>7</sup> According to preliminary data based on national classification the fiscal deficit in 2011 was 2.1 percent of GDP.

### 3. Select Dimensions of Competitiveness

**26.** This section examines competitiveness from three perspectives: (i) the real effective exchange rate (REER); (ii) developments in unit labor cost (ULC); and (iii) export performance. Measured by these basic indicators, Bulgaria’s competitiveness is adequate but can be improved. Reform options are presented at the end of each section.

#### The Real Effective Exchange Rate

**27. Estimates for Bulgaria, while sensitive to the method and period of estimation, indicate that its REER is in line with fundamentals.** Taking a long-term perspective<sup>8</sup>, in the last 11 years the cumulative ULC-based REER appreciation of Bulgaria’s lev is smaller than the appreciation of national currencies in Lithuania, the Czech Republic, Romania and Slovakia (Table 1). However, Bulgaria’s lev appreciation is larger than that observed in the rest of the EU10. The IMF reports<sup>9</sup> that the macroeconomic balance approach suggests that the REER may be slightly undervalued while the external sustainability shows a larger REER undervaluation. In contrast, the equilibrium real exchange rate methodology suggests a small overvaluation. However, the CGER methodology shows the REER of Bulgaria is broadly in line with fundamentals. Export performance has been improving over time and exports as a share of total world manufacturing exports have nearly doubled in the last 11 years (see Table 1).

**Table 1. REER and Export Market Share Indexes, 2010  
(1999=100)**

Country	ULC-total economy based REER (vs the rest of EU27)	Market Share in World Manufacturing Exports
Bulgaria	143	199
Czech Rep.	161	186
Estonia	142	161
Hungary	132	143
Latvia	132	194
Lithuania	120	262
Poland	104	221
Romania	170	220
Slovakia	177	243

Source: EC for REER and, IMF for world market share data.

<sup>8</sup> Taking a short-term view of price and wage developments estimates of REER can show larger variance. For example, according to IMF estimates trade-weighted REER estimates, in 2006-08 the consumer price index (CPI) based REER appreciated by 17 percent and the ULC-total economy based REER appreciated by 27 percent (see IMF Bulgaria Article IV Consultation, June 2010),

<sup>9</sup> MF Bulgaria: Article IV June 2011.

**28. Unit labor costs in Bulgaria are the lowest in the EU, but wage growth needs to be kept low to improve competitiveness.** According to Eurostat, Bulgaria's hourly labor cost is just €2.4 which seems to be in line with labor productivity in other EU countries. However, due to the rapid growth of the economy in 2006–08, Bulgaria suffered labor shortages, so wage growth increased from 6 percent in 2004 to 20.6 percent in 2007 and 22.7 percent in 2008. Although it is now declining, in 2010 wage growth was still 10 percent when it was negative in many other EU10 countries. Over the medium term, wage growth needs to increase generally in line with productivity to avoid loss of competitiveness. Controlling growth in public wages is therefore critical, because wage increases in the private sector are highly correlated with increases in public wages (Figure 9). In addition, there is room to improve non-wage dimension of competitiveness by implementing structural reforms particularly public spending and institutional structure, the business environment, upgrading the skills of the labor force, and the quality of the infrastructure.

## Export Performance

**29. Export performance indicators suggest Bulgaria is becoming more competitive.** Despite weaknesses in the business environment, inadequate infrastructure, and inefficiencies in public administration, between 2000 and 2010 Bulgaria expanded its export capacity. Total exports of goods and services increased in nominal terms by 274 percent, from €7.6 billion in 2000 to €20.7 billion in 2010 (Table 2). Per capita exports increased from €933 in 2000 to €2,770 in 2010. The global crisis that hit in late 2008 slowed exports severely, down to 3 percent in real terms for the year – half the growth rate in 2007– and then by 11 percent in 2009. However, in 2010 total exports experienced a healthy recovery, growing by 16 percent. Among the EU10 countries only the Czech Republic and Romania also increased their world import market share in 2008–10.

**30. Exports of goods and services grew vigorously in real terms in 2000–10 (Table 2); prices also grew, but more slowly.** Total exports of goods and services more than doubled in 2000–10, reflecting an average annual growth rate of close to 7 percent in real terms, and export of goods grew even faster, averaging 9 percent a year. Exports of services expanded at the rapid but lower rate of 3 percent a year. Price increases were larger for services exports, which grew at 6 percent a year, while prices of goods increased at an average annual rate of 3 percent. Price increases were driven by increases in the prices of copper, mineral fuels, oil, and other natural resource-based commodities.<sup>10</sup>

**31. Bulgaria has a revealed comparative advantage in exports of services.** Its services exports have expanded faster than in most EU10 countries, helping to balance the trade account. Bulgaria has had a relatively large surplus in trade in services, which almost quadrupled between 2000 and 2010, which to some extent offset the expansion of the gap in trade in goods for 2000–2008.

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<sup>10</sup> See the World Bank's forthcoming *Innovation Report*.

**Table 2. Bulgaria's Exports, 2000–10**

Millions of Euros	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Exports of goods and services	7,620	8,143	8,518	9,397	11,247	13,031	16,199	18,272	20,559	16,616	20,726
Exports of goods	5,253	5,714	6,063	6,668	7,985	9,466	12,012	13,512	15,204	11,699	15,561
Exports of services	2,366	2,429	2,455	2,729	3,262	3,564	4,187	4,760	5,355	4,916	5,164
<b>Volume indices (2000=100)</b>											
Exports of goods and services	100	106	116	129	144	119	179	190	196	174	202
Exports of goods	100	112	128	124	158	106	207	220	229	203	245
Exports of services	100	95	94	104	117	138	130	137	137	123	129
<b>Per capita</b>											
Exports of goods and services	933	1015	1083	1201	1445	1684	2104	2385	2697	2191	2751
Exports of goods	643	712	771	852	1026	1223	1560	1764	1994	1542	2065
Exports of services	290	303	312	349	419	461	544	621	702	648	685

Sources: World Bank staff calculations based on National Statistics Institute (NSI) and BNB data.

**32. Services exports are dominated by travel and transport (see Table 3).** Exports of services expanded by 8.4 percent a year in nominal terms between 2004 and 2008. Travel had the largest share, accounting for about 53 percent of services exports in 2010 and expanding faster than in most EU10 countries. Travel services also seem more resilient to external shocks; though they declined by 6.7 percent in nominal terms between 2008 and 2009, exports of transport services fell by 16.8 percent and total services exports by 8.6 percent. Exports of other services, particularly business services, computer and IT services, communication, and construction, now represent close to 24 percent of total services exports and have been expanding steadily. In particular, computer and IT services have seen more than ten-fold growth since 2004 and in 2010 already represented 5.6 percent of total services exports. Transport services, representing 19 percent of total services exports, have been expanding at 3.5 percent a year since 2004.

**Table 3. Trends in Exports of Services, 2004–10**  
(€ millions)

Millions of Euros	2004	2005	2006	2007	2008	2009	2010
<b>Exports of Services</b>	<b>3262</b>	<b>3564</b>	<b>4187</b>	<b>4760</b>	<b>5355</b>	<b>4916</b>	<b>5164</b>
Transportation	825	965	1260	1106	1211	1008	987
Travel	1789	1956	2064	2594	2874	2681	2747
Other services	648	644	863	1061	1271	1227	1431
Communications services	65	118	120	120	176	160	164
Construction services	99	83	134	191	175	304	145
Insurance services	22	24	30	36	40	97	108
Financial services	31	15	28	24	33	27	22
Computer and information services	23	26	44	86	130	118	290
Royalties and license fees	6	4	8	7	8	7	26
Other business services	331	329	453	537	656	473	638
Personal, cultural and recreational services	34	32	45	58	52	39	34

Sources: BNB and World Bank staff calculations.

**33. Yet exports of services of Bulgaria are still below their potential.** Weaknesses in the business environment, deficiencies in basic infrastructure, and inefficient and often non-transparent public administration have slowed services exports. In Southeastern Europe, Bulgaria borders with Turkey and Greece to the south, Romania to the north, FYR Macedonia and Serbia to the west, and the Black Sea to the east. This strategic location could allow Bulgaria to control major land routes from Europe to the Middle East and Asia if transport services were more developed. Similarly, tourism is below potential given Bulgaria's cultural heritage, mountains, and Black Sea beaches. Recognizing this, the government is proceeding with efforts to streamline the business environment, upgrade infrastructure, and modernize public administration (see NRP 2011–15). These reforms are expected to promote expansion of services exports, and the economy as a whole.

**34. Bulgaria is exporting more to highly competitive markets.** Integration with the EU has been deepening, with the share of exports to the EU27 rising from 44 percent in 1995 to 60.8 percent in 2010. Integration with the EU15<sup>11</sup> has been particularly close, with the share of exports to those countries rising from 39.3 percent in 1995 to 45.7 percent in 2010. Today the largest market for Bulgaria's exports is Germany, one of the most competitive and fastest-growing economies in the EU.

<sup>11</sup> EU15 refers to the 15 member states of the EU before it expanded in 2004.

**Table 4. Exports of Bulgaria to EU Markets by Factor Intensity, 2000–09**

Factor Intensity Product	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
<b>Exports to EU27 (Euro million)</b>										
Natural resources	1,223	1,218	1,288	1,381	1,595	1,967	2,769	3,188	3,660	3,800
Unskilled labor	1,172	1,540	1,547	1,698	1,893	1,977	2,256	2,083	2,028	1,796
Capital intensive	578	649	679	793	908	1,072	1,403	1,569	1,791	1,559
Skilled labor	442	537	429	490	710	785	875	881	1,106	758
Total	3,414	3,943	3,943	4,362	5,106	5,801	7,302	7,720	8,584	7,912
<b>Export Share (%)</b>										
Natural resources	35.8	30.9	32.7	31.7	31.2	33.9	37.9	41.3	42.6	48.0
Unskilled labor	34.3	39.1	39.2	38.9	37.1	34.1	30.9	27.0	23.6	22.7
Capital intensive	16.9	16.4	17.2	18.2	17.8	18.5	19.2	20.3	20.9	19.7
Skilled labor	12.9	13.6	10.9	11.2	13.9	13.5	12.0	11.4	12.9	9.6
<b>Share of EU27 External Imports (%)</b>										
Natural resources	0.28	0.25	0.28	0.33	0.34	0.34	0.36	0.46	0.42	0.64
Unskilled labor	1.07	1.35	1.35	1.43	1.51	1.42	1.40	1.25	1.13	1.07
Capital intensive	0.14	0.16	0.19	0.22	0.22	0.25	0.28	0.30	0.34	0.35
Skilled labor	0.36	0.43	0.34	0.37	0.47	0.48	0.46	0.41	0.52	0.48
All above product	0.32	0.35	0.37	0.42	0.44	0.44	0.46	0.48	0.48	0.58
<b>Export Specialization Index</b>										
Natural resources	0.89	0.72	0.75	0.79	0.76	0.76	0.80	0.95	0.88	1.11
Unskilled labor	3.38	3.81	3.67	3.37	3.42	3.23	3.08	2.58	2.35	1.86
Capital intensive	0.44	0.46	0.51	0.51	0.51	0.56	0.63	0.63	0.71	0.60
Skilled labor	1.14	1.23	0.93	0.87	1.06	1.10	1.01	0.84	1.08	0.83
<b>Exports as % in Imports (%)</b>										
Natural resources	122	127	141	123	113	119	128	102	95	115
Unskilled labor	145	147	138	139	143	151	154	164	147	159
Capital intensive	42	37	37	40	40	37	39	39	38	42
Skilled labor	58	59	42	42	45	41	35	30	31	39
Total	87	85	81	79	77	75	75	68	63	78

Source: World Bank staff calculations based on data from UN COMTRADE Statistics. The export specialization index is calculated as the ratio of Bulgaria's export share to the share of EU27 external imports. Specifically, the export specialization index (ES<sub>ij</sub>) for a product j of country i, is specified here as follows:  $ES_{ij} = (x_{ij}/X_i) / (m_j/M)$  where:  $x_{ij}$  is country i's exports of product j to the EU;  $X_i = \sum_j x_{ij}$  is country i's total exports to the EU;  $m_j = \sum_i x_{ij}$  is EU's total 'external' imports of a product j;  $M = \sum_j m_j$  is EU's total external imports. Bulgaria export performance is robust where specialization index is greater than unity ( $ES_{ij} > 1$ ) and exports of the product exceeds its imports ( $> 100$ ). The export specialization index changes dynamically as the economy continues to restructure with the implementation of structural reforms and developments in EU and world markets

**35. The composition of exports to EU markets is also gradually improving (see Table 4).**

Natural resource-based and unskilled labor-intensive commodities still make up 70 percent of total commodity exports to EU markets, partly because Bulgaria has a meaningful comparative advantage in metals like copper, aluminum, steel, and zinc and agricultural products like sunflowers and wheat. Its exports of electricity have also risen. There was progress in capital-intensive and skilled-intensive exports in 2000–09, although the expansion slowed in 2009. Export of capital-intensive commodities to the EU increased in nominal terms from €578 million in 2000 to €1,559 million in 2009, a 10 percent annual growth rate. Skilled labor-intensive commodities also more than doubled during that time, but these were more vulnerable to the global financial shock. Nevertheless, the export specialization indices of capital- and skilled-intensive products are below 1 and exports to imports are below 45 for both of these export groups indicating that Bulgaria's export performance in these exports is weaker compared to other exporters to EU 27.

**36. Diversification of exports was a useful buffer against the global crisis.** Table 4 shows that natural resource-based commodities were more resilient to shocks in 2008–09 than were other goods. They grew, though slowly, while all other commodity groups declined. This illustrates the importance of export diversification and having a robust competitive edge in international markets. It underlines the thesis that policies to promote competitiveness should aim at improving productivity across the board. Policies that target specific industries make the economy less flexible when markets and technologies change.

**37. From preliminary estimates, it appears that producers in Bulgaria are beginning to link to networks, both buyer-driven and producer-driven.** Buyer-driven networks can be found in industries in which large retailers, marketers, and branded manufacturers have set up decentralized production networks in a number of exporting countries. This type of network is often found in sectors that are labor-intensive, such as clothing, footwear, housewares, and consumer electronics. Producer-driven networks are typically organized by large transnational manufacturers that organize their networks both upstream and down. These tend to be in capital- and technology-intensive industries, such as automobiles, aircraft, computers, semiconductors, and heavy machinery.

**38. Only 41 percent of Bulgaria's exports to EU are linked to either type of network (Table 5).** Buyer-driven networks represent 50 percent of all Bulgaria's exports of network products to the EU. Most are in textiles and clothing. However, exports through buyer-driven networks have been declining since 2000. In contrast, exports of producer-driven network have been expanding at a rate of 16 percent a year, though they started from a base of less than 2 percent of Bulgaria's total exports. The potential of structural reforms to expand exports through producer-driven networks is large.

**Table 5. Bulgaria's Exports of Network Products and Other Parts to EU27, 2000–09**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	% Change in 2009	
											over 2000	over 2005
<b>Share of Exports to EU27 in Total Networks and Other Parts (%)</b>												
Buyer-driven network	73.2	75.2	70.5	69.4	68.8	65.9	62.7	55.5	51.3	50.1	-31.6	-24.0
Of which: T&C network	60.7	61.8	56.6	55.3	55.4	52.7	50.5	46.1	43.0	40.8	-32.8	-22.7
Producer-driven network	4.2	3.2	4.1	4.6	4.3	5.5	5.2	6.6	9.4	11.3	166.5	104.5
Of which: ICT network	2.2	1.4	2.1	2.5	2.1	3.1	3.1	3.4	4.2	5.5	150.1	76.8
Other parts and engineering products	22.6	21.6	25.4	26.0	27.0	28.6	32.1	37.9	39.3	38.6	71.0	35.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0		
<b>Share in Bulgaria's EU27-Oriented Exports (%)</b>												
Buyer-driven network	31.6	36.1	35.4	35.7	33.9	31.1	28.0	24.7	21.4	20.6	-34.9	-33.8
Of which: T&C network	26.2	29.7	28.4	28.4	27.3	24.9	22.6	20.5	18.0	16.8	-36.0	-32.7
Producer-driven network	1.8	1.5	2.0	2.4	2.1	2.6	2.3	2.9	3.9	4.6	153.6	78.1
Of which: ICT network	1.0	0.7	1.1	1.3	1.0	1.5	1.4	1.5	1.7	2.3	138.0	54.0
Other parts and engineering products	9.8	10.4	12.8	13.4	13.3	13.5	14.4	16.9	16.4	15.9	62.8	17.6
Total	43.2	48.0	50.2	51.4	49.3	47.2	44.7	44.5	41.7	41.1	-4.8	-12.9

Source: World Bank staff calculations based on EU data from UN COMTRADE

Notes: ICT is information and communication technology and refers to Standard International Trade Classification (SITC) codes 75, 76, and 77-office machines and automatic data-processing machines, telecommunication and sound-recording equipment, and electrical machinery; T&C is textiles and clothing refers to SITC codes 65 and 84-textile and articles of apparel and clothing accessories.

**39. Bulgaria's exports through producer-driven networks are at an early stage of development.** Table 6 shows the share of network exports in manufactures and in key producer-driven networks, such as the automotive and the ICT networks for EU10 countries. Bulgaria's share of network exports in manufactures excluding chemicals is 6 percent; the average for the rest of the EU10 is 34.3 percent. Competition is intense. The share of network exports in manufactures excluding chemicals rose in 2009 in Bulgaria, the Czech Republic, Lithuania, Poland, Romania, Slovenia, and the Slovak Republic but fell in Estonia, Hungary, and Latvia.

**Table 6. Links to EU Producer-Driven Networks, 2000 and 2009: Regional Perspective**

Country	Share of Network Exports in Manufactures, excl Chemicals (%)		LS Average % Growth in Exports (US\$) in 2000-09		Share of Parts in Automotive Network Exports (%)		Share of Parts in ICT Network Exports (%)		Share of ICT Network in Total Producer Network Exports (%)	
	2000	2009	Мрежи	Части	2000	2009	2000	2009	2000	2009
Bulgaria	2.0	6,2	26.4	22.0	56.6	22.7	43.1	34.3	52.2	49.0
Czech Rep	29.2	48,3	21.0	19.6	42.6	47.4	41.6	21.9	15.9	41.0
Estonia	49.9	22,2	2.0	3.1	27.6	35.2	21.1	48.9	95.2	45.4
Hungary	51.9	54.6	13.4	10.3	68.7	66.7	21.8	11.2	52.2	57.4
Lithuania	3.0	22.7	42.6	35.6	22.1	29.4	42.6	12.9	63.4	51.7
Latvia	9.9	13.4	17.8	5.9	15.8	20.9	69.0	19.9	61.7	39.4
Poland	24.9	38.1	20.8	20.1	53.4	58.4	27.3	14.6	19.2	31.5
Romania	8.2	27.3	28.3	27.0	80.0	61.1	63.8	17.8	75.1	33.6
Slovakia	28.9	50.1	24.0	21.1	25.4	43.8	57.3	6.5	15.0	50.4
Slovenia	22.4	31.7	14.3	15.1	34.2	37.8	31.7	72.3	7.0	5.4

Source: World Bank staff calculations based on UN COMTRADE data. Growth rates are estimated using the least squares method based on values of export in US\$.

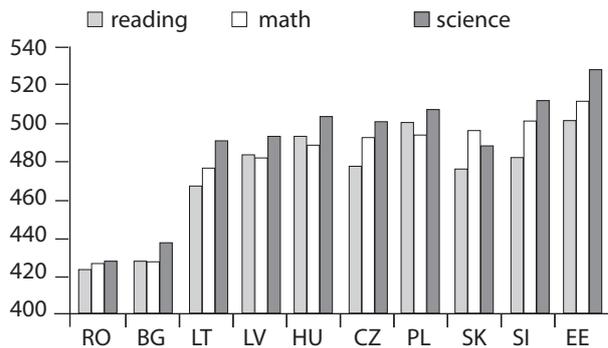
## Reform Options

**40.** The NRP 2011–15 describes the government’s reform program to build Bulgaria’s competitiveness. If the program is fully implemented, Bulgaria’s competitiveness should improve in the medium term. According to the findings in this report, priority reforms to enhance competitiveness would be to

- **Improve the public services that are essential to competing in world markets:** education services that equip the labor force with relevant skills; efficient and quality health services that improve labor force health; and research and development that helps firms innovate and expand production. Currently Bulgaria is worse than most EU10 countries in terms of quality of and access to education (Figure 4A), quality of health care (Figure 4B), and capacity to produce high-tech products (Figure 4C).
- **Streamline the business environment.** Burdensome regulation and inefficient administrative services limit corporate growth opportunities, stifle innovation, and depress competitiveness. The government goal is to reduce administrative burdens by 20 percent by the end of 2012. However, even more reforms are needed if Bulgaria is to become more welcoming to business. Currently Bulgaria is ranked below the median for the EU10 on ease of doing business (Figure 4D).
- **Upgrade basic infrastructure.** The quality of road and rail infrastructure in Bulgaria is far below where it needs to be for producers to reach far-away markets more easily and at less cost. While some EU10 countries doubled and tripled their motorways in 2000–09 (Figure 4E), Bulgaria has been slow not only in building highways but also in rehabilitating its long-neglected road network. Provided reforms of railways are implemented, the railway sector could play an important role in supporting expansion of Bulgaria’s trade in the region.
- **Improve labor market participation and labor force skills.** This is especially important because Bulgaria’s population is aging and declining. In 2009–10 activity rates fell more in Bulgaria than in the other EU10 countries, to the point that they were among the lowest in the region (Figure 4F).

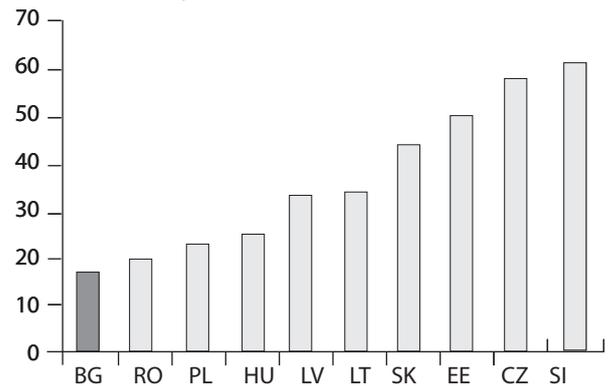
**Figure 4. Constraints on Competitiveness**

**A. Student Assessment (PISA<sup>12</sup> 2009)**



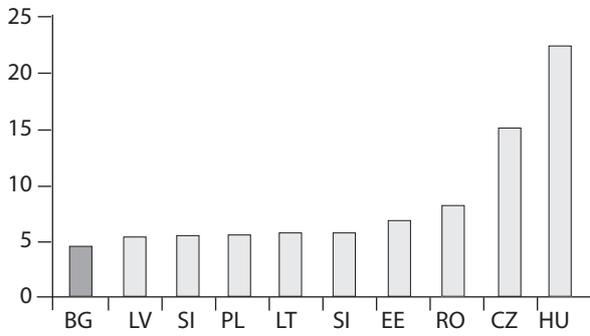
Source: OECD.

**B. Quality of Health Provision, 2008**



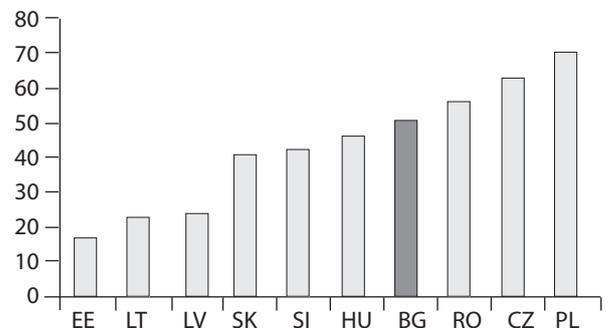
Source: Eurobarometer, October 2008 survey.

**C. Share of High-Tech Exports, 2009**



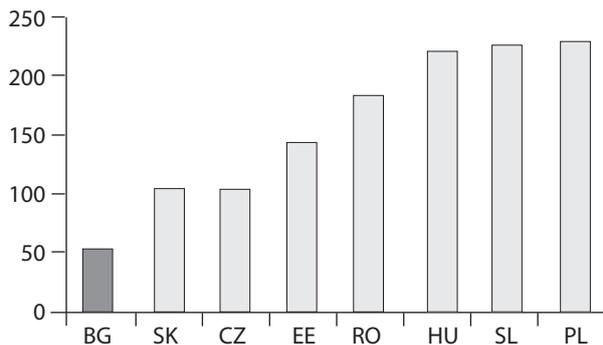
Source: Eurostat.

**D. Ease of Doing Business, 2011**



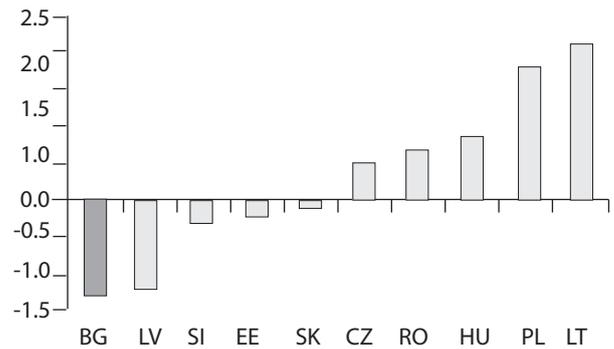
Source: World Bank, *Doing Business 2012*.

**E. Increase in Length of Motorways in 2009–00 (percent change)**



Source: Eurostat.

**F. Change in Activity Rate (15–64 years), 2010 compared to 2008, percentage points**



Source: Eurostat.

**41. To succeed in these reforms and sustainably improve competitiveness and growth, the government needs to radically increase public sector productivity.** Here, two areas are central: (i) reforming public administration (Section 4); and (ii) improving public investment management (PIM) (Section 5).

<sup>12</sup> PISA = Programme for International Student Assessment. The OECD conducts the PISA to test application of knowledge acquired at school by 15-year-olds.

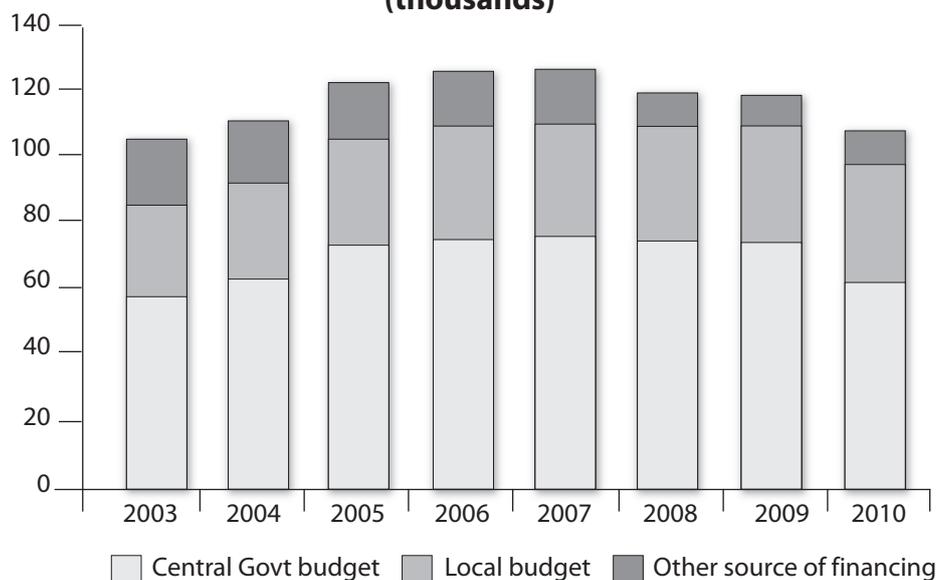
## 4. Public Administration: Analysis and Directions for Reform

**42.** This section analyzes aspects of public administration where reform could significantly enhance productivity. The section evaluates management of Bulgaria’s public sector human resources, government efforts at reform, and what still needs to be done. Attracting and retaining high-caliber staff – particularly in management and policy positions – is vital for good policy formulation, especially policies that affect competitiveness. Employing high-caliber staff in front-line services will increase efficiency in sectors critical to economic growth and public well-being, such as education, health care, and security. Finally, carefully controlling the wage bill – especially ensuring that it is not wasted on unproductive staff – is crucial for fiscal sustainability.

### Structure of Public Employment

**43. Government is a major employer in Bulgaria, which has several different employment regimes, each with its own system for control, wage setting, recruitment, and promotion. Government is a major employer in Bulgaria with close to 440,000 staff (excluding staff in state-owned enterprises).** According to the Council for Administrative Reform (CAR), out of the total 440,000 public employees in Bulgaria as of March 2010 (not counting staff in state-owned enterprises [SOEs]), staff paid directly by the central government account for about 57 percent. These fall into three groups. The first, in Bulgarian parlance, is „public administration,” which includes staff of ministries and subordinate agencies and of local governments (Figure 5). Public administration accounts for about 15 percent of all public employment (excluding SOEs).

**Figure 5. Trends in Public Administration Employment (thousands)**



Source: Council of Administrative Reform.

The second group consists of police and senior members of the army, who account for 18 percent of total employment and have their own employment regime. The third and largest group consists of „public sector employees“: teachers, health workers, members of the army, and staff of certain independent agencies, such as the Bulgarian Academy of Sciences and the National Social Security Institute. Teachers account for about one-third of this group, with health workers and members of the army accounting for most of the rest. The central government sets the wage structure for all three groups but has little direct control over staffing decisions.

**44. The central government does not control the number of local government employees.** Nevertheless, it can force staffing reductions through its control over local government finance. Local governments employ roughly 30,000, mainly administrative, personnel, plus 4,000 political positions (mayors and deputy mayors of municipalities, villages, and sub-villages), school doctors, and staff of social care institutions. Local governments finance staff and operations and maintenance using their own revenues (property taxes and various charges and fees) and transfers from the central government. The amount of the national transfer that is provided to each local government is set out in the annual budget. In 2009, BGN288 million was allocated for the general subsidy to municipalities; in 2010 and 2011 this was reduced to BGN 217 million. Local governments responded by shortening work hours and furloughing staff.

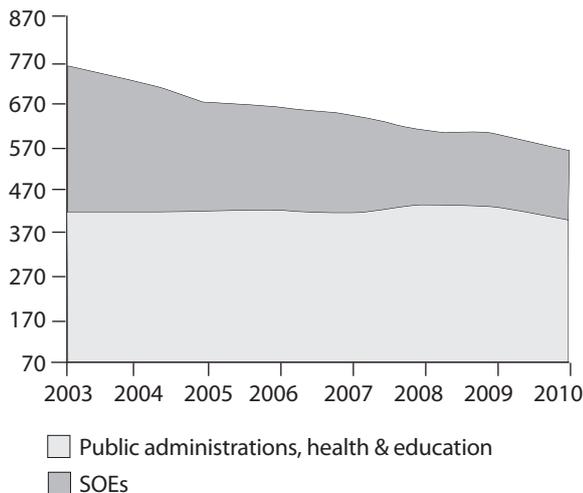
**45. Similarly, the central government can indirectly control the number of teaching staff.** Salary and other operating expenses of public schools are financed through earmarked transfers to municipalities based on enrollment in their schools. Each year, the Ministry of Education (MOE) in consultation with the MOF sets a standard amount per pupil, the unified per student cost standard (UPSCS) or capitation-based financing. Capitation-based financing is seen as a way to force schools with under-enrolled classes to consolidate and lay off excessive personnel. Bulgaria’s student-age population declined by 30 percent between 2000 and 2009, and actual enrollment fell by 28 percent. Yet staffing numbers declined only slightly. However, for 2007–09, the Government undertook an ambitious school consolidation program when a total of 495 schools were closed. Over the entire period, the number of teachers and principals with teaching responsibilities was reduced by 15,549 (24 percent). As a result, when capitation financing was fully rolled out in 2009, much of the consolidation had already occurred.

**46. Despite the consolidation effort, further efforts might be needed as pupil-teacher ratios are still lower than necessary in Bulgaria.** Reducing teaching staff by 24 percent barely managed to keep up with the decline in enrollments between 2000 and 2009, leaving pupil-teacher ratios nearly unchanged. At the primary level, the student-teacher ratio increased from 17 to 18, but at the secondary level, it actually declined, from 12 to 11. These ratios fall within the mid-range for OECD countries – most of which, however, have the resources to afford them. Low pupil-teacher ratios in Bulgaria, particularly at the primary level, reflect the continued existence of small rural schools. The annual budget specifically funds such „protected“ schools. Low secondary school pupil-teacher ratios reflect current curriculum requirements; certain subjects require separate classes regardless of the number of students in each class.

## Trends in Public Employment

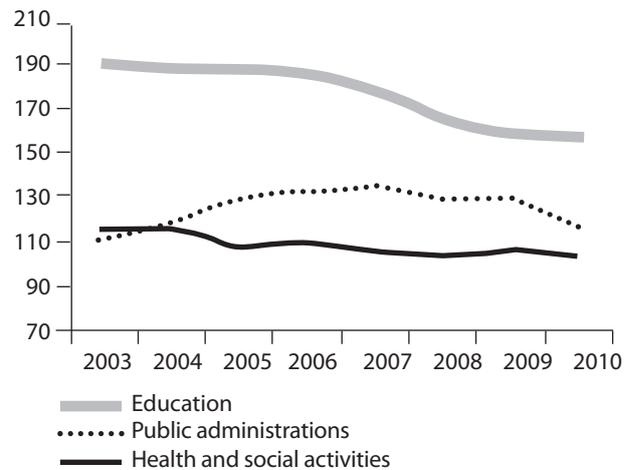
**47. During the boom, both central and local public administration staff grew.** According to NSI data, employment in public administration (general government, defense, and compulsory social security) increased by 16 percent between 2003 and 2008 (Figures 6 and 7). Even declining numbers in education and health could not offset the increase. Most of the expansion was related to setting up new agencies to respond to the needs for new skills that emerged on Bulgaria's accession to the EU and absorption of EU funds. Between 2003 and 2007 public administration staff financed by the central government budget grew by 29 percent and local government staff increased by 26 percent (Figure 5). However, growing employment needs in certain sectors or with certain skills were not accompanied by efforts to optimize staff or eliminate structures that have lost their relevance. The expansion in public employment paralleled growing private demand for staff and growing labor shortages, which raised labor costs throughout the economy. To arrest the growth in public employment, the government in 2007 initiated an across-the-board 12 percent cut in central government administration, but not all ministries and agencies complied; most simply left some positions unfilled rather than truly optimizing staff use. The effect in terms of staff reductions was below 4 percent and the aggregate wage bill continued to increase.

**Figure 6. Public Employment (in thousands)**



Source: NSI

**Figure 7. Public Administration, Health, and Education Employment (in thousands)**



Source: NSI

**48. To contain spending on the wage bill as its fiscal position worsened rapidly, the government in late 2009 initiated a program to optimize public administration staff by 15 percent by 2011.** This program was elaborated to include not merely staff cuts but also optimization of functions, improving the effectiveness and efficiency of administrative structures, and eliminating or simplifying administrative services.<sup>13</sup> The program set out nearly 600 measures ministries and agencies were to implement by 2011. According to Council for Administrative Reform data, nearly 11,000 positions were eliminated between July 2009 and February 2011 and other

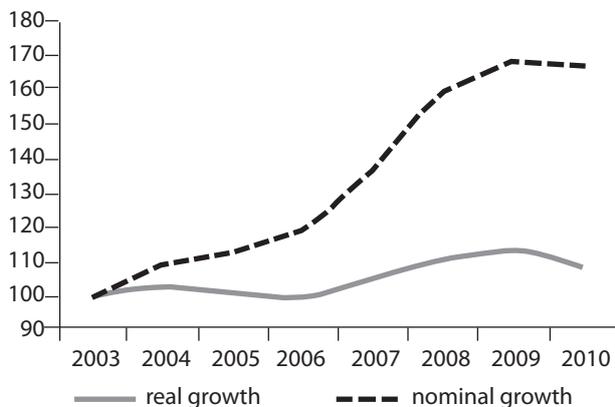
<sup>13</sup> Plan for Implementation of the Measures for Optimization of the State Administration, 2010-2011, approved by the Council of Ministers in July 2010.

optimization measures are on track. Preliminary data for 2010 suggest that public administration<sup>14</sup> has been reduced by 16 percent from its peak in 2007, with most of the optimization having taken place in 2010. Since most of these positions were occupied, this would be expected to result in small but not insignificant savings in the medium term. Assuming, conservatively, that salaries for eliminated positions were equal to the average for all public employees, the wage bill would be reduced by just over 3 percent. In the short term, these savings, of course, would be offset by severance payments.

## Trends in Public Wages

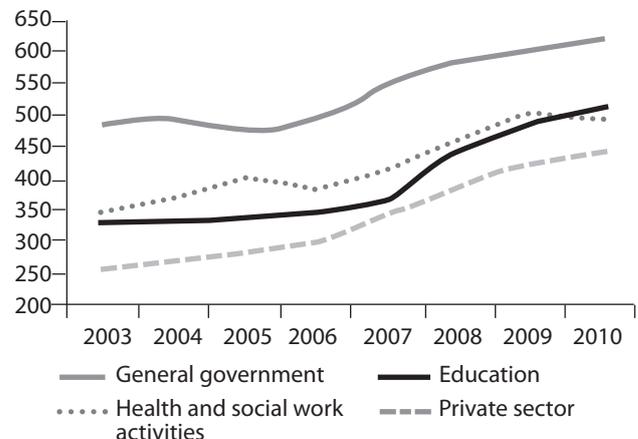
**49. The increase in public employment in the boom years was accompanied by rapid growth in the aggregate wage bill.** Between 2003 and 2008 the wage bill almost doubled in nominal terms (Figure 8), particularly after 2008 when it was growing at a nominal rate of close to 17 percent per year. Growth slowed substantially in 2009, to 7 percent annually, as a result of fiscal consolidation in the second half of the year. Sectors where wages were lower than average for public administration, such as health and education, saw higher real increases, exceeding 42 percent between 2003 and 2009 (Figure 9). With the declining number of teachers, however, the education wage bill grew by only 13 percent in real terms. The wage bill for health increased 42 percent in real terms and for executive and legislative functions by 30 percent. The judiciary, which has an autonomous budget, saw the highest increase, 85 percent in real terms.

**Figure 8. Growth of Aggregate Wage Bill**



Source: MOF.

**Figure 9. Real Wages in the Public and Private Sectors**



Source: NSI.

**50. The unsustainable rise in public salaries was halted in mid-2009.** Decree 191 forbade authorizing officers at the central government level to „make expenditures that would increase individual basic monthly salaries.“ Across the board the freeze continued in 2010. The 2010 budget law fixed the wage bill allocated to each ministry at its 2009 level. Managers were allowed to increase individual wages only if they could be financed by savings from previous years. This appears to have had a significant impact, although nominal wages did rise somewhat in 2010. According to NSI Enterprise Survey data, after increasing by 20 percent in nominal terms in 2007 and 2008, growth in public administration wages slowed to 5 percent a year in 2009 and 2010. Adjustment of private

<sup>14</sup> Excluding the police, the army, the judiciary, teachers and non-teaching school staff, and doctors and other health care staff.

wages, in contrast, was less severe. Wages still grew in double digits in 2009, reflecting the release of low-skilled and low-paid labor during the recession. After growing at 35 percent in nominal terms in 2008, wage growth in education slowed to 13 percent in 2009 and 7 percent in 2010.

**51. In practice, then, the wage bill has been frozen at the 2009 level for two years.** Preliminary data suggest that it was essentially unchanged in 2010 and the same amount was budgeted for 2011. Note that wage bill data also include severance payments for laid-off employees, which are paid for longer periods for certain professions (e.g., the military). Tightly controlling both the number of public positions and the amounts of wages would be a prerequisite for meeting the deficit reduction goal and exiting the excessive deficit procedure.

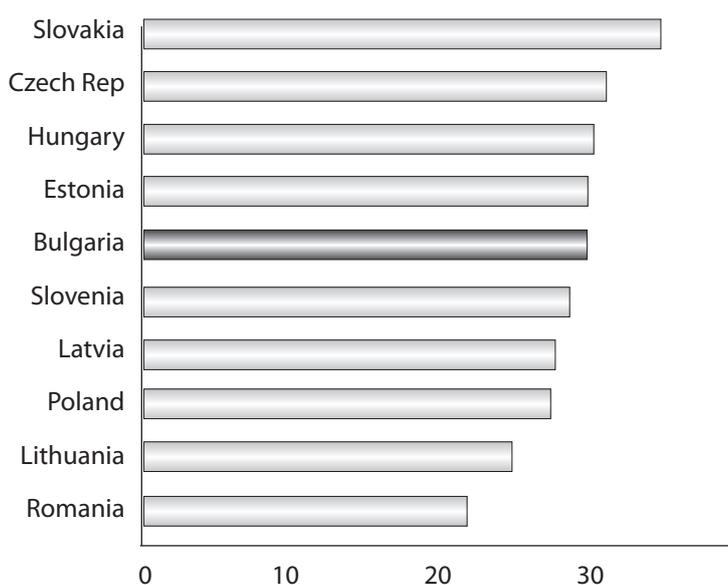
**52. The government continued the general wage freeze in 2012 and intends to increase wages in 2013 and 2014.** According to the medium-term fiscal framework (MTFF), in 2013 the aggregate wage bill would increase by 4.2 percent and in 2014 by 6.4 percent. Strict control over new hires and wage rises is critical if Bulgaria is to reduce the deficit to 0.5 percent of GDP by 2014 and also finance necessary infrastructure investments.

Is the Bulgarian Public sector overstaffed and overpaid?

**53. Identifying overstaffing and overpayment would depend on a detailed functional review of all government agencies.** This would involve calculating the number of staff required to perform specific functions and the wages required to attract and retain the necessary staff. This is more easily done in some sectors than in others. The number of teachers required to instruct primary school children, for example, could be derived from enrollment figures and classroom size standards (assuming these are set at an optimal level). Determining the staffing needs of the Ministry of Defense or Interior would be less straightforward. Similarly, wages in the public sector might be based on comparable wages in the private sector where both sectors are competing for the same talent pool, but public and private employment are not strictly comparable. Job security, at least for civil servants, tends to be greater in the public sector, and many public occupations have no precise private equivalent. Job descriptions for private and public clerical staff may be similar. Those for security personnel are not.

**54. Compared to other EU10 countries, Bulgarian public administration appears to be overstaffed.** Bulgaria has about 30 public employees per 1,000 population (Figure 10), one of the highest proportions in the EU10 despite substantial downsizing that has taken place in 2009-10. Since other EU10

**Figure 10. Public Administration, 2010  
(per 1,000 population)**

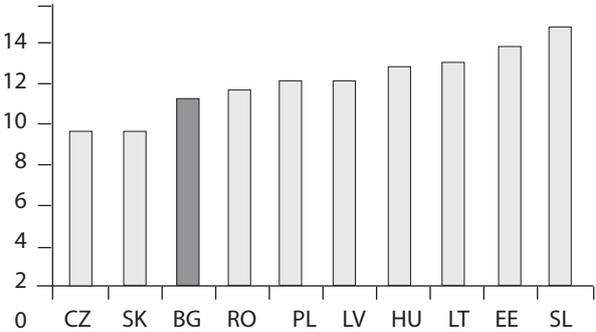


Source: Eurostat and World Bank staff estimates.

countries probably are also overstaffed, this means that Bulgaria is sustaining a relatively large public administration at the expense of productivity. Attracting and retaining high-caliber staff in public administration is critical if Bulgaria is to achieve its extensive structural agenda. With scarcer fiscal resources this can be done only by optimizing public administration. Current reforms in a number of government agencies and the expected broadening of e-government and e-services in Bulgaria would reduce the need for staff because most services will be automated, simplified, or eliminated, though more staff may be needed for project, financial, and IT and other advanced skills to support **absorption of the billions in EU structural funds**.

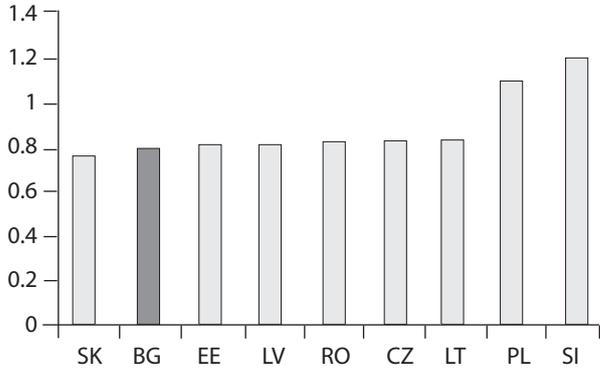
**55. The Bulgarian wage bill does not look oversized compared to other EU10 countries.** Its aggregate wage bill in 2010 (Figure 11) was lower as a percent of GDP than in most other EU10 countries. This means Bulgaria is spending less than its peers, but for a higher number of staff. This is confirmed by a comparison of average wages in the public sector relative to per capita GDP (Figure 12).

**Figure 11. Wage Bill, 2010 (Percent of GDP)**



Source: Eurostat.

**Figure 12. Ratio of Average Public Sector Wage to Per Capita GDP, 2010**



Source: Eurostat and World Bank staff estimates. Data for Poland refer to 2009.

**56. The key consideration in assessing public sector wages in Bulgaria is not, of course, how they compare with other countries but how they compare with wages in the domestic labor market, where the government must compete for talent.** In principle, the government should offer wages that are just sufficient to attract and retain the caliber of staff it wishes to employ – no less, but also no more.

## Public Employment and Pay Policy and Practice

**57. Like most European countries, Bulgaria has a well-established system of establishment control for employees in public administration.** There are also indirect controls over staffing in local governments and in education and health. If these were effectively enforced, adding new positions would be quite difficult. Moreover, legal impediments to dismissing staff are not particularly high. Most public employees are contract workers who are not subject to civil service protection. Wages are also tightly controlled. The central government sets the wage scales

for all public employees. While individual managers in both central administration and local government have considerable leeway to adjust individual salaries within grades, to varying degrees they all face hard budget constraints.

**58. Bulgaria already has a fairly tight system of establishment control covering employees in public administration.** Each ministry has a rule book specifying the functions of the ministry and each of its departments and the number of positions assigned to each department. The MOF, for example, has 627 posts currently authorized. The agencies attached to each ministry have their own rule books. To add a position, a manager must first obtain the approval of the internal coordination council within the ministry. The request is then forwarded to all government ministries, including the MOF, for comment and then to the Council of Ministers for approval or rejection. Local governments have their own rule books, which must be approved by local councils.

**59. The pay and grading system was streamlined in 2010.** The wages of all employees in public administration (as well as all other public employees paid out of the budget) are determined through a standardized system that sets out a salary range for each grade. For public administration employees, there are 14 grades: 9 for civil servants and 5 for contractual workers. Decree 67 of April 14, 2010, on the other hand, sets out 21 different grades for public administration staff alone, with additional tables for (1) employees of the national revenue agency and customs administration; (2) heads and members of the cabinet of the prime minister and deputy prime ministers, ministerial advisors, and their technical staff; and (3) deputy ministers, chairmen, mayors, and deputy mayors. The range of salaries within each grade is fairly wide, allowing managers to adjust individual salaries for seniority or performance. Until recently, performance was not well defined and funding for performance increases tended to be concentrated in agencies that generated their own revenues.<sup>15</sup>

**60. Normally, the entire wage scale is adjusted periodically, economic conditions and political considerations permitting.** Although adjustments are not explicitly linked to trends in the private sector, the two have moved in tandem for the last five years, although the causality relationship is not clear.

**61. As a longer-term strategy, of course, wage bill freezes are risky. Ministries can either freeze positions or allow individual wages to fall in real terms.** But persistent position freezes would prevent the government from responding to new demands (such as the staffing increases required to facilitate disbursement of EU structural funds). In time, persistent wage freezes would make it difficult to attract and retain competent staff. A 2008 government report on administrative reform,<sup>16</sup> in fact, noted that some ministries and agencies had „great difficulty recruiting staff ... due to low salaries.“ The problem was especially acute in positions requiring experience. Since then, of course, conditions have changed. On the one hand, since 2007 public salaries have increased 5 percent a year in real terms. On the other, the economic slowdown has reduced employment opportunities in the private sector. In the present circumstances, salaries for most positions may be sufficient to attract and retain competent staff. This could change, however, once economic growth resumes.

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<sup>15</sup> Until recently, performance increases took the form of so called ‘additional material incentives’ (DMS) which were typically retained by revenue-generating entities that exceeded their targets. As discussed in the text, this system has been reformed.

<sup>16</sup> Ministry of State Administration and Administrative Reform. 2008. *Report on the State of Administration in 2007*

**62. As Bulgaria's fiscal accounts improve, there may be a case for raising salaries.** The government should be wary, however, of reverting to the practice of setting wages in response to political pressure. One long-term approach might be to index wage levels to inflation. In effect, the freeze of 2009–11 will have reset wages significantly lower in real terms than what prevailed in 2008. Tying future wage increases to changes in the cost of living would protect the purchasing power of government employees without increasing the wage bill in real terms. There is ample precedent for this approach. According to the OECD (2008) pay levels for government employees are indexed to inflation in Belgium, Hungary, Italy, and Slovakia – although the index sometimes acts as a floor for negotiation, rather than an absolute determinant.

**63. Tying wages to inflation does not, however, guarantee that public wages will remain competitive.** Wages for equivalent positions in the private sector may rise with productivity. To ensure competitiveness, some countries base public wage increases on surveys of wages in the private sector. Changes in the wage scales of US federal government employees, for example, are based on surveys of private wage levels. While much maligned (see James 2002), this system has succeeded in maintaining a rough parity between private and public wages.

**64. In the short term, however, the Bulgarian government should not tie its own hands.** Given the constraints imposed by the currency board arrangement, the government needs maximum flexibility over fiscal policy so as to respond promptly to changing economic conditions. Public sector wage policies are a key part of this effort. For the foreseeable future, then, the government needs to be able to reduce wage levels in real terms. Nevertheless, there is a need to periodically review each ministry's experience in recruitment and retention – particularly in high-skilled, more competitive jobs – to ensure that key positions are well enough paid to attract and retain qualified staff. If not, position-specific wage increases may be appropriate.

**65. Two recent ordinances on public sector pay represent a step forward.** The ordinances abolish the existing system of ad hoc bonuses and replace it with a standardized system of performance evaluation. Under the new system, employees will be evaluated annually on the basis of performance. Those failing to meet minimum expectations will receive no salary increase. Those meeting or exceeding expectations will receive an increase of up to 12 percent of their base salaries. The ordinances also authorize recruitment and retention bonuses for positions in acute demand. These may range as high as 100 percent of the basic salary for the position.

**66. In introducing performance-related based pay, the Government was wise to keep the performance element relatively small.** International experience with government PRP, notably in the OECD, has generally been disappointing. In the first wave at the end of the 1980s, the central governments of Denmark, the Netherlands, New Zealand, Spain, Sweden, the United Kingdom, and the United States (Box 1) all adopted some form of PRP. Australia, Finland, Ireland, and Italy followed in the early 1990s. In 2004, France started experimenting with PRP for top civil servants in six pilot ministries (Finance, Defense, Interior, Equipment, Agriculture, and Civil Service). Most recently, in the late 1990s and early 2000s, Germany, Korea, Switzerland, Hungary, Poland, Slovakia, and the Czech Republic began to put PRP mechanisms in place.<sup>17</sup>

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<sup>17</sup> Bulgaria reportedly introduced a PRP system at that time, although it could not be evaluated for this report.

## Box 1. Performance Management for Senior US Civil Servants

In 2004 the US government introduced a new performance management system for senior civil servants, based on performance agreements, to better link compensation to performance. Departments are free to determine the content of their performance agreements, although the Office of Personnel Management (OPM) has issued guidelines. These include, for example, the rule that 50 percent of the objectives are to be measurable, though the rest can be more qualitative. Through a yearly review and a process for certifying agency performance appraisal systems, OPM retains quality control over performance arrangements.

Performance agreements cover both program and internal management objectives. The former reflect the agency's operational and strategic goals, the latter such competencies such as managing people, effective conflict resolution, and compliance with internal procedures. Executives and line managers are responsible for drafting performance agreements. Individuals are graded on three to five categories, depending on the agency. The five rating levels often are: (i) unsatisfactory; (ii) minimally satisfactory; (iii) fully meets expectations; (iv) exceeds expectations; (v) outstanding. For each level, a description of expected performance is given, and levels may be given measurable quantitative or qualitative indicators. For example, a performance indicator for „outstanding“ may be achieving a result or output more quickly than the commitment/objective, or producing more outputs (regulations, policies) within a given time. The actual time frame or required number will be specified. Targets are kept achievable to minimize gaming. Some agencies assign weights to each commitment to indicate the importance of a particular objective.

All performance evaluations are reviewed by a Performance Review Board and approved by the agency director. Superior performance normally results in a wage increase above the civil servant norm. Pay is not the only performance motivation. High-performing individuals can also receive the President's Rank Award for exceptional long-term accomplishments. Civil servants can also be demoted or dismissed for poor performance, although formal appraisal processes are required, and poor performance must be addressed by formal performance improvement plans covering a specified period. While the improvement plan is in place, performance is monitored and additional training and mentoring are available. If performance is still unsatisfactory, the civil servant may be dismissed but only if it is well documented that all procedures have been followed.

Based on Ketelaar, A., N. Manning and E Turkisch (2007) „Performance Based Arrangements for Senior Civil Servants: OECD and other Country Experience“ OECD Working Papers on Public Governance.

**67. In PRP countries performance is usually evaluated annually.** At the outset, the line manager and each employee identify objectives for the year, generally aligned to organizational goals. After a period of time (usually one year), the manager assesses the employee's performance. The evaluation can be based on a detailed grid or list of criteria or can be much more informal. Depending on the position, it can include measures or standards of service quality, either as part of organizational performance agreements or as stand-alone performance contracts with employees.

**68. Despite their widespread use PRP systems have a poor reputation.**<sup>18</sup> The World Bank's Governance and Social Development Resource Center reports that „There is no strong evidence that PRP improves worker or organizational performance—at least not in staff (as opposed to line) functions. In the latter case, performance can, to varying degrees, be measured objectively, for example, according to the number of patients seen, and can be rewarded accordingly. But

<sup>18</sup>. See Ketelaar et al. 2007; OECD 2008; and EU 2007.

in management and policy making roles, it is very difficult to objectively measure and quantify performance.” Similarly, previous OECD studies play down the effectiveness of PRP, noting that „Performance assessment is inherently difficult in the public sector. [It] requires a large element of managerial judgment. The notion of performance itself is complex, owing to the difficulty of finding suitable quantitative indicators and because performance objectives often change with government policy.“ Other studies have concluded that the impact of PRP on performance is limited and may even be negative.

**69. PRP systems are particularly difficult to implement when management is weak, because managers tend to assign ratings on the basis of nonperformance factors, such as personal friendship or family connections.** Attempts to counteract this by adopting more quantitative performance measures can create difficulties. Focusing too much on easy-to-measure quantitative targets can drive out harder-to-measure but more important qualitative aspects of performance. Over the last 10 years OECD countries have been moving away from quantitative performance measures. Their performance evaluations now rely less on numbers and more on previously set objectives and on dialogue with line management (OECD 2005).

**70. Performance evaluation nevertheless can make a contribution to the Bulgarian human resource management system.** But rather than being used solely to determine annual salary increases, performance evaluations should be seen as an opportunity to discuss problems in job performance and career expectations with individual staff, as well as to evaluate staff for promotion or dismissal.

**71. Performance can also be encouraged through other means.** The HR literature suggests that selecting the right staff in the first place is an absolute precondition for good performance. It also shows that wage competitiveness and stability (rather than individualized rewards) is the main consideration in retaining good staff. This suggests that the Government, in addition to rewarding individual performance, should also focus on ensuring that recruitment procedures function effectively and that levels of remuneration – particularly in key positions--are competitive with domestic comparators.

## Reform Options

**72.** To raise the productivity of the public sector and attract and retain well-trained professionals, the government may wish to consider the following options:

- **Continue optimizing public administration staff and structures.** With more employees per 1,000 than most other EU10 countries and one of the lowest wage bills, the Bulgarian public sector would appear to be overstaffed. Plans for increasing the efficiency of administrative services and expanding e-government should permit a leaner administration in the future.
- **Be careful with the implementation of the PRP.** Introducing a performance element into remuneration should encourage productivity, but international experience has generally been disappointing: measuring and quantifying performance objectively is difficult, and the impact of PRP on performance is limited and may even be negative, especially when weak managers assign ratings on the basis of factors unrelated to performance. Therefore, performance evaluations should be used to evaluate staff for

promotion or dismissal, encouraging better performance through means other than bonuses, such as careful recruitment and competitive wages.

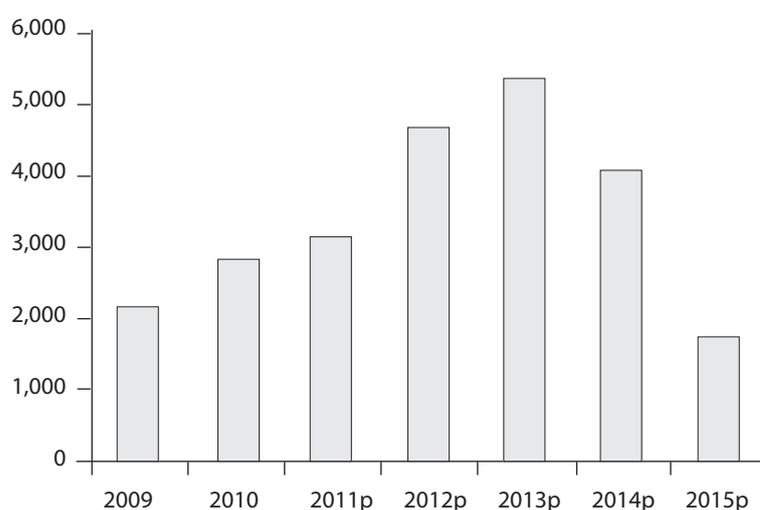
- **Be flexible in setting wages.** Wage bill freezes are risky as a longer-term strategy; they may make it difficult to attract and retain competent staff, especially once economic growth resumes. One long-term approach would be to index wage levels to inflation. Another would be to survey wages in the private sector to ensure that public sector pay is competitive.
- **Regularly review recruitment and retention policies.** This is particularly important to ensure that wage levels for positions demanding superior skills are high enough to attract and retain qualified staff. Assigning position-specific wage increases might be a possibility.

## 5. Public Investment Management: Reinforcing the Foundations for Growth

**73.** This section analyzes current public investment management (PIM) practices in Bulgaria, elsewhere in the EU, and globally. It sets out a sound PIM system that starts with strategic guidance and prescreening processes that help identify national priorities. The section then moves through project appraisal and selection and into project monitoring and evaluation. Other analytic frameworks draw on similar principles (Annex 2). They are anchored in an understanding that the quality of public investment is affected not only by the selection of projects but by their management and ex post review.

**74. Capital expenditures are a large share of public expenditure reaching 13.6 percent in 2010, 5.2 percent of GDP.** Bulgaria plans to significantly increase its access to EU structural funds in 2012 and 2013 to almost triple the 2009 levels (Figure 13). A considerable share of the EU funds is used to finance infrastructure investments, which are vital for Bulgaria. Nevertheless, there has as yet been little progress in improving public infrastructure, particularly the long distance transport network and absorption of EU funds could be improved.<sup>19</sup>

**Figure 13. Implementation of EU-funded Projects 2009–2015 (BGN million, including national co-financing)**



Source: MOF.

Note: Covers only projects in the current financial perspective (2007–13).

**75. Throughout the EU public investment is seen as a critical driver of economic convergence, but the literature is also clear that its quality and efficiency affect its marginal productivity.** Countries need to be concerned with the quality as well as the volume of spending. The MOF has a vital role in helping make public investment more efficient and effective. Even in highly developed countries, where decisions about individual projects are primarily the responsibility of another ministry, the MOF can ensure that the line ministry's standards for project analysis and management are appropriate, and that the government is obtaining full value for its investment. Although the line ministry generally leads project appraisal, the goal of the MOF should be to assure that appropriate standards of project analysis are met, to bring

<sup>19</sup> To speed up implementation of EU funded projects the Government signed in late January 2012 a Memorandum of Understanding with International Financial Institutions (IFIs--European Investment Bank, European Bank for Reconstruction and Development and the International Bank for Reconstruction and Development). The IFIs would provide knowledge and advisory services to help improve capacity for management and implementation of large projects.

to light the impact of public investment decisions, and to identify where systemic weaknesses in management of public investment projects are affecting the quality of spending. Nor does the MOF role end once a project is selected and budgeted; it should undertake monitoring and evaluation during the entire cycle of public investment management.

**76. Although in Bulgaria projects financed from the government budget are relatively few compared with the EU-financed portfolio, the MOF has rightly focused on more closely monitoring these projects.** In 2008, when both EU- and government-financed projects were its responsibility, the MOF began exploring ways to integrate procedures used for nationally financed projects with those used for EU projects. Although there have since been changes in government and ministry reorganizations, the concern for reviewing and reinforcing PIM remains. This section briefly reviews good PIM practices globally and suggests how they might be applied to Bulgaria's management of nationally financed projects.

## Strategic Guidance

**77. Investment strategies need to be well-defined if they are to be a meaningful basis for identifying priorities and selecting projects.** Strategic documents are a prerequisite for accessing and absorbing EU structural funds, and they are well-publicized. However, some strategic documents prepared for the EU do not necessarily provide guidance on how to set priorities for projects. When the World Bank (2009) conducted a comparative study of PIM practices for transparent infrastructure projects in certain member states, it found that national strategies were sometimes driven more by external EU requirements than by an internal government need for high-quality planning and management tools. Even strategic plans for a specific sector provided only a list of possible investment options rather than a well-defined set of priorities that reflected interdependencies between policy areas and projects. For countries seeking more technically driven strategies that can be sustained over time, this is a problem. High-level sector strategies without clear links to operations give politicians more discretion to select projects that fit their own objectives. Inevitably, as governments change over time, follow-through on individual projects is likely to deteriorate.

**78. In the best examples of strategic planning, long-term sector priorities are framed by realistic budgets.** In both the UK and Ireland, transport investment is guided by a multiyear budget agreed with the Treasury (in the UK) and the Department of Finance (in Ireland). In Ireland the planning horizon for transport is 10 years, in the UK it is 7; other sectors have shorter horizons. In both cases the objective is to help the sector reduce the number of potential projects to those that are likely to be funded – even if resource envelopes are only indicative. While the EU10 countries in the study also had well-defined sector strategies, links to the budget were more tenuous. In general, the documents did not attempt to give a basis for sequencing or make much of an effort to prioritize projects, although the rationale for an investment is usually clearly stated, and the planning documents offer guidance on projects that might support the strategy. Slovakia has a Public Works Plan with a three-year rolling list of potential projects (across sectors) to be financed, although there is no attempt to fit them within the budgetary envelope.

**79. Since there is asymmetry of information between the line ministry and the MOF, it is helpful to periodically pursue external validation of the investment strategy.** Even though most of the expertise resides in line ministries, for example, the UK Treasury collaborated with the Department of Transport on a major policy review by a team of external experts. Similarly,

in Ireland the government conducted a competitive tender for an ex ante review of proposed investment priorities. As the systems in the UK and Ireland have evolved over many years, the focus is increasingly on investment value-for-money. The volume of resources going into public investment programs and the potential for poorly targeted spending suggest that spending up-front to improve planning and prioritization could increase the return on investment.

**80. Bulgaria's strategic guidance for public investment was not reviewed, but there are indications that prioritization could be improved by closing slow or low-yielding projects.**

In particular, Bulgaria would benefit from rationalizing the size of the public investment portfolio and working toward medium-term project prioritization. Far more projects have been approved than there are resources to complete them. The MOF is aware that some projects have moved slowly and others have been frozen for years. There seems to be little incentive for ministries to cancel projects outright; instead, some are kept frozen until funding becomes available or there is a change in government. The risk is that the initial assumptions or justification for a project become obsolete. Where long-term planning has been highly valued, a phenomenon referred to as „path dependency” sets in, and engineers and planners find it hard to give up on projects already started. The Government of Bulgaria could consider cleaning out the whole investment portfolio and formally closing low-priority or frozen projects so that resources can be directed to projects with high economic benefit. Ministries that wish to restart closed project could be required to submit an updated project appraisal.

**81. Although Bulgarian line ministries produce annual strategic plans as part of the program budgeting initiative, the MOF might review whether the plans offer enough information to make clear the medium-term public investment objectives.**

Current strategic plans are primarily for one year, with a simplified projection of t+1 and t+2 expenditures. It is unclear whether ministry projections of future expenditures on investment projects are robust or whether they reveal new projects planned for t+1 and t+2. The MOF should be concerned to make sure that project funding is not ad hoc from one year to the next but is consistent with a medium-term budgetary strategy. It should also assess whether a specific project's goals are aligned with the performance indicators for the program that is funding the project.

## Project Appraisal and Selection

**82. Consistent with good PIM practices, Bulgaria's MOF has established clear analytical criteria that ministries must comply with if projects are to be funded by in the national budget.**

Two years ago the MOF revised its procedures for screening nationally financed projects to integrate practices from EU-financed projects. The rationale was sound: regardless of the source of financing, project economic benefits should be assessed carefully. However, it is important to ensure that the requirements are scaled to the size and complexity of the project. Because EU projects on average are much larger than those of the government, they justify heightened analysis. Analysis of large-scale nationally financed projects should be equally rigorous. But some projects might be well-served by analysis of cost alternatives, rather than an attempt to monetize the benefits, especially when the benefits are intangible. It is also important, even for nationally financed projects, to tailor guidelines to specific sectors.

**83. The quality of cost-benefit analysis (CBA) and its impact on decision-making are two critical areas Bulgaria may wish to study.** CBA skills are likely to vary by line ministry and may be particularly thin in local administrations. Even when analysis is contracted out, it is important that

public administration retain some core competencies. EU countries like Ireland, and others further afield like Chile, have invested heavily in training public servants in project appraisal methodologies. Equally important is the impact CBA has on decision-making. Officials in some EU countries acknowledge that CBA is sometimes performed merely to confirm a decision already taken or to comply with EU project requirements. Certainly, economic analysis is not the only factor that affects project selection. In countries like Latvia, the Ministry of Transport uses six criteria to determine whether to go forward on a project, of which economic analysis is only one. Moreover, in democratic societies governments make political trade-offs based on the priorities of their stakeholders. However, CBA needs to inform the process and be applied transparently. If political leaders opt for a project that has low economic returns, that choice should be quite clear.

**84. Focusing project appraisal on CBA is a necessary but not sufficient condition for assuring good project selection; as Bulgaria's institutional capacity grows, other factors should be integrated into the decision-making for large projects.** While CBA is traditionally a core component of project appraisal, more advanced countries like the UK and Ireland have refined their approach to incorporate risk adjustments, distributional issues, and project management arrangements. For example, the 2003 edition of the UK's *Green Book* introduced risk adjustment factors for different types of investment, in part responding to an observed CBA „optimism bias“ where project beneficiaries are inclined to see the projects more favorably than more objective observers might. Risk adjustments are intended to improve average forecasting accuracy. The Department for Transport (DfT), which generates a high proportion of project appraisals in the UK, has moved to more clearly distinguish the distribution of costs and benefits among segments of the population. Risk mitigation and project management structures are also taken into account in deciding whether a UK project goes forward. The DfT emphasizes not only economic analysis but also procurement strategies and potential cost and timing risks. In Ireland, the sponsoring agency may be required to put in place strategies to minimize risk through project management, review procedures, or information flows. Project monitoring guidelines issued by Ireland's Department of Finance, coupled with a requirement for independent spot checks, are intended to assure that risk is indeed being managed.

**85. Bulgaria's MOF need to have the authority to block poorly justified projects.** The role of ministries of finance in Central and Eastern Europe is still evolving. Although experienced in setting limits on ministry spending and assuring proper allocation of funds, few have a culture of assessing and promoting value for money. Although in Bulgaria the MOF is able to block projects that lack funding and require economic analysis of projects before they start, the real test of its authority is whether it can prevent projects from starting based on the economic assessment or the lack of sufficient risk mitigation. Changing the organic budget law or the framework law for a ministry is not a task governments want to undertake often. However, the MOF needs to have authority not only to require additional technical analyses from line ministries but also to be able to block projects even in the most powerful sectors. Although the current formation of the government gives the MOF more authority in the Cabinet than previously, Bulgaria might be well-served by creating a more institutionalized structure through which the MOF can credibly challenge line ministries on the economic value of a given investment.

**86. Where infrastructure has been chronically underfunded and assets have deteriorated, the MOF must deal head-on with political and institutional incentives to move projects out the door rather than addressing whether they offer value for money.** Finding projects that generate positive economic returns may not be a major challenge for line ministries in Bulgaria, but they are not always incentivized to select the project with the highest ul-

timate value. As a result, line ministries do not rigorously evaluate all feasible alternatives; instead, they present only options that are clearly inferior to their preferred choice. Then, projects are sometimes over-designed relative to what is really needed to fulfill the policy objective. Engineers may promote the latest and best technical approach rather than opt for a less expensive design that would still achieve the primary purpose. After a feasibility study has been paid for and completed, projects can be more difficult to block than they would be during a pre-appraisal review. If the MOF does not already have a prescreening process, it may wish to introduce one (see Annex 3). Moreover, the MOF should encourage line ministries to publish a comparative economic analysis so that the basis for selecting a given project is more transparent.

## Medium-Term Budgeting and Programming

**87. Bulgaria, like several other EU countries, uses an MTFE to guide its management of public finances.** The MOF has used it successfully to facilitate macroeconomic stability and to guide ministries in strategic planning and program budgeting. For public investment projects, which by their nature tend to be multiyear, the MTFE can be especially useful. MTFEs have taken different forms; Bulgaria's is devoted to high-level strategic allocation decisions. The MOF now gives only aggregate ceilings to line ministries without specifying portions for capital and for recurrent expenditures. Presumably, the intent is to give line ministries maximum flexibility to determine allocation of funds within their sector of responsibility.

**88. In EU countries where PIM has been most developed, medium-term budgeting is used to make project funding predictable and to facilitate efficient management of investment projects.** MTFEs can be used effectively not only with top-down aggregate ceilings but also with more detailed, bottom-up information on what specific investment projects or programs need. This type of MTFE, which emphasizes budget programming, helps to align project financing in each year with cost-effective implementation and procurement strategies. In countries where PIM is more advanced, the financing schedule will be heavily influenced by project needs and the goal of optimizing value in the public procurement of services. The MOF should use the MTFE to anchor financing of priority investments (including major repairs of assets) into a base line budget and to prevent crowding-out by politically motivated new projects. Latvia's experience with a three-year MTFE is relatively new, but it illustrates an effort to make project financing more predictable. The Latvians have created an appendix to the state budget that lists each program or project. The list is approved by Parliament separately for the next three years and in one sum until the project is completed (World Bank 2009). Once the project is ready for service, the operational expenses are included in the Ministry's base budget request and in future medium-term ceilings. In Ireland as well, budget resources are authorized in their entirety once the contract is awarded, and the annual allocation is adjusted to take into account actual progress. Funding is slowed only if physical progress is slower than anticipated, for example, due to delays in a statutory approval process. Although the global economic crisis has made it difficult for governments across Europe to preserve this type of budget stability, such processes are likely to regain favor once economies recover.

**89. Bringing fiscal discipline to the public investment portfolio may require a longer budget programming horizon than an MTFE typically covers.** It is not uncommon for line ministries to make project costs fit within MTFE ceilings by spreading costs out beyond the three-year MTFE horizon. In this way they create fiscal space within the MTFE period for new projects. Over time the investment portfolio grows to such an extent that the average lifespan of projects becomes unusually long and the cost to complete the entire portfolio grows beyond

the MTFF envelopes. In other words, more projects end up competing for the same resources, and the public investment portfolio resembles a wish list rather than a plan. To the extent that the MOF is concerned about value for money, this problem needs to be dealt with. As a general rule, the most cost-effective procurement strategies would encourage the contractor to complete the project as quickly as possible, to avoid having expensive equipment tied up for long periods and to reduce the risk of increases in the cost of materials. There are sometimes legitimate reasons why progress is slower than expected, but when projects slow for financing reasons, this often adds to their total cost.

**90. Bulgaria should rationalize its public investment portfolio and use the medium-term budget process to force line ministries to set priorities.** One tool to facilitate that would be to expand the budget planning horizon for public investment to perhaps five to seven years.<sup>20</sup> The MOF could insist that financing needs for all projects must fit fully within this range<sup>21</sup> or the agency should downsize its portfolio, formally closing low-priority and inactive projects. Obviously, even under optimal conditions it may not be possible to complete some mega-projects within seven years, but they should be rare – and even those can sometimes be segmented into components that could serve as useful stand- useful pieces even if the rest of the work is not completed. This provides a discipline for limiting introduction of new projects. The MOF should not allow financing of current projects to be spread out simply to accommodate new projects. Such a discipline process could also offer incentives to assure that vital maintenance and repairs are not neglected in favor of more politically visible activities.

## Monitoring and Evaluation

**91. In a well-functioning PIM system financial and physical progress is closely monitored until a project is operational.** Monitoring should provide early warning of any problems and be supported by formal procedures that ensure that warnings are acted upon. More sophisticated performance monitoring checks that projects are delivering the expected results with the intended outcomes, e.g., services have the anticipated positive effects on beneficiary welfare. Performance monitoring provides the raw material – information – for mid-term and ex post evaluation exercises.

**92. While the MOF is primarily concerned with the aggregate picture, it should still be concerned about the details of individual projects, especially those that have considerable fiscal impact.** Monitoring varies in intensity because information requirements differ depending on the responsibilities of the organizations involved in the PIM and delivery process. Organizations at the center of government, like the MOF, will have different information needs from project managers responsible for delivering a project on time and within budget and from the spending agency that is financially accountable for the project. All the same, because the aggregate picture must be built up from accurate information about each project, the MOF should be concerned about individual projects, especially those where poor performance might undermine ultimate value.

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<sup>20</sup> The World Bank's EU study (2009) revealed that budget horizons for public investment vary. In the UK, the Highways Agency receives a three-year budget authorization but a long-term indicative budget, and railways receive a five-year statement of government funding availability. In Ireland the National Roads Authority is given a five-year envelope for road expenditure and a ten-year indicative budget.

<sup>21</sup> The World Bank acknowledges that changes in the legislation regulating the MTFF and the Annual State Budget Law may be necessary.

**93. Bulgaria's MOF appears to have set up a solid process for collecting project data from ministries and a reliable electronic database from which to retrieve data over the life of the project.** Because the MOF has chosen a decentralized Treasury model, line ministries manage their own systems and then report data to the Treasury in a specified format. The MOF database contains financial information on both active and inactive projects so that reports can be generated at any time. There is comprehensive information on annual expenditures, both planned and executed. However, one element that is missing is information on the state of physical progress, which would allow comparison of the pace of spending with the work completed. The question is how this additional information can be captured efficiently and without imposing heavy burdens.

**94. To generate information on actual expenditures by project as a matter of course through the Treasury system requires project-level expenditure coding, which Bulgaria does not currently use.** Without this it is impossible for ministries to systematically record expenditures to a given project. Codes would improve accuracy, regularity, and functionality. Linked to this issue is the need to have an agreed final list of projects (new and ongoing) that have been approved for funding through the budget preparation process. This does not need to be part of the budget law itself, although it could be an annex to it, but it does need to be available as information for those approving the budget and should be prepared before the budget is approved.

**95. The MOF may want to consider refining its definition of „project“ to consolidate smaller projects and those that are part of larger projects.** Ministries may put forward relatively small projects so that they can be completed within a single budget year, such as building or repairing a few kilometers along a major road corridor. Presumably the rationale is to assure that financing is predictable. However, the MOF cannot perform an effective monitoring role if it is swamped with information because too many small projects are cluttering the system. Therefore, it should consider rationalizing how projects are defined so that they are fewer in number and more strategic in scope.<sup>22</sup>

**96. For major projects, in-year monitoring of actual expenditures against budgeted amounts is an important function for the MOF.** When this information is combined with information on physical progress, the MOF would be in a position to assess whether transfers to „faster-moving“ projects are indeed that and not unauthorized increases in the total estimated cost of a project. Frequent major reallocations are not conducive to good implementation planning; they may also present opportunities for poorly prepared, politicized projects to slip into the budget. It is usually advisable to limit reallocations and instigate long-term improvements in planning.

**97. To go even further in its stewardship of public finances, the MOF may want to initiate an annual examination of whether major projects are on track and likely to be completed on schedule and within the original budget.** The reports currently tend to look only at annual financial flows. While this is important from a budget control and audit perspective, it misses vital information about project efficiency. The database may have information on budgeted cost, but it is not being used to identify cost over- or under-runs on individual projects. Because EU projects may have more complex management arrangements, and fewer of them

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<sup>22</sup> One possible definition: A project is a set of specific activities, with a specific starting point and a specific ending point, intended to accomplish a specific objective. It results in the creation of a capital asset that will produce sustainable benefits to a defined target group over an extended period. It logically lends itself to planning, financing, and producing as a unit. For strategic planning and budgeting purposes, small projects can be grouped into programmatic projects.

have moved close to genuine completion in Bulgaria, the immediate priority should be given to examining the nationally financed projects.

**98. When the MOF identifies problem projects, it can probe into the causes of cost overruns or delays.** Ex post review of project implementation would have two objectives: first, it would help identify recurring PIM problems so that they can be addressed, and second, it begins to make ministries more accountable for their management of public investment funds. Although Bulgaria has adopted some principles from New Public Management that encourage delegation of responsibility, mechanisms of accountability to accompany such authority seem to be minimal at best. One is public transparency about how funds are used and what are the results achieved. Although ministries regularly publish reports on budget execution on their websites, these generally lack a critical comparison of planned versus actual experience for projects (see Annex 4 for a possible format).

**99. The annual implementation reports that ministries make on their program budgets are an excellent example of the MOF's efforts to focus on results, but they need to be refined if decision-makers are to find the information, especially on public investment, useful.** Transparency is an important principle for accountability, but the size and scope of the current reports may render them inaccessible to many who should be using them. The State Expenditures Directorate synthesizes the reports for decision-makers, but this could be preceded by a more focused presentation by the line ministries themselves. Ministries with major PIM programs should certainly make available a more customized presentation. Ministries should be expected to account for how well they have managed or are managing projects at the basic level of whether they are meeting their financial, time, and quality targets. At a more advanced level, ministries should eventually be expected to explain how the projects have contributed to the higher level program objectives or performance indicators, such as reducing travel time or accidents or improving water quality. Currently, plans simply describe the intended purposes of the project and the expected financial results; there is no assessment of relative performance. Whether implementation reports or different reports would be the most appropriate place to house such analysis of public investment deserves consideration, but the point in any case should be to build a user-friendly supply and a political demand for such information. This cannot happen overnight, but the MOF could draft a plan for how it will get there, perhaps starting with small pilot programs.

## Reform Options

**100. Making PIM more effective and efficient over the long term will catalyze a paradigm shift in many Central and Eastern European states.** Much of today's public administration culture centers on compliance with clearly defined regulations, though countries with the most advanced PIM would encourage a managerial culture that increases transparency about outcomes. Even financial management information systems relate primarily to budgetary control and accounting against each contract; rarely is there an accounting for the whole cost of a project, from acquisition through supervision, design and other fees, and construction itself. While the original feasibility study may have dealt with these, there is usually no check to see how reality compares with the original projected cost. Ex post project audits also are concerned with financial oversight and compliance with procedures rather than the effectiveness of expenditure or improving risk management. All EU member states, regardless of income, experience projects that go off track or cost more than planned. However, countries that manage PIM best constantly review their procedures and processes against past failures to anticipate problems. Nor

should governments overlook the importance of transparency in bringing to light poor management and creating incentives for ministries and agencies to assure good practices. The complexity and diversity of PIM is a challenge in many countries, but ministries of finance must focus Cabinet attention not merely on absorption and disbursement but also on cost-effectiveness.

**101.** To make Bulgaria's PIM more effective and deliver on its ambitious program for upgrading and modernizing infrastructure, the following reform options might be considered:

- **Strengthen strategic planning of projects.** This would require that ministries align their long-term strategies with the MOF to ensure that projects are underpinned by realistic budgetary parameters. Bulgaria needs to better prioritize over the medium term, rationalize the size of its public investment portfolio by closing slow or low yielding projects and redirecting resources to activities that have the highest economic benefit. Criteria should be carefully considered on which projects to close; percentage of the project already completed, contract termination costs, and marginal economic benefits to completion could all be potential factors.
- **Enhance project appraisal and selection.** This might include establishing an institutional structure through which the MOF can challenge line ministries on the economic opportunity offered by a given investment. The MOF could also consider tailoring guidelines for project applications to specific sectors and to the complexity of projects. To improve CBA quality and impact on decision making, public servants could be trained on project appraisal methodologies. As institutional capacity grows, other aspects of project selection might be considered such as risk analysis and adjustment, project management arrangements, and distributional considerations. Pre-screening of projects might be improved to encourage line ministries to show comparative economic analysis of individual projects.
- **Strengthen medium-term budgeting and programming.** The MTFF could be used to anchor financing of priority investments (among them major repairs of assets) in a baseline budget and to prevent crowding out by new, politically motivated projects. To enforce prioritization of projects by line ministries, the budget planning horizon for public investment could be expanded to five to seven years; projects that cannot be completed within that horizon would be either downsized or closed. The three-year MTFF horizon continues to be a realistic basis for budget planning overall, but some additional annex could be used to record the commitments that have already been entered into by the Government that extend beyond the three-year window. This reflects prudent long-term economic planning to assure that ministries are not taking on bigger commitments than the expected financial resources can bear.
- **Improve the monitoring and evaluation of projects.** Monitoring should provide early warning of any implementation problems, and there should be formal procedures to ensure that problems are acted upon. The MOF might consider initiating in-year monitoring and annual reviews of major projects to check if these are on schedule and within budget and analyze the reasons for any delays or overruns. The MOF could issue a list of all projects approved through the budget preparation process. Giving projects codes would make it easier to systematically record expenditure against project.
- **Strengthen transparency and accountability.** Performance-based budget implementation reports need to provide meaningful PIM information. Ministries with major investment programs should account for how well they have managed and are managing project costs, progress, and outcomes.

# Annex 1

## „Must-have“ features for efficient public investment management

The World Bank has developed guidance to help formulate a pragmatic and objective assessment of the quality of public investment efficiency in a context where governments are seeking to mobilize additional fiscal resources for investment. An indicator-based approach has been developed around a set of core „must-have“ dimensions, namely:

- Investment guidance and preliminary project screening
- Formal project appraisal processes (with cost-benefit analysis a best practice)
- Independent review of appraisals (including alternatives)
- Project selection and budgeting need to establish envelopes for public investment so that a sustainable investment program can be undertaken;
- Realistic implementation plans
- Flexibility to adjust for changes in project circumstances
- Facility operation – asset registers need to be maintained and asset values recorded
- Evaluation to ensure that there is learning and feedback.

This approach is designed to provide both a basis for objective assessment and an opportunity to identify weaknesses that should be addressed if use of fiscal resources is to enhance public sector assets and economic growth. An assessment might, for instance, help to identify quick-win reforms to accelerate investment spending during a crisis. While the approach does not identify best practices, OECD countries commonly provide guidelines and seek to strengthen their management capacity around similar dimensions.

Source: A Diagnostic Framework for Assessing Public Investment, Policy Research Working Paper 5397, World Bank, August 2010.

# Annex 2

## Components of the Public Investment Management Index (PIMI)

### **1. Strategic Guidance and Project Appraisal**

- Nature of strategic guidance and availability of sector strategies
- Transparency of appraisal standards
- Observed conduct of ex ante appraisals
- Independent review of appraisals conducted

### **2. Project Selection and Budgeting**

- Existence of a medium-term planning framework and its integration with the budget
- Inclusion in the budget (or similar) of donor-funded projects
- Integration of recurrent and investment expenditures into the budget
- Scrutiny as well as funding by legislature and its committees
- Public access to relevant fiscal information

### **3. Project Implementation**

- Degree of open competition for award of contracts
- Nature of any mechanism for complaints about procurement
- Funding flows during budget execution
- Effectiveness of internal controls (if any), such as commitment controls
- Effectiveness of the internal audit system

### **4. Project Evaluation and Audit**

- Degree to which ex post evaluations are conducted
- Degree to which external audits are produced on time and scrutinized by the legislature

# Annex 3

## Preliminary Project Screening

A process for filtering project concepts as they are identified has significant advantages that can enhance the quality of the entire investment program:

- It forces project promoters to clarify the project logic (problem being addressed, project purpose, target beneficiaries) and consider alternative solutions before committing resources to project preparation.
- Project objectives can be verified early for compliance with government policy and expenditure priorities, and projects not consistent with policy and priorities can be rejected.
- The scope of the project can be verified to ensure that it represents a complete solution to the problem being addressed and not just a component of a larger project.
- Where project preparation is unlikely to inform the investment decision, screening at identification stage forces an early decision on priorities and helps to prevent resources being used up preparing unaffordable or irrelevant projects. An example would be the case of social projects where cost-benefit analysis is difficult to perform and the investment decision is more policy-based.
- By requiring rough cost estimates at identification stage, it is possible to determine whether and when the project can be fitted under medium term capital expenditure ceilings within the MTFE.
- Early recognition of any significant recurrent financing needs allows more time to develop the necessary coherence between the capital and current parts of a spending agency's budget.
- Any important design issues, including possible project alternatives, can be identified early and built into the terms of reference for studies.
- The preliminary screening process disciplines spending agencies, by guiding them toward priority areas for investment and causing them to think in terms of a pipeline of projects that respond to MTFE limits.
- Monitoring and evaluation results from current and completed projects can later be fed more easily into the project preparation stage.

# Annex 4

## Formats for Report on Project Progress

### Formats for Report on Project Progress

Sector	Project name	Original estimated cost	Year started	Total spent before 2008	2008 Financing		2009 Financing		2010 Financing		Additional financing needed
					Budget	Actual	Budget	Actual	Budget	Actual	

### Projects more than 10 years old

Sector	Project name	Start date	Original total cost estimate	Total spent thru 2010	Estimated cost to completed	Average annual funding to date

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