INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT
ON A PROPOSED LOAN

IN THE AMOUNT OF 101.7 MILLION EURO
(US$150 MILLION EQUIVALENT)

TO THE

REPUBLIC OF BULGARIA

FOR A
SECOND SOCIAL SECTORS INSTITUTIONAL REFORM
DEVELOPMENT POLICY LOAN (SIR DPL II)

October 6, 2008

Human Development Unit
Central Europe and the Baltic Countries Department
Europe and Central Asia Region
BULGARIA - GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of October 6, 2008)

<table>
<thead>
<tr>
<th>Currency Unit</th>
<th>Bulgarian Lev (BGN)</th>
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<tr>
<td>US$1.00</td>
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<td>1.00 EUR</td>
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<tr>
<td>US$1.00</td>
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</table>

Weights and Measures
Metric System

ABBREVIATION AND ACRONYMS

ALMP  Active Labor Market Program
CPS   Country Partnership Strategy
CFAA  Country Financial Accountability Assessment
DDO   Deferred Drawdown Option
EU    European Union
Eurostat The Statistical Office of the European Commission
GDP   Gross Domestic Product
GNP   Gross National Product
GoB   Government of Bulgaria
HIPC  Heavily Indebted Poor Countries
IBRD  International Bank for Reconstruction and Development
IDA   International Development Association
IFC   International Finance Corporation
IMF   International Monetary Fund
LDP   Letter of Development Policy
LLL   Life Long Learning
MDGs  Millennium Development Goals
MES   Ministry of Education and Science
MOF   Ministry of Finance
MOH   Ministry of Health
MTEF  Medium-Term Expenditure Framework
NRP   National Reform Program
OP HRD Operational Program Human Resource Development
PER   Public Expenditure Review
PHRD  Japan Policy and Human Resources Development Trust Fund

Program for International Student Assessment
ROSC  Report on the Observance of Standards and Codes
SDR   Special Drawing Rights
SMEs  Small and Medium Enterprises
TIMSS Trends in Mathematics and Sciences Study
UNDP  United Nations Development Program

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Country Director: Orsalia Karatzopoulou
Sector Director: Tamar Manuelyan Atinc
Task Team Leader: Daniel Dulitzky
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Bulgaria

SECOND SOCIAL SECTORS INSTITUTIONAL REFORM DEVELOPMENT POLICY LOAN (SIR DPL II)

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**PROGRAM DOCUMENT DATA SHEET**

<table>
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<th>Date: October 6, 2008</th>
<th>Lending Instrument: Development Policy Lending</th>
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<tr>
<td>Country: Republic of Bulgaria</td>
<td>Board Approval Date: November 4, 2008</td>
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<tr>
<td>Operation: Second Social Sectors Institutional Reform Development Policy Loan (SIR DPL II)</td>
<td>Effectiveness Date: March 4, 2009 (est.)</td>
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<tr>
<td>Operation ID: P102160</td>
<td>Closing Date: December 31, 2011</td>
</tr>
<tr>
<td>Team Leader: Daniel Dulitzky</td>
<td>Sectors: Health (45%); General education sector (45%); Other social services (10%)</td>
</tr>
<tr>
<td>Sector Manager/Director: Tamar Manuelyan Atinc</td>
<td>Themes: Health system performance (P); Education for all (P)</td>
</tr>
<tr>
<td>Country Director: Orsalia Kalantzopoulos</td>
<td>Environmental screening category: NA</td>
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</tbody>
</table>

**Operation Financing Data**

<table>
<thead>
<tr>
<th>[X] IBRD Loan</th>
<th>[ ] IDA Credit</th>
<th>[ ] Grant</th>
<th>[ ] Other</th>
</tr>
</thead>
</table>

Total Bank financing (US$m.): 150.00 equivalent
Proposed terms: Variable-Spread Loan (formerly the VSCL)

### Tranche Release Information

List binding conditions as stated in the **Legal Agreement**.

**Tranche 1**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Expected release date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single tranche operation subject to completion of prior actions as described below</td>
<td>EUR 101,700,00</td>
<td>10/31/2011</td>
</tr>
</tbody>
</table>

Condition 1: same as triggers

### Triggers

- Government has removed the automatic portability of the seniority bonus, transforming it into a bonus for relevant professional experience
- The MLSP has restructured active labor market programs as per the Employment Action Plans 2007 and 2008 to strengthen on the job qualification and training programs linked to private sector skill needs, consistent with European Social Fund priorities
- The Government has prepared an ex ante assessment of the impact of measures to strengthen work incentives in the social assistance system, and based on its conclusions has developed an employment activation program including individual action plans for social assistance beneficiaries
- Bulgaria has taken part in international assessment tests, like PISA 2006, PIRLS 2006, and TIMSS 2007. In addition, MES has administered sample testing of Matura in Bulgarian language and Literature, Math and Foreign languages, a new national placement test for 7th graders and a new census-based test of 4th graders
The Ministry of Education and Science (MES) has trained at least 50 percent of school directors through the Institute of School Directors.

The role of the NHIF as a primary payer of hospitals is maintained and payment system has been improved to promote an efficient use of resources and financial sustainability of the national health insurance system.

The Government has taken the first steps towards implementation of the masterplanning exercise by endorsing: (i) the guidelines and recommendations on health service planning; and (ii) framework for prioritizing investment needs. It is also using accreditation of facilities as a tool for rationalizing services.

The government further adopts and implements measures that would improve pharmaceutical approval, pricing, and reimbursement policies to increase the efficiency of public spending on pharmaceuticals and access to essential drugs (e.g. unify drug lists into one single list based on inn name and ATC/DDD classification).

The Government has maintained the unified standard and per student financing, and introduced delegated school budgets as a national policy.

The Council of Ministers has approved a package of measures and incentives to support the continued implementation of the unified standard and school consolidation.

<table>
<thead>
<tr>
<th>Does the operation depart from the CAS in content or other significant respects?</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Does the operation require any exceptions from Bank policies?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Have these been approved by Bank management?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Is approval for any policy exception sought from the Board?</td>
<td>Yes</td>
<td>No</td>
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</table>

**Operation development objective**

Support the Government of Bulgaria (GoB) to meet some of the challenges associated with EU accession in the case of DPL I and post-accession DPL II and III. The DPL series would support the adoption and implementation of policies to (i) increase employment and lay the foundations for long-term productivity growth by providing incentives for job creation and improving quality of education and; (ii) promote fiscal sustainability through efficiency gains in social sectors.
# Loan and Program Summary

**Bulgaria**

**Second Social Sectors Institutional Reform Development Policy Loan (SIR DPL II)**

<table>
<thead>
<tr>
<th>Borrower</th>
<th>Republic Of Bulgaria</th>
</tr>
</thead>
<tbody>
<tr>
<td>Implementing Agency</td>
<td>Ministry of Finance, Ministry of Health, Ministry of Labor and Social Policy, Ministry of Education and Science</td>
</tr>
<tr>
<td>Amount</td>
<td>Euro 101.7 million (US$150.0 million equivalent)</td>
</tr>
<tr>
<td>Terms</td>
<td>EURO denominated IBRD Flexible Loan at 6-month LIBOR for EURO plus variable spread with (i) a 17-year maturity, including a five-year grace period; (ii) bi-annual, level repayments; (iii) disbursement linked repayment schedule; (iv) deferred drawdown option; and (v) the payment of the front-end fee from the Borrower's own proceeds.</td>
</tr>
<tr>
<td>Tranching</td>
<td>Single tranche</td>
</tr>
<tr>
<td>Description</td>
<td>The proposed series has been designed to support the Government of Bulgaria (GoB) to meet some of the challenges associated with EU accession — in the case of DPL I — and post-accession — DPL II and III. The DPL series is supporting the adoption and implementation of policies to (i) increase employment and lay the foundations for long-term productivity growth by providing incentives for job creation and improving quality of education and; (ii) promote fiscal sustainability through efficiency gains in social sectors. Many of the policies are well placed to improve access to and quality of social services in the medium term, a secondary objective of the program. The actions supported by the DPL series are expected to contribute in the medium term to increased speed of convergence with EU policies and standards, enhanced competitiveness through increased skills of the labor force and better investment climate, more efficient health, education, and social assistance systems, and a more equitable access to basic social services. The focus of this DPL series reflects the Government’s social sectors and productivity agenda and its strategic use of multilateral organizations support to implement reforms and improve outcomes in sectors that remain outside the sphere of intervention of the European Union.</td>
</tr>
<tr>
<td>Benefits</td>
<td>It is expected that at the end of the DPL series (i) the employment rate of younger workers will have increased to at least 25 percent and older workers to at least 40 percent¹, (ii) the hospital sector will have a coherent plan for streamlining and increasing responsiveness to population needs; hospital</td>
</tr>
</tbody>
</table>

¹ 25% age 15 – 24, Eurostat data and 40% age 55 -64, Eurostat data
spending will be under control; and more resources will be allocated to outpatient care, therefore reaching a larger percentage of the underserved population, (iii) a basic package of drugs will become more affordable and introduction of new pharmaceutical products will be faster; and (iv) school financing will be more efficient, and schools will have more incentives to retain students and improve quality of education.

Four types of risks could affect implementation of policies supported by DPL II:

**Political risks**

1. Recent European Parliamentary and municipal election results and loss of momentum after EU accession have created tension among and within the coalition member parties (which have wide differences and views on certain reforms). This may increase the difficulty of reaching an agreement on some reforms. Upcoming parliamentary elections in 2009 may shift focus from important reforms and contribute to loss of momentum during preparation of DPL III.

2. The benchmark against which Bulgaria’s performance is measured has shifted, not only with regards to productivity and social indicators but also regarding wages and living standards; after many years of relatively flat wages and following accession to the EU trade unions are demanding salary increases, adding pressures to the economy and threatening to oppose reforms.

**Macroeconomic risks**

1. There are risks that the ongoing turmoil in international financial markets and the projected weakening of economic activity in the eurozone may result in a slowdown in capital flows and real GDP growth in Bulgaria. Risks reflect Bulgaria’s large current account deficit, high gross external debt and elevated inflation. These risks are mitigated by the government’s commitment to continued tight fiscal policy, following an increase in the fiscal surplus to 3.4 percent of GDP in 2007 and the decrease in external public and publicly guaranteed debt to 14 percent of GDP.

**Institutional risks**

1. As an EU Member State, the Government’s attitude to DPL supported measures may change relative to pre-accession-DPL I supported measures, and leverage capacity of Bank to guide policy changes could become more limited.

**Technical risks**

1. Implementation capacity in some line ministries is limited.

**Mitigation mechanisms** include maintaining a close dialogue with officials from all political parties in the coalition, supporting policies that should contribute to ease pressures on the economy —contributing to increases in labor productivity and flexibility of labor market, efficiency improvements in social sectors; close cooperation with various departments in the European Commission, and substantial technical assistance to support institutional strengthening of line ministries.
I. INTRODUCTION

1. This Program Document describes the second phase of three planned Social Sectors Institutional Reform — Development Policy Loans (SIR DPL II or simply DPL II). The proposed series has been designed to support the Government of Bulgaria (GoB) to meet some of the challenges associated with EU accession — in the case of DPL I — and post-accession — DPL II and III. The DPL series would support the adoption and implementation of policies to (i) increase employment and lay the foundations for long-term productivity growth by providing incentives for job creation and improving quality of education and; (ii) promote fiscal sustainability through efficiency gains in the social sectors. The actions supported by the DPL series are expected to contribute to increased speed of convergence with EU policies and standards, enhanced competitiveness through increased skills of the labor force and better investment climate, and more efficient health, education, and social assistance systems. Many of the policies are well placed to also improve access to and quality of social services over the medium term, a secondary objective of the program. The focus of this DPL series reflects the Government’s social sectors and productivity agenda — as stated in the Bulgaria Convergence Program and the National Reform Program submitted to the EU — and its strategic use of International Financial Institutions support to implement reforms and improve outcomes in sectors that are not fully covered by the Acquis Communautaire, i.e. the explicit request of the Government of Bulgaria to assist in reforming the social sectors.

2. The issues tackled by the DPL II have been highlighted by the EU both before and after accession. In the European Union health, social protection and education policies are treated as national affairs and therefore differ widely among countries. However, they are increasingly subject to a process of policy exchanges and mutual learning among Member States called the Open Method of Coordination, first introduced for the purpose of social policy at the 2000 Lisbon European Council.2 There are at least four arguments supporting interventions in the social sectors in a European context: (i) there is a link between well functioning social sectors and economic competitiveness, which is among the parameters set by the Lisbon agenda; (ii) as indicated by the experience of other new EU member states, social sector spending may have a large impact on the fiscal outlook of Bulgaria, whose improvement is sought in preparation for the adoption of the Euro in accordance with the Maastricht Criteria; (iii) harmonizing and

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2 During the meeting of the European Council in Lisbon (March 2000), the Heads of State launched a “Lisbon Strategy” aimed at making the European Union (EU) a more competitive economy and achieving full employment by 2010. This strategy rests on three pillars: (i) an economic pillar preparing the ground for the transition to a competitive, knowledge-based economy. Emphasis is placed on the need to adapt constantly to changes in the information society and to boost research and development; (ii) a social pillar designed to modernize the European social model by investing in human resources and combating social exclusion — investing in education and training, and conducting an active policy for employment; (iii) an environmental pillar, which draws attention to the fact that economic growth must be decoupled from the use of natural resources. Given that the policies in question fall almost exclusively within the sphere of competence of the Member States, an open method of coordination (OMC) entailing the development of national action plans has been introduced. Besides the broad economic policy guidelines, the Lisbon Strategy provides for the adaptation and strengthening of existing coordination mechanisms.
converging to EU standards has now become an important goal of Government; and (iv) improving the functioning of social sectors is part of an effective participation in the Open Method of Coordination.

3. The Government remains committed to the goal of convergence to EU standards and has made significant progress in implementing the policies agreed in the DPL program. The government is convinced that one of the pillars to achieve convergence while maintaining fiscal discipline is a well functioning labor market and more efficient delivery of social services to the entire population. The objectives of the reform strategy supported by the DPL program are to be achieved through the implementation of policies and actions oriented towards

- Creating incentives for individuals to join the labor market and to move to higher productivity jobs, and improving the institutional and regulatory framework—so that it is easier for companies to start new businesses and to hire workers, and for labor to be mobile
- Improving capacity of education authorities to assess quality of education and use information critically to improve the education system
- Changing the financing mechanisms of health (hospitals) and basic education services to make the systems financially sustainable and lay the ground for improving their quality
- Prepare and initiate implementation of a plan for restructuring the health facilities network, and make purchasing and reimbursement policies for pharmaceuticals more rational; and
- Promoting monitoring and evaluation of policies

4. The DPL program emphasizes the need for evidence based policy making, and has succeeded in developing a cross-cutting agenda in this area with the Government. It is supporting the government’s efforts to invest in information gathering and developing monitoring and evaluation capabilities. To this end the program is: (i) supporting the ex-ante assessment, and subsequent impact evaluation, of changes in one of the main social assistance programs; (ii) promoting the collection and the critical use of information on education quality through student assessments; and (iii) building the capacity to evaluate the impact of policy changes and implement household surveys through accompanying technical assistance associated to the DPL. Some of the policies supported by the DPL program are going to show results only in the medium term, i.e. not until after the three-year DPL program. These include an increase in quality of education and access to underserved populations, a decrease in long term unemployment, and an improvement in health outcomes through a more responsive supply of services and improved access to drugs. While it will not be possible to capture and report on these changes during the life time of the DPL program, the focus on evidence-based policy-making and establishment of an evidence base for the supported reforms are an essential contribution to monitoring medium-long-term effects of the reform program (including specific DPL actions and complementary policies).

5. The main strategic choices adopted in DPL I are maintained in DPL II. First, the Bank is providing high level policy advice and TA in addition to financial assistance associated with the DPL program. Second, this situation requires a very streamlined approach, focusing on a few very significant policies and concentrating the TA on those policies. Third, the DPL is also aiming at strengthening the implementation capacity of the government to support its strategies and policies. Finally, the program has to remain flexible in order to respond to emerging needs and requests from the Government. For example, in the context of the preparation of DPL II the Government has requested assistance in higher education, life-long learning, improving the investment climate, and evaluating the impact of policy changes, issues that were not originally part of the program. Making use of the flexibility of the DPL instrument some of these areas may be included in the next phase of the program. For example the Program Document sets the
stage to include new actions to enhance labor productivity by adopting a broader view of job creation, along the lines of the “MILES” approach. Finally, due to Bulgaria’s continued fiscal surplus and to the enhancements of the Bank lending instruments recently approved by the Bank Board, the Loan supporting the second phase of the program includes the deferred drawdown option (DDO) at the Government’s request, further adding flexibility to the operation.

II. COUNTRY CONTEXT

RECENT ECONOMIC DEVELOPMENTS IN BULGARIA

6. In January 2007 Bulgaria became a European Union member, nine years after the Accession Partnership was decided by the European Council. Over these nine years, a broad reform agenda was implemented, macroeconomic stability was maintained and the economy grew at a robust rate of 5.1 percent per year on average. Most of the non-infrastructure enterprises and banks were privatized or liquidated, trade and prices were liberalized, energy reforms made important progress, institutional reforms were implemented in a number of areas and have improved the effectiveness of public institutions, and the first steps were taken in regulatory reform to improve the investment climate. Fiscal consolidation reduced the overall fiscal deficit from 15.2 percent of GDP in 1996 to a balanced budget in 2003 and increasing fiscal surpluses since then. Prudent fiscal policy has supported a substantial reduction in total public debt — from over 100 percent of GDP in 1997 to below 25 percent in 2006. The markets have responded well to Bulgaria’s sustained, solid track record, and its credit risk rating was upgraded to investment grade in mid-2004. Since then, FDI flows have exceeded 15 percent of GDP per year, contributing to improved productive capacity of Bulgaria’s economy. Sovereign bond spreads declined significantly and borrowing costs for domestic investors were reduced substantially thus boosting investment and credit growth.

7. As a result of sound macroeconomic policies and deep structural reforms, average growth exceeded 6 percent per year in 2004-07. Until 2003 economic growth was driven by strong private consumption but the importance of investment has increased substantially since then with investment accounting for 32 percent of GDP in 2006 compared to 23 percent in 2004. Manufacturing, finance, and trade contributed most to GDP growth with the contribution of manufacturing increasing substantially over the last two years. These sectors were the recipients of the largest amounts of FDI inflows. Strong economic growth was associated with substantial improvements in labor market performance. Number of employed increased by more than 300,000 between 2004 and 2007 with most of the new jobs generated in the private sector mainly in construction and service sectors, while employment in public sector further declined. The unemployment rate declined from 12 percent in 2004 to 6.1 percent of the labor force in Q4-2007. However, Bulgaria’s participation rate remains one of the lowest among the EU10 countries, while shortages of labor are increasingly visible in a number of dynamic sectors.

8. Risks to growth prospects are mounting in view of the increasing volatility in the external environment and the projected slowdown in economic expansion in the eurozone, although the investment boom may pay off in terms of higher productivity growth. Real GDP growth remained little changed in 2007 at about 6.2 percent relative to 2006.

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3 This approach maintains that a multi-sector strategy is necessary in order to increase productivity and foster employment growth, involving at least five areas: (i) macroeconomic stability; (ii) improving the investment climate; (iii) labor market reforms; (iv) improving education and skills; and (v) reforming the social safety net. The new policies incorporated in DPL II and III are related to improving the investment climate and fostering skills acquisition through higher rate of innovation and adoption of new technologies.
despite a slowdown to 4.9 percent year-on-year in the third quarter of 2007 that reflected a sharp decline in agricultural production and decelerated growth of investment. Agricultural production declined by close to 44 percent in the third quarter of 2007 reflecting adverse weather conditions which affected severely major crops in the country. Outside of agriculture, however, output expansion remained very strong throughout 2007. Increased investment in agriculture and expected inflows of EU funds for agriculture producers would help reverse this downward trend in agriculture this year. EU funds and planned large investment projects by the Government are also expected to keep high investment activity in the near term. Moreover, the recent upgrade of capital stock and accelerated acquisition of machines and equipment is expected to translate into increased growth in productivity, as also observed in other new EU member states.

9. **Inflation has been on the rise in line with global developments and increasing demand pressures.** Inflation averaged 6.5 percent between 2004 and 2006 and rose further to 7.6 percent on average in 2007 because of stronger domestic demand, higher prices for food and imported oil, increase in administrative prices, and harmonization of excises with EU levels. Inflation has continued to rise in early 2008, with year-on-year inflation at 13.2 percent in March 2008, up from 11.6 percent in December 2007. Demand pressures have reflected strong increases in real wages in the private sector growing at double-digits rates in 2007 following a long period of moderate growth. The recent acceleration of wage growth was underpinned by a tighter labor market with shortages of labor more pronounced in construction, tourism, and manufacturing. Higher than expected inflation has put on hold plans to join the Exchange Rate Mechanism II (ERM II) in preparation for subsequent entry to the Euro zone.

<table>
<thead>
<tr>
<th>Table 1 Selected Economic Indicators</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>GNI per capita (Atlas method, US$)</td>
<td>1,600</td>
<td>1,720</td>
<td>1,870</td>
<td>2,230</td>
<td>2,870</td>
<td>3,510</td>
<td>3,990</td>
<td>4,600</td>
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<tr>
<td>Unemployment rate, average $^2$ (LFS)</td>
<td>16.3</td>
<td>19.4</td>
<td>17.6</td>
<td>13.7</td>
<td>12.0</td>
<td>10.1</td>
<td>9.0</td>
<td>6.9</td>
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<tr>
<td>Real GDP Growth (% change)</td>
<td>5.4</td>
<td>4.1</td>
<td>4.5</td>
<td>5.0</td>
<td>6.6</td>
<td>6.2</td>
<td>6.3</td>
<td>6.2</td>
</tr>
<tr>
<td>CPI $^2$ (av., % change)</td>
<td>10.3</td>
<td>7.4</td>
<td>5.8</td>
<td>2.3</td>
<td>6.1</td>
<td>6.0</td>
<td>7.4</td>
<td>7.6</td>
</tr>
<tr>
<td>Total revenues and grants $^3$ (% of GDP)</td>
<td>38.5</td>
<td>38.6</td>
<td>38.3</td>
<td>39.9</td>
<td>40.3</td>
<td>41.1</td>
<td>40.0</td>
<td>41.3</td>
</tr>
<tr>
<td>Total expenditure and net lending (% of GDP) $^3$</td>
<td>38.5</td>
<td>38.4</td>
<td>38.9</td>
<td>39.9</td>
<td>38.6</td>
<td>38.0</td>
<td>36.4</td>
<td>37.5</td>
</tr>
<tr>
<td>Overall Fiscal Balance $^3$ (% of GDP)</td>
<td>-0.6</td>
<td>0.2</td>
<td>-0.6</td>
<td>0.0</td>
<td>1.7</td>
<td>3.1</td>
<td>3.5</td>
<td>3.5</td>
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<tr>
<td>Current Account Balance</td>
<td>-5.6</td>
<td>-5.6</td>
<td>-2.4</td>
<td>-5.5</td>
<td>-6.6</td>
<td>-12.4</td>
<td>-17.8</td>
<td>-21.5</td>
</tr>
<tr>
<td>FDI inflows (% of GDP)</td>
<td>8.1</td>
<td>5.9</td>
<td>5.9</td>
<td>10.5</td>
<td>13.8</td>
<td>14.4</td>
<td>23.6</td>
<td>21.1</td>
</tr>
<tr>
<td>Gross External Debt (% of GDP)</td>
<td>86.9</td>
<td>78.6</td>
<td>65.0</td>
<td>60.1</td>
<td>63.8</td>
<td>69.8</td>
<td>80.7</td>
<td>97.3</td>
</tr>
<tr>
<td>Claims on non-government sector (% of GDP)</td>
<td>12.0</td>
<td>15.0</td>
<td>19.7</td>
<td>27.4</td>
<td>30.3</td>
<td>43.6</td>
<td>47.1</td>
<td>66.8</td>
</tr>
<tr>
<td>Non-performing loans (% of total gross loans)</td>
<td>3.4</td>
<td>2.7</td>
<td>1.8</td>
<td>2.5</td>
<td>2.0</td>
<td>1.7</td>
<td>1.6</td>
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</tr>
</tbody>
</table>


$^1$ Data for 2000-2003 and 2007 refer to June while the rest are annual averages. Methodological changes have been introduced to data from 2003 onwards.

$^2$ Harmonized Index of Consumer Prices.


10. **External imbalances are increasing with widening current account deficits and rising external debt.** The external current account deficit is estimated at 21.5 percent of GDP in 2007 (preliminary data), more than triple the level in 2004. Growing foreign savings have financed a boom in private investment over the last several years following a long period of underinvestment. Despite reasonably strong export growth, imports continued to finance growing investment needs, while imports of consumer goods saw only a modest increase in line

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$^5$ Harmonized Index of Consumer Prices, NSI, Eurostat
with moderate consumption growth. High oil prices added further to the pressure on the current account deficit as Bulgaria relies almost exclusively on imported oil and gas. In contrast to the Baltic countries, strong FDI inflows to Bulgaria have more than fully covered the external current account deficits, while the reliance on portfolio investment and short-term flows has been limited. The stock of FDI is expected to exceed 80 percent of GDP in 2007, one of the highest shares compared to the other NMS. FDI in manufacturing doubled in absolute terms between 2004 and 2006 and now represents 25 percent of the total FDI stock, supporting rapid growth of manufacturing output. FDI doubled also in financial intermediation and trade, and surged to 16 percent of total stock in real estate and business services. To finance larger stock of domestic and foreign investments, private sector external indebtedness has grown rapidly and between 2004 and 2006 increased by 32 percentage points of GDP. Inter-company debt to FDI parent companies accounted for more than half of this increase, with the other half attributable mainly to corporate borrowing from abroad taking advantage of favorable interest differentials. Short-term corporate borrowing more than doubled during this period, raising concerns for rollover risk. Banking sector contribution to the rising external debt remained moderate. A substantial increase in private sector indebtedness led to an increase in the gross external debt to GDP ratio to 80.7 percent of GDP in 2006 despite substantial reduction in public debt. External public debt was squeezed to half of its 2004 level as a result of several active debt management operations—retirement of all Brady bonds, early repayments of all outstanding debt to the IMF and a portion of debt to the IBRD.

![Structure of FDI Stock, 2006](image)

11. **Significant increase in gross official reserves provided a cushion to heightened external vulnerabilities.** Gross official reserves, at 41 percent of GDP in 2007, almost doubled in absolute terms compared to 2004 and provide coverage of close to 6 months of imports of goods and services. In addition, indicators of reserve coverage of short term debt and foreign exchange deposits of population remained relatively stable. Despite rapid increase in gross external debt, its ratio to exports of goods and services increased to only 127 percent in 2006 from 112 percent in 2004 owing to steadily growing exports.

12. **In 2007, the external current account reached 21.5 percent of projected annual GDP, an increase of 3.7 percentage points year-on-year, owing mainly to the widening**
trade gap. While exports growth rebounded to double digits levels by the third quarter of 2007, the demand for investment goods and raw materials has remained strong supporting much faster growth of imports. Services balance improved slightly but could not offset the deterioration of current transfers and income balances. The former was affected negatively by the payment of Bulgaria’s contribution to the EU budget while the latter reflects higher dividend and interest payments to FDI parent companies. Net FDI flows increased to 21 percent of GDP in 2007 financing almost fully the current account gap and reflecting improved investors’ sentiment and expectations of high returns on investment. Nearly 30 percent of the FDI inflows in 2007 are in real estate pushing up prices of real estate further. In addition, increasing inter-company borrowing contributed to the growth in external debt to 97.3 percent of GDP in end-2007. The substantial increase in inter-company debt relative to 2006 values reflects the one-off effect of borrowing for acquisition of a large telecommunication company. Short-term debt of private sector continued to grow but remained more than fully covered by international reserves.

13. Indicators of external competitiveness of Bulgaria do not point to a significant loss of external competitiveness6 suggesting that the currency board arrangement could remain viable until the eventual Euro adoption. According to IMF estimates the equilibrium current account deficit is around 8 percent of GDP (or about 10 percent including EU capital grants)7, well below the actual current account level. This estimate, however, is subject to substantial margin of uncertainty in light of the major restructuring that the economy is going through. In addition, estimates of real exchange rates indicate that the actual real exchange rate has appreciated largely in line with the estimated equilibrium rate, and in line with experiences in Bulgaria’s peers. Both the Government and the Bulgarian National Bank are committed to maintaining the currency board until the eventual Euro adoption9.

14. Policy responses to the growing external vulnerabilities have been adequate. Sizable fiscal surpluses have been recorded since 2003 while the Government’s incomes policy has remained generally prudent. The fiscal surplus exceeded 3.5 percent of GDP in 2006 and remained almost unchanged in 2007. Public debt further declined to 20 percent of GDP in December 2007 compared to 40 percent at end-2004. Sustaining relatively high fiscal surplus in 2007 was aided by strong revenue over-performance as a result of booming economic activity and improved tax compliance. Buoyant revenue collection allowed for further cut in social contribution rates by 3 percentage points and spending the buffer of 10 percent6 but mostly for capital investments and co-financing of EU-financed projects. Nevertheless, most of the sizable revenue overperformance was saved and the fiscal surplus exceeded the budget target for 2007 of 2 percent. Income policy has been geared to ensure that wages in the public sector rise in line with productivity growth. At the same time, optimization of public administration has taken place and a further 12 percent downsizing is envisaged in 2008.

15. Credit to private sector continued to expand to finance increased investment and strong private consumption. Between 2004 and 2006 domestic credit increased by 11 percentage points of GDP in response to strong economic growth, increased competition among banks, and low borrowing costs for banks, especially foreign-owned. To contain credit growth, which was fuelling further the expansion of the current account gap, the Bulgarian National Bank (BNB) introduced administrative credit ceilings. These administrative measures did slow down credit growth in some banks but led to the rapid expansion of the non-bank financial sector,

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9 According to the budget law, spending units are allowed to spend up to 90 percent of their allocations until the fourth quarter of the year in case there is a need to consolidate fiscal accounts if external environment worsens.
which was initially less subject to strong regulation. In addition, some banks sold a portion of their loans abroad to comply with the credit ceilings. Thus, when the credit ceilings were removed as of January 1, 2007, most of the sold credits were transferred back increasing the credit growth to approximately 59 percent year-on-year by December 2007. Most of the growth was concentrated in the corporate sector, reflecting reclassification effects of credits transferred back from foreign banks to their local subsidiaries but also continuing strong investment activity mainly in trade, manufacturing and construction. Consumer loans growth was less pronounced which was reflected also in the slowdown of private consumption in 2007.

16. Despite rapid credit growth, banks which are mainly foreign owned remain well capitalized, liquid, and profitable; banking supervision and regulation is strong and prudent. Most of the banks in Bulgaria are subsidiaries or branches of large foreign banks with access to capital at comparatively low cost, while deposits of private sector have rapidly increased reflecting strong economic performance. In line with robust economic growth and steady increase in incomes, the share of non-performing loans remained below 2 percent of total loans while other prudential indicators do not signal for the time being worsening of banks' balance sheets. To respond to accelerated credit growth and weather banks from possible slowdown in economic activity and related worsening of balance sheets of corporations and banks, the BNB raised the minimum reserve requirements to 12 percent from 8 percent before September 1, 2007. This move, as well as worsening of global credit conditions has forced banks to raise the cost of lending with no immediate effect on credit growth as yet. Nevertheless, the banking supervision remains strong, regulation on loan provisioning is more stringent than in other EU countries, while supervision of non-bank financial institutions is improving.

MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

17. The medium term macroeconomic framework centered on the CBA is expected to maintain macroeconomic stability and high rates of growth in the first years of EU accession and prepare Bulgaria for monetary integration soon thereafter. The medium term outlook envisages a robust growth of 6 percent per annum, a gradual narrowing of the large external current account deficit, and persistently high debt to GDP ratios. Fiscal and income polices would remain prudent. Growth would be driven by a continuous rise in investment, strong domestic consumption and improved export performance in line with the increased competitiveness of Bulgarian goods on international markets. Consistent with the planned upgrades in the infrastructure sectors, investment is likely to grow at a high speed but slow down to 32 percent of GDP by 2010. Inflation is projected to decline to about 4 percent in 2009-2010. The projections for the inflation decline reflect the following assumptions: (i) the adverse effects of bad weather conditions on Bulgaria’s agriculture output in 2007 would subside and would not affect negatively food prices, (ii) the excise harmonization with EU levels would be more or less completed as most of the excise hikes have been front-loaded already; (iv) moderate wage growth. External current account deficit is projected to remain high reflecting catch-up effects but would gradually decline from 20 percent in 2007 to 13 percent in 2010 as a result of moderate FDI inflows. FDI inflows are expected to continue to be the primary source of balance of payments financing although declining to about 5 percent of GDP by 2010, while gross external debt is projected to remain at close to 100 percent of GDP in the medium term. A deterioration of the external environment and increased prospects of a European growth slowdown may affect adversely the projections shown in Table 2.
<table>
<thead>
<tr>
<th>Table 2 Macroeconomic Framework</th>
<th>Actual</th>
<th>Estimate</th>
<th>Projected</th>
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<tr>
<td><strong>Indicator</strong></td>
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<td>2006</td>
<td>2007</td>
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<td>National accounts and prices</td>
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<tr>
<td>Real GDP growth (%)</td>
<td>6.2</td>
<td>6.1</td>
<td>6.4</td>
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<tr>
<td>CPI (%)</td>
<td>6.0</td>
<td>7.4</td>
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<td>GDP deflator (%)</td>
<td>3.8</td>
<td>8.1</td>
<td>8.0</td>
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<td>Real effective exchange rate (CPI based)</td>
<td>0.6</td>
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<td>Investment (% of GDP)</td>
<td>28.0</td>
<td>31.9</td>
<td>34.8</td>
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<td>Public fixed investment (% of GDP)</td>
<td>4.8</td>
<td>4.7</td>
<td>5.9</td>
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<tr>
<td>Private fixed investment (% of GDP)</td>
<td>23.2</td>
<td>27.2</td>
<td>28.9</td>
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<td><strong>Monetary indicators</strong></td>
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<tr>
<td>Broad money</td>
<td>23.9</td>
<td>26.9</td>
<td>28.5</td>
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<tr>
<td>Domestic credit</td>
<td>32.4</td>
<td>24.6</td>
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<td><strong>Fiscal Policy</strong></td>
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<tr>
<td>Revenue (% of GDP)</td>
<td>39.8</td>
<td>39.0</td>
<td>40.5</td>
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<td>Expenditure (% of GDP)</td>
<td>37.5</td>
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<td>37.0</td>
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<td>Overall fiscal balance</td>
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<td>Public debt / GDP (%)</td>
<td>31.3</td>
<td>24.7</td>
<td>21.3</td>
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<td><strong>Balance of payments</strong></td>
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<td>Foreign direct investment, net (% of GDP)</td>
<td>17.7</td>
<td>16.8</td>
<td>14.6</td>
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<td>Merchandise Terms of Trade (percent change)</td>
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<td>3.5</td>
<td>-3.2</td>
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<td>Export volume (percent change)</td>
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<td>13.8</td>
<td>8.5</td>
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<tr>
<td>Import volume (percent change)</td>
<td>15.3</td>
<td>15.0</td>
<td>13.5</td>
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<tr>
<td><strong>Debt Management</strong></td>
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<tr>
<td>External debt (% of GDP)</td>
<td>69.0</td>
<td>78.4</td>
<td>87.6</td>
</tr>
<tr>
<td>Short term external debt / reserves (%)</td>
<td>48.3</td>
<td>58.8</td>
<td>71.4</td>
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<tr>
<td>Gross international reserves (in months of G&amp;S)</td>
<td>4.3</td>
<td>4.4</td>
<td>5.1</td>
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</table>

18. The current course of fiscal policy is basically appropriate to ensure macroeconomic stability, growth and poverty reduction in the medium term. The Government medium-term budgetary strategy laid out in the Convergence Programme of Bulgaria\(^\text{10}\) envisages a continuation of overall fiscal surpluses of 3 percent per year in 2008-2010 to counteract the growing external imbalances and rising demand-side inflationary pressures. Taking into account the already high level of public spending and the need to contain domestic demand the Government decided to cap the level of public expenditures as a share of GDP at 40 percent (excluding the contribution to the EU budget) and substitute existing expenditures with EU funds to the extent possible.

19. The main fiscal challenge in the medium term will be to improve the efficiency and efficacy of public spending, especially in health, education and social protection. Structural reforms in these sectors are expected to ensure that public sector resources are spent more effectively. To improve the efficiency of public administration and help reduce shortages of labor in private sector, the Government decided to decrease the number of public sector employees by 12 percent in 2008. In addition, the Government is introducing a 10 percent flat

\(^{10}\) Convergence Programme of Bulgaria, 2007-2010, November 2007.
personal income tax in line with the corporate income tax of 10 percent already in effect since 2007.

20. **Heightened medium-term risks of widening external imbalances and worsening of external environment with a possible negative effect on growth weigh heavily on the fiscal stance and advancement of productivity-enhancing structural reforms.** In the context of the domestic environment there are risks of loss of momentum in the implementation of structural reforms and weakening of macroeconomic discipline. Pressures to raise wages in the public sector are building up while restricting current spending in the context of sizable surpluses has proven to be a difficult political economy issue. Relaxation of fiscal policy would further increase domestic demand pressures and their impact on external imbalances and inflation. Vulnerabilities to external shocks are also increasing in light of the already large external imbalances and worsening global environment. The economy is vulnerable to external shocks, including further increases in oil prices and interest rate increases, and greater capital flow volatility or the falling short of FDI flows from the levels needed to finance the large external current account deficit. Furthermore, the gradual progress towards monetary integration raises additional macroeconomic challenges. Greater monetary integration has potential benefits, but it is not without risks given the large structural differences between Bulgaria and countries in the Euro zone. The preparation for, and eventual adoption of, the Euro will increase the need for deeper economic restructuring, in addition to enhanced macro-financial discipline, to ensure adherence to the conditions for participation in the currency area. Provided that downside risks to the baseline scenario materialize, growth would accelerate above its potential, inflation would further increase, while external current account deficit and external debt would remain at unsustainable levels.

21. **Policies supported by the DPL series would contribute in the medium term to sustaining macroeconomic stability and accelerating convergence to EU income levels.** These policies focus on increasing labor force participation and employment especially among the long term unemployed, improving productivity through narrowing the skills gap of the labor force, and improving the efficiency of public spending in education, health, and social assistance systems. Improved mobility and skills of labor would provide incentives to firms and employees to reallocate resources to most productive use, which would support enhanced export competitiveness and growth. Increased labor force participation would dampen the effects of labor shortages on wages, while improved efficiency in social sector spending would strengthen the sustainability of fiscal accounts. In the long term, improved quality of education would also result in higher productivity levels.

22. **Policies supported by the DPL program are fully consistent with the Medium Term Expenditure Framework (MTEF), the Government's Convergence Program, and the National Reform Program.** As in the past, the MTEF allocates significant portion of public resources to the social sectors. For 2008, the planning spending for these sectors is close to 53 percent (including pensions) of overall government spending. The MTEF calls for spending on health as percentage of GDP to remain at between 4 and 4.5 percent of GDP until 2010. Table 3 shows the expected evolution of spending in health and education over the medium term. It is worth noting that in spite of a relatively constant percentage of GDP devoted to the social sectors, the strong GDP growth projected in the macroeconomic framework would result in significant increases in education and health budgets over the 2007-2009 period. This is exemplified in the planned budget increases for 2008—16 percent in health spending, 22 percent in education, and 13 percent in social protection in spite of almost constant percentage of GDP.

23. **Bulgaria's spending on the social sectors is consistent with its current level of development, but the increasing needs in light of the objective of convergence to EU**
standards has put additional pressure on improving the efficiency of spending. As the Bulgaria Convergence Program agreed with the EU states, “The main priority of the government is to maintain macroeconomic stability and high rates of economic growth in the medium term. The most important factors to accelerate economic growth will be the structural reforms, the improvement of the business climate and the increase in the efficiency of institutions.”

Table 3: Expenditures in Education and Health, MTEF 2005-2009

<table>
<thead>
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<th></th>
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</thead>
<tbody>
<tr>
<td><strong>EDUCATION</strong></td>
<td>1,814</td>
<td>1,907</td>
<td>2,134.6</td>
<td>2,607.7</td>
<td>2,586</td>
</tr>
<tr>
<td>Percent of GDP</td>
<td>4.3</td>
<td>4.0</td>
<td>3.9</td>
<td>4.2</td>
<td>4.3</td>
</tr>
<tr>
<td><strong>HEALTH (PLUS RESERVE)</strong></td>
<td>2,009</td>
<td>2,002</td>
<td>2,216.5</td>
<td>2,605.7</td>
<td>2,641</td>
</tr>
<tr>
<td>Percent of GDP</td>
<td>4.7</td>
<td>4.1</td>
<td>4.2</td>
<td>4.2</td>
<td>4.4</td>
</tr>
</tbody>
</table>


24. **The concerns about efficiency of institutions are pervasive in the social sectors.** A few examples illustrate these concerns:

25. **Example 1: Inefficiencies in the health sector.** Bulgaria shares the problem of excessive hospital infrastructure with many countries in Europe. Many countries are emphasizing outpatient care, day surgery procedures, and moving away from hospital care and extended stays in inpatient facilities. This has also been used as a tool to control spending as inpatient care tends to be more expensive. Bulgaria has reduced the number of beds but evidence suggests that more could be done. Pilot studies in the Gabrovo, Lovech, Stara Zagora, and Razgrad regions to evaluate the functioning of hospitals and assess the extent by which there could be excess capacity in the sector found that (i) there is excess capacity in all the regions analyzed; (ii) in some cases there is excessive utilization of hospitals due to the lack of alternative facilities that could address some of the more simple conditions at a lower price; (iii) some hospitals perform social functions, like taking care of terminal patients, and long term medical care; (iv) distortions in hospital practices are frequent, like discharging and re-admitting patients in order to be paid twice and code-creeping in order to match more expensive payment codes.11

26. **Example 2: Inefficiencies in the education sector.** While Bulgaria is experiencing a demographic transition, with the school-age population shrinking substantially, a generous education infrastructure remains since before the transition. As Figure 1 shows, student numbers declined by more than 25 percent in the period 1992 to 2005. Municipalities have been closing down schools in recent years in response to this decline, but there has not been a systematic plan to adapt to this demographic transition, leading to declining student-teacher ratios and growing per student costs. There are a large number of schools that operate with very low student-teacher ratios, e.g. about 31 percent of municipal schools operate with ratios below 11 —both in rural and urban areas. In addition, (i) the stock of non-teaching personnel reflects recruitment

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11 In the case of Stara Zagora for example, the pilot study estimated that the number of reported discharges was about 76 percent higher than the theoretical estimate based on population needs. In addition it estimated that the theoretical number of discharges could be handled with 910 beds instead of the current 1,973.

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practices that did not necessarily follow cost-effectiveness considerations—in Bulgaria's schools there are currently 43 non-teaching staff for every 100 teachers; and (ii) the financing mechanism in place until the end of 2006—where local authorities' freedom to adjust human and capital resources is limited and resource allocation to schools is determined exclusively at the central level—failed to create incentives for an efficient management of resources.

Figure 1: Teacher and student numbers and real expenditure per student
Student and teacher numbers, index, 1992-2005
Real expenditure per student, index, 1997-2006

Source: National Statistical Institute and Ministry of Finance

27. **Example 3: Inefficiencies in the labor market.** Bulgaria is facing a severe demographic decline which risks hampering long-term growth because of reductions in the working age population. According to UN population statistics, Bulgaria's population is expected to shrink by 18 percent (about 1½ million people) between 2000 and 2025. Bulgaria's expected share of population over 65 will be 21 percent in 2025, the fourth-highest in the region (up from 16 percent in 2000). Moreover, its working age population is projected to shrink by 9 percent, or 750,000 people, in the next 15 years (by 2020). This creates additional pressures to increase labor force participation rates. For example, were Bulgaria to achieve the EU 25 average labor force participation rate, the decline would be limited to just 100,000. Bulgaria has seen impressive falls in unemployment and increases in employment relative to the EU15 in recent years, but its employment and labor force participation rates remain low overall. While its labor market outcomes among those aged 25-54 is on par with that of the EU 15 (e.g. a labor force participation of 82.3 vs. 84.6 percent in 2006), Bulgaria continues to face high unemployment and low employment as well as labor force participation among younger and older workers as well as those with low educational attainment. As for younger workers, the share of the 15-24 year old Bulgarians who are in part time employment is the lowest in the EU. Moreover, the share of

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12 The data quoted here on "non-teaching staff" are data from the Annual Census of School from the National Statistical Institute. However, school visits across the country suggest that these numbers do not always include all the non-teaching staff which is associated with the schools. Often, school principals who fill out the surveys have excluded security staff or cafeteria personnel if these staff members are paid by the municipality and/or outsourced to a private firm. In some instances, schools visited by the World Bank team in the outskirts of Sofia had 4 security guards, guarding tiny school buildings on a 24-hour basis. In one instance, in the Village of Marchevo the expenditure on the security guards exceeded the expenditures on teachers' wages.


14 Ibid.
long-term unemployment in total unemployment, at above 55 percent, remains above the EU25 average. Stemming the demographic decline and reaching the Lisbon targets will, therefore, require paying attention to activating those unemployed and inactive who are harder to place.

Figure 2: Projected Change in Population between 2000 and 2025


Figure 3: Share of long-term unemployment in total unemployment, 2006

Source: Eurostat, World Bank (2007); Long-term unemployment = unemployment lasting more than 12 months

28. The focus of the Government's reform program is therefore on restructuring institutions to utilize existing resources more efficiently, reinvesting the savings in the same sectors. The next section explains the Government strategy in each sector, medium term objectives, and broad policy directions.
III. THE GOVERNMENT'S PROGRAM

29. The policies implemented by the coalition government that took office in late 2005 were initially dominated by the objective of securing a timely and orderly accession to the European Union. Post-accession policies on the other hand are organized around the overarching goal of converging in both outcomes and standards with the rest of the Union. The Government is also interested in designing policies that can make use of European structural funds. The policies under implementation are summarized in various strategic documents produced in line with EU requirements (summarized in Box 1), as well as sector strategies — in health, education, and labor and social protection — prepared to reach consensus in policies among the coalition members.

Box 1: Recent Strategic and Investment Planning Documents

1. **The National Reform Program (2007-2009) (NRP)** is a major strategic document of the government of Bulgaria. Its objective is to systematize the efforts of state administration, the non-governmental sector, and the social partners to implement reforms to achieve sustainable economic growth and increase the employment in the country. It was developed based on the European Council guidelines for Growth and Jobs aimed at achieving the objectives of the re-launched Lisbon strategy.

2. **The Convergence Program of the Republic of Bulgaria (2006-2009)** is elaborated in compliance with the requirements of the Stability and Growth Pact of the EU. Its elaboration is related to the fulfillment of the Economic and Monetary Union (EMU) membership criteria, and its main goal is the achievement of convergence of the economic indicators of the country to those of the most advanced Member States. The Convergence Program is updated annually. It contains information concerning the previous and the current year, as well as forecasts for at least the following three years. When and if the EURO is adopted by the member state, the Convergence Program becomes a Stability Program. It briefly describes the government’s reform plans in the social sectors.

3. **The Bulgarian National Development Plan (2007-2013) (NDP)** is a national strategic document presenting the long-term public investment program of the country, consisting of investments in both physical and human capital. The role of the NDP is to structure and present the strategic choices made by the national investment policy in order to ensure adequate coordination, justification and provision of financing of the interventions, co-financed by the EU resources.

4. **The National Strategic Reference Framework (2007-2013) (NSRF)** is the strategic document for the absorption of the EU Structural funds that was formally adopted by the European Commission in June 2007. It is elaborated on the basis of the NDP 2007-2013 and consists of the strategic platform for justification and coordination of the EU Structural funds’ financial assistance.

5. **The Operational Programs 2007-2013 (OPs)** express in concrete form the NSRF strategy in their relevant thematic areas at operational level.

The following national strategic documents are not required by the EU:

1. **The Pact on Economic and Social Development (2007-2009)** is a tripartite agreement reached in September 2006 between the Government of Bulgaria, the two major trade union confederations, and six nationally representative employer organizations. It provides a framework for economic and social development that is independent of the political cycle and the particular government in office. The document identifies the main challenges for Bulgaria’s social and economic development, while outlining the country’s future policy and priorities until 2009. The pact covers measures in the following key policy areas:
   - improvement of economic competitiveness;
   - implementation of fiscal policy conducive to economic growth, including amendments to tax and social security legislation;
   - active labor market policies and development of human resources, including:
     - creating at least 240,000 new jobs, thereby reducing the unemployment rate to less than 9%
     - preparing a national strategy on lifelong learning and increasing the proportion of people involved in such learning to 7%-8% of the economically active population
     - modernizing the education system;
   - modernization and streamlining of public administration, including further development of e-government, public-private partnerships, decreasing regulatory regimes;
   - increase of incomes and living standards of citizens based on a policy agreed by the tripartite group, corresponding to the country’s economic potential and aimed at reaching EU25 levels. This would be combined with the promotion of a sustainable policy on social security and social inclusion to increase the quality of life and reduce poverty levels; and

2. **The National Employment Strategy (2004-2010)** was adopted by the Bulgarian government in November 2003. The strategy was drawn up by a working group of representatives of the government and social partners, and seeks to deal with labor market problems such as low employment, high unemployment and negative demographic trends. The strategy is regarded as consistent with the EU’s European employment strategy (EES). An update of this strategy, following EU accession and the adoption of other related strategies and investment plans, was also adopted for the period 2008 - 2015.
30. The main objectives and policies in the health sector as highlighted in the Government's strategy are:

(a) Delivering high-quality and guaranteed healthcare services, by improving the accreditation system for healthcare establishments and increasing access to healthcare services through the reduction of financial and geographic inequities;

(b) Emphasizing the role of primary outpatient care, by refining the payment mechanisms and clearly defining the division of the responsibilities between the primary and the outpatient specialized medical services;

(c) Optimizing the network of the health care providers, by improving the links between outpatient and inpatient care, devising a masterplan and implementation strategy for achieving a more efficient hospital network; strengthening hospital management, and revising the prospect payment system for hospitals;

(d) Implementing a transparent and fair pharmaceutical policy, by increasing the awareness of patients, controlling prices and rationalizing the drug prescription practices and drug therapies used by healthcare professionals;

(e) Securing the financial stability and sustainability of the system in the long-term, by promoting the rational use of pharmaceutical products, creating an efficient and effective drug reimbursement policy, refining the models of primary and specialized outpatient healthcare and the restructuring of inpatient care, improving compliance for health insurance contributions, improving the negotiation process for the National Framework Contract, increasing the monitoring and enforcement capacity of the NHIF, improving the prospective payment system, developing a voluntary health insurance, and introducing regulated co-payments.

DPL support is focused on (c), (d), and (e).

31. The Government's strategy in primary and secondary education approved by Parliament in June 2006 states that the main challenges in primary and secondary education systems are the decrease in the quality and relevance of skills taught and a decline in participation rates, particularly in upper secondary. Together with an ineffective use of existing resources these problems will affect adversely the competitiveness of Bulgarian school children in the EU labor market. In order to reverse these negative trends, the Government appreciates that it needs to increase access to education for all children and strengthen the quality of the education process. To achieve these two goals, the program has identified six broad objectives:

(a) Orienting school education towards the stimulation of thinking and independence, towards the formation of practical skills and towards personality building;

(b) Establishing an efficient internal assessment system through the wide-scale use of tests and introduction of a system for national standardized external assessment;

(c) Decreasing the number of drop-outs and increase enrollment rates for children in the compulsory schooling age;

(d) Strengthen the authority and improving the social status of the teacher;

(e) Decentralizing the school network through the gradual introduction of delegated budgets for all schools and providing more flexibility to municipalities to appoint school directors; and

32. As laid out in the National Employment Strategy 2004-2010 — is now extended to 2015— the Government is going to implement measures to increase labor force participation, improve skills, and remove barriers to inter-sectoral mobility in labor legislation. The recent National Reform Program 2007-2009 also reflects those challenges prominently. In a context of rapidly decreasing unemployment — in Q3 of 2007 registered unemployment fell to 6.6 percent — the strategy of the Government centers in increasing the employment and labor force participation rates and reducing distortions to labor mobility. The reforms through which the government wants to address the activation and skills agenda are:

(a) Implementation of policies to improve the quality of human capital over the medium term, including the reduction in the number of school drop-outs, integration of early school leavers into the educational system, the development of a modern system for standardized external evaluation in secondary education, the reform of the system of vocational education and training in compliance with labor market needs, the development of lifelong learning and the improvement in the quality and efficiency of higher education;

(b) Implementation of policies to activate labor supply in the short term, in particular for those hardest to activate in light of the rapidly falling unemployment, through consolidating and better targeting the National Program “From Social Assistance to Employment”, increasing the role of the private sector in the provision of ALMPs and in cost sharing, as well as increasing the provision of long-term sustainable jobs in the social services sector. The NRP also highlights the need to improve the employment opportunities for specific categories like youth, older workers, female workers, persons with permanent disabilities and Roma.

(c) Implementation of policies to reduce the cost of labor, the transaction costs associated with hiring workers and additional barriers to labor mobility.

DPL support is focused on (b) and (c).

33. In June of 2007 the European Commission proposed the establishment of the common principle of “flexicurity” in the EU, combining flexibility and security principles. EC and Member States have agreed on the following components of flexicurity policies: “(i) Flexible and reliable contractual arrangements (from the perspective of the employer and the employee, of “insiders” and "outsiders") through modern labor laws, collective agreements and work organization; (ii) Comprehensive lifelong learning (LLL) strategies to ensure the continuous adaptability and employability of workers, particularly the most vulnerable; (iii) Effective active labor market policies (ALMP) that help people cope with rapid change, reduce unemployment spells and ease transitions to new jobs; (iv) Modern social security systems that provide adequate income support, encourage employment and facilitate labor market mobility. This includes broad coverage of social protection provisions (unemployment benefits, pensions and healthcare) that help people combine work with private and family responsibilities such as childcare”.

16 Republic of Bulgaria, National Reform Programme 2007-2009, Summary of Challenges, Policies and Governance. Annex 6 summarizes the areas and policies related to labor and social protection in the National Reform Program and highlights the policies supported by the DPL program.

17 Communication for the Commission to the Council, the European parliament, the European Economic and Social Committee and the Committee of the Regions, Towards Common Principles of Flexicurity: More and Better Jobs through Flexibility and Security, June 2007.
IV. BANK SUPPORT TO THE GOVERNMENT'S STRATEGY

LINK TO CPS

34. The DPL series is consistent with the three priority areas laid out in the CPS:

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

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

c. Poverty reduction and social inclusion. Even though social inclusion and poverty reduction are not explicit themes of the DPL, the policies supported by the program are well placed to have a positive impact on the poor. For example the policy measures targeting the labor market inclusion of people with disabilities are expected to have a distinct positive impact on incomes. The same applies to the increased focus on active labor market policies and emphasis on capturing the long term unemployed and other vulnerable groups, which should help address skill gaps and enhance employment prospects for individuals in low quality subsidized jobs. The actions supported in the health sector are expected to increase access to basic care, as the reimbursement policies for basic drugs that are now preventing some groups from obtaining them at affordable prices will be thoroughly revised. The restructuring of hospital networks envisioned for the medium term should redraft the current mapping of health care facilities and promote access by (i) shifting the focus from inpatient to outpatient care, and (ii) using the resources saved from the hospital restructuring to improve quality in lagging areas. The DPL is also increasing awareness of the Bulgarian Government about the impact of policies on vulnerable groups. It is a success of the policy dialogue under the DPL program to have supported a "mitigating fund" so that municipalities consolidating schools could provide additional services to at-risk groups, something that the Government had not originally planned. The same applies to the evaluation of the impact of changes in social welfare policies, which is included in the policy matrix. The DPL would be complemented by the Social Inclusion Project (FY08) to address the needs of the most vulnerable groups.
COLLABORATION WITH THE IMF AND OTHER DONORS

35. The IMF has completed the fourth and final review of the Stand-By Arrangement (SBA) in March 2007, and an Article IV consultation in October 2007. A precautionary 25-months SBA with access of SDR100 million was approved by the IMF Board on August 6, 2004. The SBA-supported program sought to reduce Bulgaria’s increased external vulnerability and to achieve sustainable high growth through: (i) continued tight fiscal policy and measures to reduce bank liquidity in order to reduce excess demand in the short run; and (ii) structural reforms to boost output and export capacity and export capacity in the medium-term. While recognizing the mitigating factors, including the prudent fiscal and income policies in support of the currency board, Article IV discussions focused on mounting external vulnerabilities as a result of Bulgaria’s catching-up process associated with large capital inflows and current account deficits. Since Bulgaria joined the EU, its participation in the EU’s Stability and Growth Pact (SGP), with related multilateral surveillance, is expected to help sustain Bulgaria’s prudent macroeconomic policies.

36. In addition to the IMF, the World Bank DPL team has been coordinating closely with the European Commission on Bulgaria’s the macro situation and the reform agendas in education, health and social protection and labor, through DG Economic and Financial Affairs (DG ECFIN) and DG Employment, Social Affairs and Equal Opportunities (DG EMPL). The DPL program is fully consistent with Bulgaria’s commitments to the European Commission in

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DPL support to improving Governance in Bulgaria

There is general agreement that governance and transparency have improved in Bulgaria during the last few years. According to the CPS, “There has been a positive trend as far as administrative corruption is concerned, although recent surveys show a slight deterioration between 2004-05.” Transparency International’s 2007 corruption perception index ranks Bulgaria in 64th place among 179 countries, ahead of other EU member states like Romania. The EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS) shows a decline in corruption as a problem of doing business in Bulgaria from 2002-05. As main areas for unofficial payments by firms, BEEPS shows obtaining government contracts, obtaining business licenses and permits, dealing with customs, and dealing with the courts.

Bulgaria joined the European Union on 1 January 2007. To address a number of areas where further work will be necessary, the European Union adopted a package of accompanying measures, including a special mechanism to help Bulgaria to continue the reforms of the judiciary and the fight against corruption. A progress report prepared in June 2007 stated that “The Bulgarian Government is committed to judicial reform and cleansing the system of corruption and organized crime. In all areas, the Bulgarian authorities demonstrate good will and determination. They have prepared the necessary draft laws, action plans and programs.” Bulgaria has stepped up efforts at the highest levels in the fight against corruption and organized crime. While recognizing these efforts, much remains to be done. Progress in the short time since the Cooperation and Verification Mechanism was set up is still insufficient. Progress has been made in all six benchmarks in this area (Independence and accountability of the judicial system, Reform of the judicial system, Reform and transparency of the judiciary, Fight high-level corruption, Fight corruption within local government, and Fight organized crime) but the Commission has assessed the progress in benchmarks 2 and 6 as insufficient (the latest report, available at the beginning of February, will contain updated information on achieving the benchmarks).

Even though the DPL program does not address governance and corruption explicitly, many of the policy actions agreed with the Government will improve governance and increase transparency in the social sectors. Specifically (i) the unification of payments to hospitals will increase the transparency in financing of health care as it will prevent hospitals from double billing for a given procedure; (ii) the changes in pharmaceutical procurement and reimbursement policies will increase the transparency in the decision making process for approval of new drugs as well as pricing and reimbursement policies; it will also promote a better use of resources by the NHIF; (iii) the introduction of changes in the financing of school with a unified standard will improve governance in the education sector as it will become clear how much each school should receive according to the number of students it has; (iv) finally the introduction of testing and quality assessment instruments should reduce the practice of private tutoring by public school teachers and improve transparency in admission to universities (an outcome at the end of the program rather than a DPL 1 outcome).

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18 The main objective of the Stability and Growth Pact (SGP) is to enforce discipline in the Euro-zone as a means to support price stability and sustainable growth. Budgetary discipline is gauged with respect to two criteria: a general government deficit-to-GDP ratio below three percent, and a debt-to-GDP ratio below 60 percent. Functioning of the SGP rests on two pillars: multilateral surveillance and corrective mechanisms. As regards surveillance, EU member states are required to prepare a Convergence Program and update it annually. The European Commission (EC) prepares an assessment of such convergence programs on the basis of which the Council of the EU issues an opinion. As regards corrective mechanisms, the Excessive Deficit Procedure identifies and forces corrections of excessive deficits, defined under non-exceptional circumstances as a deficit over three percent of GDP.
the framework of the National Reform Program, the National Strategic Reference Program and related Operational Programs and other strategic documents (see Annex 6). With Bulgaria having joined the EU, the Bank-EC relationship related to Bulgaria has evolved over the lifetime of the DPL program from a formal cooperation of donors to an informal dialogue about structural policy reforms and information-sharing.

RELATIONSHIP TO OTHER BANK OPERATIONS

37. The DPL series is complementary to existing and planned operations in the social sectors, and is intended to become the pillar around which future investments and policy dialogue in these sectors will be structured. The current health sector reform project includes a component on hospital restructuring in selected municipalities and technical assistance to develop the hospital master-plan. In addition one of its main activities is the strengthening of the management and administrative capacity of the NHIF, an essential condition to improve financial sustainability and efficiency in health care provision.

38. The proposed social inclusion project (FY08) will help to address the needs of Bulgaria's most vulnerable groups (national minorities—in particular Roma—people with disabilities, children in institutionalized care and others), in support of meeting the goals of the JIM signed with the EU. This operation will complement the DPL series in its objective to improve targeting of social welfare programs to reduce distortions in the labor market, develop and agenda to improve the delivery of social welfare services and promote access to quality education. An Institutional Development Fund Grant is supporting the capacity building in the Ministry of Education and Science through the strengthening of CKOKO, the planned Institute of Directors and the MES department in charge of developing programs aimed at absorbing European Social Funds. The proposed regional development project (FY09) would address regional imbalances by strengthening capacity to manage the programming and strategic allocation of EU structural funds, integrate them into public expenditure management and the intergovernmental fiscal system, and capacity building at regional and local levels for project preparation and absorption of EU funds. It is expected that the increased capacity of Bulgaria to absorb structural funds will feed into some of the policies supported by the DPL series, like the hospital restructuring.

LESSONS LEARNED

39. The preparation and implementation of the PAL series and the DPL I have provided some useful lessons that have been taken into account in the preparation of DPL II. Namely:

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

- Maintain a flexible approach to adjust to changing environment and demands. The DPL program defines triggers in broad terms in order to accommodate changes in government's requests for assistance in specific areas or to allow for time to define specific actions. For example the triggers in education call for introduction of per capita financing or delegated budgets but the specific details of the policies have been fine-tuned during preparation, through technical assistance.

- Accompany reform program with technical assistance. This has proven essential to the success of the program, as it has been used to both define details of policy changes and also to strengthen the capabilities of counterparts to implement policy reforms.
Sustainable reform takes time. The programmatic approach has also been extremely useful as the reforms in many areas have built upon changes in previous years. For example the change in pharmaceutical policy consisted of approving an overall framework during the first year and defining details during the second year through by-laws. The third year it will be consolidated through implementation of the policy changes and evaluation of its impact.

ANALYTICAL UNDERPINNINGS

40. The operation is well integrated with the World Bank’s analytic and advisory work. As part of the preparation activities for the DPL I the Bank team produced (in December 2005) policy notes in health, education, and social protection providing a comprehensive overview of the three sectors, highlighting the main problems, and identifying key areas where Bank intervention would be needed. In addition the DPL team prepared brief technical notes on hospital restructuring, the pharmaceutical sector, education financing, assessment of quality of education, labor market and unemployment, disability cost containment, social assistance and social services delivery. More recently the Bank completed two short reports on health sector policies, one regarding the National Framework Contract and another assessing the Clinical Care Pathways mechanism to set prices of hospital services.

41. In the education sector, and as part of the preparation of the DPL I, the World Bank education team has worked closely with the MES and MOF in compiling a school level expenditure data base, and investigating the drivers of costs in education. The ongoing dialogue on poverty and living standards through the poverty assessment programmatic work is provide information to set some baseline indicators and measuring the impact of various reforms supported by the DPL program. The programmatic work on poverty includes a household survey with education and health modules. The Bank team and the MLSP have agreed to conduct some joint work on various issues related to labor market policies and social assistance using the data gathered for the Multi-Topic Household Survey.

42. The DPL II is complemented by a PHRD grant supporting a number of pieces of analytical work to inform the DPL-supported reform agenda. Table 4 summarizes the main activities financed by the PHRD.
Table 4: PHRD activities supporting DPL 2 and objectives

<table>
<thead>
<tr>
<th>Objective of the Assignment</th>
<th>Assignment Details</th>
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<tbody>
<tr>
<td>Increase the sustainability of health insurance system by better defining the national health insurance scope of services, increasing the scope of privately provided supplementary health insurance and possibly by increasing targeted co-payments</td>
<td>Definition of basic benefit package and corresponding co-payment and financing policy, proposing options for developing a private supplementary health insurance system.</td>
</tr>
<tr>
<td>Increase the sustainability of health insurance by conducting a medical audit of inpatient cases determining the reasons for medically inappropriate admissions or lengths of stay</td>
<td>Analyze trends in hospital admissions and referral practices. Analysis of appropriateness of hospitalization and admission practices in various hospitals and recommend changes to discourage unnecessary hospitalizations.</td>
</tr>
<tr>
<td>Increase the sustainability of the health insurance system by improving the performance based provider payment system</td>
<td>Improving Clinical Care Pathways methodology, analyze the current payment process between providers and the NHIF and recommend ways to improve it.</td>
</tr>
<tr>
<td>Increase the sustainability of the health insurance system by hosting an roundtable conference in Sofia with a few key international and Bulgarian experts with key policy makers on the needs/options for the next stage of Bulgarian health reform</td>
<td>Organization of health policy roundtables on selected topics: private participation in the health insurance market, European experience in controlling hospital spending, absorption of EU funds for health.</td>
</tr>
<tr>
<td>Develop a framework to balance protection and activation incentives in social assistance, employment and social services</td>
<td>Analysis of the characteristics / profile of the current social assistance beneficiaries with a focus on the able-bodied long-term unemployed beneficiaries who will drop out of the system after receiving benefits for 12 months effective as of June 2008.</td>
</tr>
<tr>
<td>Fill the gap in the understanding of the current state of poverty and its future trends among various population sub-groups; build a foundation for impact evaluation of national programs supported by the World Bank in Bulgaria; suggest policies aimed at reducing social risks and vulnerability, and promotion of social inclusion and cohesion with a focus on reducing ethnic and regional disparities</td>
<td>Multi-topic household survey to define baselines in various indicators and collect information to be used in evaluating impact of selected policy changes.</td>
</tr>
<tr>
<td>Develop a framework to balance protection and activation incentives in social assistance, employment and social services</td>
<td>National Employment Strategy 2008 - 2015.</td>
</tr>
<tr>
<td>Facilitate and improve the process of school consolidation through the application of the unified standard and incentive mechanisms through peer exchange</td>
<td>Training and workshop to share experience and best practices in school consolidation and organizing.</td>
</tr>
<tr>
<td>Facilitate and improve the process of school consolidation through the application of the unified standard and incentive mechanisms through the design of a communication strategy</td>
<td>Technical assistance to design a communications strategy.</td>
</tr>
<tr>
<td>Improve the unified standard design and build capacity for data analysis and program evaluation</td>
<td>Work with Government counterparts to further develop the school-level database; evaluate impact of the implementation of the unified standard.</td>
</tr>
<tr>
<td>Facilitate access to higher education institutions</td>
<td>Recommend financial, institutional model for student loan system in Bulgaria based on best international practices.</td>
</tr>
<tr>
<td>Improve the quality of education by building capacity to analyze student performance data for the purposes of informing policy and teaching practices</td>
<td>Developing the capacity of Chiko and MES staff in evaluating student performance based on the international and national student assessments and developing a system to use that information for quality improvement programs.</td>
</tr>
<tr>
<td>Improve the relevance of education by supporting the establishment of a new National Center of ICT Resources in Education</td>
<td>Support the implementation of the new Education and ICT Strategy.</td>
</tr>
<tr>
<td>Improve the quality of education by developing an teacher in-service training and professional development strategy</td>
<td>Technical assistance and workshops to evaluate policy options and provide assistance in developing a comprehensive in-service teacher training and professional development strategy.</td>
</tr>
</tbody>
</table>

43. The recently completed PFPR2 — *Accelerating Bulgaria’s Convergence: the Challenge of Raising Productivity*—provides recommendations on various areas supported by the DPL program. The key messages of the report are summarized in Box 2.
**Box 2: Main recommendations from Bulgaria ABC report**

**Primary and Secondary Education**
- Continue implementing per student financing
- Establish a clear and credible timeline for reform implementation to facilitate school consolidation
- Monitor the impact of reforms, and introduce external evaluation of learning outcomes
- Relax central regulations on teaching hours and class sizes
- Implement school-based management and delegated budgets:
  - Reinvest savings in measures aimed at promoting quality of education and access

**Labor markets**
- Develop and encourage lifelong learning: expanding the network of adult training centers, VET schools and private providers
- Reassess labor legislation and regulations (e.g. re-write labor code)
- Shift the emphasis of active labor market programs (ALMP) and strengthen their monitoring and evaluation. A large-scale direct job creation program is discouraged for Bulgaria
- Revise the current eligibility and entitlement rules of the unemployment benefit:
- Revise the mechanism for establishment of the minimum wage and its level

**VET**
- Introduce per student financing to VET
- Delay the introduction of VET until the completion of compulsory education
- Develop curricula for the remaining vocational schools that balance vocational and general studies
- Establish a National Qualification Framework and Authority to Strengthen Life Long Learning

**Higher education**
- Base the funding on actual student enrolments
- Strengthen university governance and strengthen links with labor markets
- Institute the Matura as access examination
- Establish higher education tuition fees according to the proposals of the higher schools, create a student loan scheme, and review scholarship programs
- Introduce performance-based component to tertiary funding
- Strengthen accreditation and quality assurance of universities and their programs

**Regulatory framework**
- Minimize administrative burdens on business, including barriers to entry and exit of firms
- Improve the enforcement of regulations in product markets
- Encourage private partnership in R&D

44. **The World Bank has produced a report examining the consequences of the demographic changes in Europe and Central Asia, and its recommendations are consistent with the DPL supported policies.**¹⁹ The starting challenge is an expected decrease in Bulgaria's population by 18 percent between 2000 and 2025. Some specific recommendations consistent with the DPL program are: (i) improving labor force participation rates; (ii) continue investment in education to increase productivity of labor; (iii) enhance labor mobility through added flexibility in labor legislation; (iv) achieve a sustainable level of health spending, completing structural reforms in health provision, pharmaceuticals procurement, and devising a strategy for long term care of the elderly.

V. **THE PROPOSED SECOND SOCIAL SECTORS INSTITUTIONAL REFORM DEVELOPMENT POLICY LOAN (SIR DPL II)**

**OPERATION DESCRIPTION**

45. **The second phase of the DPL program continues to focus on the social sectors and supports actions to accelerate convergence to EU standards.** The accession to the European Union has changed the benchmark against which Bulgaria's performance is measured. The lag in many social indicators is now more evident than before and requires decisive action in those areas which will affect the productivity and employment prospects of the work force and

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the efficiency of public spending. At the request of the Government the second phase of the DPL program maintains its focus on the social sectors, and emphasizes actions to contribute to improving productivity and skills of the labor force as well as complementing the main areas of intervention of other multilateral agencies. As in the first phase of the DPL series, the second DPL is assisting the government in transforming the education and labor strategies, and the policies contained in the NRP and CP strategic documents into concrete action plans with measurable indicators of progress. The DPL program performs many functions: (i) it anchors the Bank's work in the social sectors, which includes various investment operations, AAA activities, and technical assistance; (ii) it provides a framework for implementation of the government's strategies and for targeting the work of other donors; (iii) it commits the highest levels of Government, and particularly the Ministry of Finance, to work together with the social sector ministries, an issue that cannot be underestimated when important reforms—like the consolidation of the financing reform in education that began in 2006/2007—are contemplated; and (iv) it provides a timeframe for reforms and outside monitoring to measure success and determine corrective actions. The design of the DPL program has also helped to shape some of the reforms under implementation. For example the Bank provided significant input into the design of health and education policies highlighted in the Convergence Program.

46. The flexibility of a programmatic approach is proving useful during preparation of DPL II. As post-accession creates additional demands on the Government and its programs it is evident that a programmatic, flexible approach is the right instrument to support policy changes in Bulgaria. The increasing pressure from trade unions and the realization that catching up to EU standards will require a multi-prong approach with emphasis on productivity growth—while providing special consideration to vulnerable groups—are but two examples of the need to maintain a flexible approach to make changes in the policy matrix as new needs materialize or previously agreed policies become unnecessary. Experience in new member states has shown that rapid changes in the Bank's work program were required in order to maintain relevance and add value to government's plans. The flexibility has been incorporated in the design of the program in the form of: (i) very few actions in the policy matrix, all of them triggers; (ii) broad definition of triggers in phase three in order to accommodate to changes in the client's demands during the first years of EU membership.

47. In light of Bulgaria's strong fiscal position the Government has decided to opt for a deferred drawdown option (DDO) for the second phase Loan of the program. Taking account of the recent enhancements for the deferred drawdown option for DPLs, the Government has decided to add the DDO feature to the second phase Loan. As Bulgaria is experiencing a sizeable fiscal surplus, there are no immediate liquidity needs; therefore, the flexibility of the DDO provides access to funds within the next three years as needed, subject to continued satisfactory implementation of the program and macro framework. The Government remains fully committed to advance the policy reform in education, health, and social affairs, including the reform actions included in DPL III, as envisaged in the CPS. Annex 9 provides a more detailed explanation of the choice of instrument.

POLICY AREAS

48. The DPL series continues to support some of the overarching objectives stated in the CPS. These are: (i) Increase employment and lay the foundations for long-term productivity growth by providing incentives for job creation and improving quality of education and; (ii)
Promote fiscal sustainability through efficiency gains in social sectors. All prior actions have been completed, and a full detail is provided in Annex 1. The prior actions for DPL II are:

1. Government Maintains a satisfactory macroeconomic policy framework
   - The Government has removed the automatic portability of the seniority bonus, transforming it into a bonus for relevant professional experience
2. The Government has structured active labor market programs as per the Employment Action Plans 2007 and 2008 to strengthen on the job qualification and professional training programs and service delivery linked to private sector skill needs
3. The Government has prepared an ex ante assessment of the impact of measures to strengthen work incentives in the social assistance system, and based on its conclusions has developed an employment activation program including individual action plans for social assistance beneficiaries
4. The Government has maintained the unified standard and per student financing, and introduced delegated school budgets as a national policy

VI. OPERATION IMPLEMENTATION

POVERTY AND SOCIAL IMPACTS

49. Following Operational Policy (OP 8.60) for Development Policy Lending the team assessed whether specific country policies supported by the DPL II were likely to have significant

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21 The PSIA analysis is based on information provided by the MTHS 2007 and additional administrative data. It is part of the Programmatic Poverty Monitoring Policy Notes currently under preparation.
poverty and social consequences. It concluded that the policies do not result in direct negative poverty or other social consequences, while many of the policies could actually contribute to improving the situation of vulnerable groups. A detailed PSIA can be found in Annex 5. In summary:

- The new pharmaceutical policies, to be effective starting in April 2008, would reduce the price of existing drugs and allow for the state to increase the cost-benefit of its spending, contributing to increasing access to basic drugs. These actions would need to be supplemented with measures aimed at changing the behavior of the patients (i.e. trusting generics) and of prescribing physicians (i.e. being motivated to follow the best prescribing guidelines) in order to have the most positive impact on access.

- The main poverty and social impact risk in the Government's education reform program is that drop outs of disadvantaged students could increase as a result of school closures. Historical data suggests that municipalities with a higher rate of school closures have not experienced a large increase in dropouts. In addition the Government has put in place a series of policies to prevent an increase in dropouts in municipalities where school closings are taking place (described in Annex 5).

- The main poverty and social impact risk in the Government's social protection reform program stems from the tightening of eligibility for Guaranteed Minimum Income (GMI), with a cancellation of eligibility for able bodied working age individuals after 18 months of benefit receipt, associated with ineligibility for the following 12 months. The DPL program is not supporting the policy change, but an assessment of its impact, as a prior action in DPL2. A preliminary analysis of this policy suggests that (i) the majority of GMI beneficiaries are poor and highly vulnerable, (ii) the loss of the GMI benefit is substantially deepening the already deep poverty among beneficiaries, but adds relatively little to the poverty headcount; (iii) the activation measures, if effective, could get individuals out of poverty by raising their chances in the labor market and thus increasing their potential earnings in excess of the benefit; and (iv) the EA needs to focus on developing effective activation mechanisms with close monitoring of beneficiaries and enhanced cooperation with the social assistance offices and community based organizations and specialized service providers. Such activation policies are supported by the DPL program.

IMPLEMENTATION, MONITORING AND EVALUATION

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

51. As the Government has chosen to add a Deferred Draw-down Option (DDO) to DPL II, additional monitoring requirements have been discussed. Specifically, the Bank will monitor
the Government's macroeconomic and overall policy framework during the next three years, to ensure that they remain adequate until such time as the Government exercises the option to withdraw the available funds. The continuous monitoring will be conducted in the form of frequent supervision missions. If during supervision it is found that the macroeconomic policy framework is no longer sustainable or the reform program is not being implemented in a manner consistent with the program, the Bank will inform the government in writing and agree on the remedial measures to be undertaken to continue making the DPL available.

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

53. With regards to evaluation of specific policy interventions, the DPL program emphasizes the need for evidence based policy making, and has succeeded in developing a cross-cutting agenda in this area with the Government. It is supporting the Government's efforts to invest in information gathering and developing monitoring and evaluation capabilities. To this end the program is: (i) supporting the ex ante assessment, and subsequent impact evaluation, of changes in one of the main social assistance programs; (ii) promoting the collection and the critical use of information on education quality through student assessments, and (iii) building the capacity to evaluate the impact of policy changes and implement household surveys through accompanying technical assistance associated with the DPL. The Bank has organized three workshops, shared international experience in the area of impact evaluation, and is preparing a menu of options to move this agenda further. There are many actions in the policy matrix that would benefit from a careful evaluation. The institutional and implementation context of the proposed reforms in education governance and financing does not allow for a rigorous impact evaluation, because there is no comparison group, as is usually the case with reforms implemented at the macro level. However, it is possible to monitor the development of the desired outcomes before, during and after the reform. This requires the collection of a baseline of the indicators in the policy matrix, an agreement on their target level and the mechanisms for data collection together with the MES units responsible for their collection. A steering group with the MES, MOF, the NMA and experts has been set up to monitor the development of the financing reform and school consolidation. The Bank has encouraged this development and pointed out that in addition, it would be desirable to combine the routine financial reporting of municipalities to the central Ministries with the feeding back of results indicators such as 'number of students transported to consolidated schools'.

54. The Bank team agreed with MoLSP, OSI and a representative of NSI to conduct jointly with OSI an independent multi-topic household survey. The survey is representative for consumption, incomes and non-monetary aspects of poverty at national and regional (28) level and will include boosters to allow assessing the income, educational, health and labor market status of the Roma and Turkish ethnic minority groups and comparing them with the country averages. The multi-topic household survey is part of the programmatic work on poverty and living standards currently being conducted by the Bank, and the data became available in December 2007. The survey is already providing baselines for many social indicators and basic data to assess the impact of some of the reforms supported under the DPL program. Finally, the DPL program incorporates as a trigger the implementation of an ex-ante assessment and impact evaluation of the reform of one of the main social assistance programs.
55. The participation of stakeholders in the program design has been assured through the support of the Government’s strategies. The health and education actions in the policy matrix are based on the strategies prepared by the MOH and MES respectively. The preparation of the strategies was done in a highly participatory manner. In addition the DPL program was discussed with the main stakeholders: the line Ministries, Ministry of Finance and Ministry of Economy; members of Parliament and Parliamentary commissions for health and education; associations of employers, teacher unions, general trade unions, and Bulgarian Medical Association and Bulgarian Nurses Association; health consumer groups and NGOs. In both education and health, field visits were organized during preparation and main components of the program benefited from discussions in the field. Finally, the education reform was also discussed with the National Association of Municipalities which has endorsed it publicly.

FIDUCIARY ASPECTS

Public Financial Management

56. The Bank has extensive knowledge of the country’s Public Financial Management (PFM) system. A Country Financial Management Assessment (CFAA) was prepared in 2003. The CFAA highlighted strong features of or significant achievements in Public Finance Management (PFM), including: (i) a well developed PFM system relying heavily on IT, (ii) sound legislation and well functioning external oversight institutions (namely the National Audit Office and the Parliament); (iii) comprehensive budget process covering also a number of previous extra-budgetary funds, (iv) well-developed Treasury Single Account (TSA) to service all budgetary institutions; (v) adequate realism of budget estimates, (vi) closely monitored cash management system, (vii) and an adequate internal control framework.

57. While the overall financial management risk to Bank funds was deemed low, the CFAA made recommendations that the Government implemented, including under PAL-2 and PAL-3, and with continued technical assistance from other development partners. An update of recent reform activities and their impact has been carried out in the first half of 2007 as part of the continuous dialogue with Bulgaria. Progress and challenges since the 2003 CFAA are detailed below:

58. Steady progress has been made in the development of systems and institutions of public financial management. The Government has made considerable progress in the development of the medium-term budget framework and program budgeting has been progressively rolled out in line ministries. Budgetary control has improved and all major budget institutions and agencies are now incorporated within the treasury system. After an overly ambitious plan to implement an advanced integrated financial management information system (FMIS) across Government progress on the development of a web based system is now progressing well and FMIS works in the whole system of the Ministry of Finance and those line ministries, which have relation to the accounting information, related to the management of EU financial instruments. The elements of a modern public sector audit function (both internal and external audit) have continued to develop in accordance with best EU and international practice and coordination between inspection and audit agencies has improved. As a result of these efforts, the quality of financial control and oversight in the country has improved substantially.

59. Some public financial management challenges remain. Program budgeting still has to be rolled out across all first line spending units (excluding at this stage the municipalities). When this work is completed and fully embedded in the budgeting system the full impact on policy planning

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22 These are detailed in the DPL I Program Document.
and prioritization across Government will be achieved. The Government also needs to build a more comprehensive picture of fiscal risks into budget documents. Finally, while the main building blocks of an internal control and internal audit function are in place considerable work is needed to ensure managers understand the basic concepts and a sufficient number of certified internal auditors are in place to implement these reforms. Additional details on the fiduciary aspects associated with DPL II are presented in Annex 7.

Disbursement and Auditing

60. The proposed SIR DPL II amounts to US$150 million (equivalent in Euro). The borrower is the GOB, represented by the MOF. The proposed DPL II is the second of the three planned development policy loans totaling up to US$450 million equivalent as provided for in the CPS, which was presented to the Board on June 13th, 2006. The proposed DPL II follows the implementation of the SIR DPL I loan which was fully disbursed in June 2007. Disbursement of funds will be triggered by implementation of agreed policies as described in the Policy Matrix (Annex 2). As the Government has chosen a DDO for DPL II the funds can be withdrawn within three years from the time the loan is signed, with an option to renew the option for an additional three year period.

61. If the Government chooses to withdraw the funds, the proposed loan will follow the Bank’s disbursement procedures for development policy lending. Disbursements will not be linked to specific purchases, thus evidence will not be needed to support disbursements, nor will procurement requirements be necessary. The government will submit a withdrawal application to the IBRD. At the request of the MOF, the IBRD will deposit the proceeds of the loan into a foreign exchange deposit account (deposit account) designated by the government that form part of the general reserves of the country and acceptable to the Bank, such account to be held at the Bulgarian National Bank (BNB). The deposit account is available for budget financing and will be managed by and subject to the control of the MOF. The government shall ensure that upon deposit of the net proceeds of the loan into said account, an equivalent amount will be credited in the Borrower’s budget management system, in a manner acceptable to the IBRD.

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

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

ENVIRONMENTAL ASPECTS

64. No significant environmental impacts are associated with DPL II. The reforms supported by the program are related to the adoption of policies and only a few could have a
future environmental impact. Specifically, reforms in the education sector are expected to result in consolidation of schools, and this will in turn require changes in some schools infrastructure (e.g. school rehabilitation). Similarly, the reforms in the health sector are expected to lead to changes in the hospital sector, including consolidation, conversion of some facilities, and therefore require investments in hospital infrastructure. These actions which may have environmental impact are expected to occur only during the last phase of the DPL program. The rehabilitation of education and health infrastructure would require compliance with the national environmental and construction codes which are now in line with EU standards.

RISKS AND RISK MITIGATION

<table>
<thead>
<tr>
<th>Risks</th>
<th>Mitigating Factors</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Political</strong></td>
<td>1. Since the coalition parties are represented in each Ministry by a different deputy minister, the Bank team is involving all parties in the preparation process by individual and joint discussions.</td>
</tr>
<tr>
<td>1. Recent European Parliamentary election results and loss of momentum after EU accession have created tension among and within the coalition member parties (which hold wide differences and views on certain reforms). This may increase difficulty to agree on some reforms. Upcoming parliamentary elections in 2009 may shift focus from important reforms and contribute to loss of momentum during preparation of DPL III</td>
<td>2. Ensure close support by key Ministers such as MES/DPM, Min. of Economy and MOF</td>
</tr>
<tr>
<td>2. Since EU accession he benchmark against which Bulgaria’s performance is measured has shifted, not only with regards to productivity and social indicators but also regarding wages and living standards; after many years of relatively flat wages and following accession to the EU trade unions are demanding salary increases, adding pressures to the economy and threatening to oppose reforms.</td>
<td></td>
</tr>
<tr>
<td><strong>Macro</strong></td>
<td>1. Labor policies supported by DPL are intended to increase flexibility in the labor market and facilitate adjustments of the economy in response to negative aggregate shocks</td>
</tr>
<tr>
<td>Bulgaria’s economic vulnerability due to the country’s significant current account deficit, inflation pressure, and increasing volatility of external environment (including the associated prospect for European growth slowdown) may grow in the future.</td>
<td>2. Increase in productivity (in the medium term) through DPL supported measures should also counteract inflationary pressures</td>
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<td></td>
<td>3. Bank team is monitoring macro situation in consultation with DG ECFIN.</td>
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<tr>
<td></td>
<td>4. Inflows of foreign direct investment (FDI) fully finance the current account deficit. Foreign exchange reserves have risen.</td>
</tr>
</tbody>
</table>
Institutional
As an EU Member State, the Government’s attitude to DPL supported measures may change relative to pre-accession-DPL I supported measures, and the leverage of the Bank to guide policy changes could become more limited.

Technical
Implementation capacity in some line ministries is limited

| 1. The ongoing Health Sector Reform Project is being used to build capacity in the Ministry of health for different reforms and is providing funds to hire the necessary technical assistance. |
| 2. The Education IDF Grant supports the MES in raising capacity in strategic areas supported by the DPL program. |
| 3. A PHRD grant is providing substantial TA. Poverty programmatic work is complementing TA activities in the PHRD grant. |

5. The fiscal surplus amounted to 3.4 percent of GDP in 2007 and the government plans a 3 percent surplus in 2008, a goal shared by all mainstream political parties. Central Government debt has fallen to 17.8 percent of GDP (as of end 2007) and is projected to slow further this year. There has been some slowdown in credit growth in early 2008.

6. Efficiency gains through health and education reforms will create additional fiscal space.

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

**Principle 1: Reinforce Ownership**

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

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

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

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

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

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

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

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

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

ANNEX 1: POLICY AREAS

Following is a description of the main areas supported by the DPL series. For each main area a set of triggers has been proposed during preparation of DPL I. A description of progress in implementing the triggers is presented together with a preliminary description of triggers for DPL III and outcomes for the program.

66. **The DPL series continues to support some of the overarching objectives stated in the CPS.** These are: (i) Increase employment and lay the foundations for long-term productivity growth by providing incentives for job creation and improving quality of education; (ii) Promote fiscal sustainability through efficiency gains in social sectors. As explained in paragraph 34 many of the policies also contribute to poverty reduction but this is omitted as an overarching objective in the Policy Matrix to prevent repetition in the presentation. A description of the actions being supported by the DPL under each objective and the expected outcomes follows.

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

As the Convergence Programme 2007-2010 states, "...The successful development of the labour market is an important issue on which depends the long-term success of economic policies. In the area of labour markets, the priority of economic policies is to improve their flexibility, to develop human resources, and to increase the labour force participation." The DPL program supports policies to address the structural problems in the labor market as well as taking some of the necessary steps to improve quality of education.

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

67. **The Government has started to implement policies under the flexicurity framework in the context of rapidly falling unemployment and emerging labor shortages.** On the flexibility side, the most recent Government policies have been focused on making labor regulations more flexible and reducing the cost of labor (e.g. reducing social insurance contributions by 6 percentage points in 2006—a policy supported by DPL I—and scheduled decrease of the share of the employer in the social insurance payments) to encourage new job creation in the private sector. On the security side, the Government has been pursuing a mixed agenda combining (i) expanded protection through more generous maternity leave compensation policy for working/insured parents and the expansion of the bilateral recognition of pension rights between Bulgaria and EU Member States as well as an extraordinary pension increase by 10 percent in October 2007; and (ii) providing incentives to unemployed individual to find employment, tightening the access to social assistance for able-bodied individuals and more active labor programs targeted at the long-term unemployed and hard to place.

68. **After amending the Labor Code in 2006 to increase flexibility in working conditions (working time and fixed and part-time contracts) and align it with the EU working time directive the Government has implemented additional policies to reduce distortions and increase flexibility in the labor market.** The Government reduced by a

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further 3 percentage point decrease in the social insurance contributions as of October 1, 2007 (Gazette 77/2007) conditional on increased compliance and collection of contributions. And, as of January 1, 2008 the Government reduced the share of the employer in the public pension contribution to 60 percent and increased the share of the employee to 40 percent.

<table>
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<tr>
<th>Original trigger 1</th>
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<tbody>
<tr>
<td>Fold seniority bonus into the base wage</td>
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<td>Status: completed</td>
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</table>

69. In order to reduce distortions to labor mobility over the medium term the Government has removed the portability of the seniority bonus by transforming it into a bonus which recognizes professional experience in a certain area. This action was included in the “Pact on Economic and Social Development of the Republic of Bulgaria until 2009” agreement, and a tri-partite working group developed a new regulation on wage structure which has been adopted by the COM and enforced as of July 1, 2007. The regulation restricts the portability of the seniority bonus while it continues to exist as a separate element in the wage structure. The bonus is now due only when the employee has relevant professional experience in case of moving to a similar job. Its size is subject to negotiation between the employer and employee, while the state determines the minimum size of the bonus per year of service. This measure is expected to reduce distortions to labor mobility as new employers are not mandated to pay a bonus for experienced new employees based only on their seniority. The Government has not yet eliminated the bonus in its entirety — folding it into the base wage. However the new regulations reduce government intervention in the labor markets and could lead to the de-facto elimination of the seniority bonus; for example it is plausible to envision a scenario in which the negotiation between employer and employee could result in a higher base wage instead of a seniority bonus. It is proposed to change the wording of this prior action to reflect this policy change.

<table>
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<tr>
<th>Revised Prior Action 1</th>
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<tbody>
<tr>
<td>The Government has removed the automatic portability of the seniority bonus, transforming it into a bonus for relevant professional experience</td>
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<tr>
<td>Status: completed</td>
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</table>

<table>
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<tr>
<th>Prior Action 2</th>
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<tbody>
<tr>
<td>The MLSP has restructured active labor market programs as per the Employment Action Plans 2007 and 2008 to strengthen on the job qualification and professional training programs and service delivery linked to private sector skill needs</td>
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<tr>
<td>Status: completed</td>
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</table>

24 The wording of some prior actions for DPL II has been modified relative to the triggers originally agreed during preparation of DPL I in order to provide a more direct language or to make editorial changes where appropriate. Only in cases where changes of substance have occurred the original trigger is presented next to the revised prior action, together with an explanation of the changes.
70. Following the results of an impact evaluation of ALMPs, MLSP started restructuring the active labor market programs (ALMPs) mix in the 2006 and 2007 annual employment action plans to strengthen their focus on on-the-job qualification and on linking training to private sector skill needs. The National Action Plan for Employment (NAPE) for 2007, adopted by the Council of Ministers on February 1, 2007, continues the 2006 trend in restructuring of Active Labor Market Policies. In the 2007 NAPE, the Government is making ALMPs more demand-driven and is shifting them towards training, at the expense of low-quality-subsidized employment provided mainly through the program “From Social Assistance to Employment”. In the 2007 Plan ALMPs have become more open to life-long learning, creation of sustainable jobs and wider participation of the private sector (instead of municipalities) as providers and financiers, and less prone to locking able-bodied people, who could find employment in the open labor market, in low-quality subsidized jobs.

Figure 4: Services rendered under Bulgaria's Active Labor Market Programs 2003-2007 (planned/budgeted)

Source: Staff calculations based on MLSP data

71. The 2007 and 2008 Employment Action Plans restructure ALMPs further, placing additional emphasis on training and improving skills among the young, the old and those with low educational attainments. The MLSP is also undertaking an assessment of the second

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25 The reform builds on the impact assessment of the main active labor market program for long-term unemployed receiving monthly social assistance, “From Social Assistance to Employment” (FSAE). The program was introduced in 2002, with 55,300 participants and scaled up in 2003 and 2004 to over 80,000 participants per year. Initially the program was heavily focused on public works — a 45 percent share. The impact evaluation of the program in 2005 revealed a mixed outcome: (i) the gross and the net program impacts on employment were negative — the program reduced the participants’ net probability of ever finding a regular job by 12.7 percent; (ii) the negative impact on employment was most pronounced in the case of disadvantaged and hard-to-reach and hard-to-place groups on the labor market; and (iii) the training provided under the program was very limited and not sufficient to improve the participants’ employability. In addition participation in the program reduced the time for job search compared to the control group. On the other hand (i) the program had a positive impact on unemployment duration, reducing it by 50 percent on average for participants; and (ii) the program had positive social effects, as the control group reported deterioration in self confidence, motivation for job search, social contacts, health status, job opportunities and income, and unchanged status of qualification and skills, while the treatment group reported improvement, except for income where they saw no change; and (iii) the program had positive long-term impact on employability in terms of improved labor habits, increased motivation for independent job search, and improved qualification and skills. A parallel survey among employers indicated that 68 percent of the employers reported lower productivity of the employees hired under the program. They also reported making additional investments in mentoring and firm-level supervision to bring the work habits and discipline at the workplace up to the level of regular workers.
The update made it more relevant to the objectives of the European Employment Strategy, increase the weight of activation policies, and improve its results focus. For 2008 the Government plans to further trim subsidized job programs and reallocate resources to occupational training and career counseling in particular for the long-term unemployed. As Table 5 shows vocational and on the job training in companies now represent almost 50 percent of the programs. The following measures have been adopted:

- The FSAE program was downsized to 33,000 participants in 2007, especially in its public works component — as shown in Figure 4. In 2007, less than 15,000 program participants were engaged with public works — beneficiaries who are not employable outside the program. The remaining program prioritizes new entrants, members of families with children where both parents are long-term unemployed and receiving social assistance, and single parents.

- The ALMPs have been diversified and the role of private entrepreneurs in providing subsidized jobs is gradually increasing, while the role of the municipal administrations in the organization and provision of the program is declining. Private employers' involvement increased in opening subsidized jobs in agriculture, maintenance of road and railway infrastructure (in some cases jointly financed with Government).

- The focus of ALMPs has shifted to those with greater difficulties in finding jobs. These include youth, young mothers re-entering the labor market after maternity leave; elderly workers who are missing up to 5 points in order to be able to retire; people with disabilities; people living in economically depressed regions with limited job opportunities on the primary market. Separate ALMPs are designed to serve the needs of these vulnerable groups, for example the “Assistants to People with Disabilities” national program, “Assistance to Retirement” program, “Support to Motherhood” project, “Vocational Training for Employment of Persons under 29 Years Old”, “Career Start” program and different internship and apprenticeship programs. In addition program participants which have been in the program for over 18 months and who are receiving social assistance will not be enrolled in the program as of January 1, 2008.

- Training and skills upgrading activities have been expanded within the ALMPs and separate training programs have been created. These include one big national vocational training program with 21,000 trainees representing 48.8 percent of all beneficiaries of training and a number of smaller national and regional literacy programs, programs for development of vocational skills and motivation to enter the labor market. The share of those benefiting from training increased to 49.5 percent of all employment program beneficiaries in 2007 (43,022 people);
Medium term actions (DPL III) and new areas of dialogue. In addition to further restructuring ALMPs the World Bank and the Government are currently discussing how to move the labor and productivity agenda further. Some of the activities under discussion are:

i. Introducing second chance policies for low skills individuals to facilitate their entry into the formal labor market. This applies to individuals who dropped out early from the education system and do not comply with the entry requirements (accomplished minimum six grades of education) for receiving formal ‘complete, or full’ vocational qualification for a certain profession. Policies in this area would entail opening flexible opportunities for the acquisition of primary and initial secondary education and introducing more flexible ways of confirmation/legalization of literacy, qualifications and skills acquired outside the formal education system, and for reclassification of ‘partial’ vocational qualification. According to the last census there are 200,000 illiterate people in the country while the Employment Agency has been providing literacy courses for not more than 1,500 people per year. It is important to introduce policy measures which will allow individuals to complete at least grade 4 to guarantee some formal access to employment opportunities; and to de-link the educational programs for adults (for grades from 1 to 6) from the curriculum and the delivery methods applied for children. As a first step, a state educational standard for grade 4 has been developed by MLSP with the assistance from specialists and has already been applied when training adult Roma. In the future MES would need to consider introducing mechanisms to (i) recognize this as formal education (proving and verifying) and (ii) legalized general education knowledge attained by adults outside the formal education system —which would require changes in the Public Education Act, the VET Act, and development of new syllabi.

As explained in paragraph 46 new areas of dialogue are developing during preparation of the DPL program. These include topics that were not originally part of the DPL series but may eventually be supported by the DPL III.
for literacy and primary education for early drop outs. The reform agenda for those with low skills and low level of education remains underdeveloped and needs a deepening of inter-agency coordination between MES and MLSP.

ii. **Expanding lifelong learning.** The share of working age Bulgarians enrolled in training — approximately 2 percent in 2006 — remains much below that in the EU 15 (11.1 percent) or the advanced EU Member States, such as Denmark (29.2 percent). The Bank team has initiated discussions with GOB and the associations of employers on measures to expand effective life-long learning opportunities, including through greater involvement of private sector provision of adult training, so as to take full advantage in this area from financing under the OP HRD. The MES has created a multi-agency working group tasked with the development of a new National Strategy on Lifelong Learning, and a PHARE-financed consultant team has been developing a draft document which will be subject to elaboration over the coming months. The life-long learning agenda is also tackled with support of the planned Social Inclusion Project which focuses on promoting access to kindergarten and preschool of children from poor and marginalized background as well as children with a disability to enhance their school readiness.

iii. The Bank is discussing the inclusion of actions to improve the regulatory environment of firms to contribute to job creation and increased productivity. Stimulating productivity growth and further reductions in unemployment require a multisectoral approach that includes efforts to improve the quality of regulations. It has been acknowledged that an unpredictable investment climate is a significant barrier to job creation. Promoting the right environment for firms to operate is conducive to lower cost of doing business, which in turns create incentives for firms to enter the market and add formal jobs to the economy. In order to improve the investment climate the Government passed the Act on Restricting Administrative, Regulation and Control on Business Activities in 2003. This Act defined the legal framework for Regulatory Impact Assessment (RIA) which lie at the core of the EU strategy to improve the quality of regulation — one aspect of the investment climate in a country. However, the Act was inconsistently implemented in the following years. In 2006, the Council of Ministers took as a priority improving the regulatory framework in Bulgaria, and mandated the Ministry of Economy (MoE) and the Ministry of State Administration (MSA) to take initiatives for regulatory reform. As a result, the MoE is now chairing an Inter-Ministerial Working Group on Better Regulation that aims to create a coordinated position on regulatory reform issues. The MoE has also initiated several efforts to implement RIAs, including the adoption of a basic short-term plan on regulatory reform, a survey of firms aimed at identifying firms’ perceptions of the main constraints imposed by current regulations, and three pilot RIAs. In the context of a multi-sector approach to job creation the DPL series would support the preparation and implementation of a comprehensive national policy to institutionalize Regulatory Impact Assessments and implementation of this policy, including: (1) building a central unit responsible for promoting and overseeing regulatory reform, (2) completing the electronic registry of consolidated

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27 World Bank, Enhancing Job Opportunities: Eastern Europe and the Former Soviet Union, 2005, Washington DC
28 Regulatory Impact Assessment (RIA) is a framework for analysis of the likely impacts of a policy change and the range of options for implementing it. It assesses the full range of potential impacts - economic, social and environmental- from existing and new regulations. RIA is a key tool in delivering better regulation because it helps governments only regulate when necessary and, when it is, to do so in a way that is proportionate to the risk being addressed. It leads to deregulating and simplifying wherever possible. As part of the 2005 renewed Lisbon Strategy, the European Commission requires Member States "to demonstrate their clear commitment to better regulation principles through their National Lisbon [Action] Programmes", the core of which consists of systematic implementation of RIAs.
regulations, and (3) developing a review strategy for the existing “stock” of regulations. This is acknowledged in DPL III through a new trigger.

<table>
<thead>
<tr>
<th>Issues/Problems</th>
<th>Prior Actions DPL I</th>
<th>Prior Actions DPL II</th>
<th>Triggers DPL III</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low employment, high percentage of long term unemployed, and high rates of informality in the labor market</td>
<td>The Government has enacted amendments to the Labor Code to increase flexibility of working time and fixed term and part-time contracts</td>
<td>The Government has removed the automatic portability of the seniority bonus, transforming it into a bonus for relevant professional experience</td>
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<td></td>
<td>The Government has enacted amendments to the Social Insurance Code to lower the contribution rate for pension insurance by 6 percentage points from 29 to 23 percent</td>
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<td></td>
<td>The Government has enacted amendments to the Employment Promotion Act to introduce a monthly bonus for unemployed recipients of social assistance who find employment at their own initiative</td>
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<tr>
<td></td>
<td>The MLSP has restructured active labor market programs as per the Employment Action Plans 2007 and 2008 to strengthen on the job qualification and professional training programs and service delivery linked to private sector skill needs</td>
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<tr>
<td></td>
<td>The Council of Ministers has approved the updated National Employment Strategy</td>
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<td>The Government has enacted amendments to the Employment Promotion Act to raise the skills and competitiveness of the employed through incentivizing adult education and on the job qualification and training</td>
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<td>The Government has enacted amendments to the Vocational Education Act, Employment Promotion Act and Act on Foreigners in the Republic of Bulgaria to open opportunities for second chance education for early school leavers, low skilled and people without education</td>
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<td>In order to improve investment climate and promote job creation the government is implementing a national policy to institutionalize regulatory impact assessments</td>
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I.2. **Problem: Social Welfare Program design creates disincentives for job searching**

**Prior Action 3**

The Government has prepared an ex ante assessment of the impact of measures to strengthen work incentives in the social assistance system, and based on its conclusions has developed an employment activation program including individual action plans for social assistance beneficiaries

**Status: completed**

73. Aiming to promote employment activation in times of rising labor demand at all levels of the skills distribution, the MLSP has introduced measures to tighten eligibility of social assistance for working age individuals who are capable to work. As of 1 July, 2006, the maximum duration of eligibility for Guaranteed Minimum Income (GMI) for able bodied working age beneficiaries is 18 months. Affected beneficiaries cannot re-apply for the program until after 12 months of break in benefit receipt. The policy measure has been enforced from January 1, 2008. This measure is linked to plans to review and adjust the targeting of the GMI
and force those receiving GMI support while working in the informal sector to enter into formal employment.

74. The Bank is supporting the analysis of the profile of the affected GMI beneficiaries and the reasons for staying unemployed in the long term, as well as an ex-ante assessment of the impact of this policy, so that the Government can make informed policy changes to the program in case of negative welfare effect. This analysis will build on administrative data from the Social Assistance Agency (SAA) and Employment Agency (EA) as well as on a survey of beneficiaries to be conducted by the National Statistical Institute (NSI) in February 2008. While the DPL program does not support the tightening of the eligibility criteria for GMI itself, the DPL policy dialogue has focused on preparatory and analytical efforts to minimize any adverse social impact and maximize the likelihood of activating affected GMI beneficiaries. As a result of this dialogue, the SAA and EA have examined administrative data and develop profiles of affected beneficiaries by education, age and prior labor market experience. On the basis of this, the EA scheduled interviews with each beneficiary and developed individual activation action plans, specifying the training needs. In addition the agency monitored the beneficiary numbers monthly from July 2007. As of December 2007 there were 17,642 unemployed on monthly social assistance (GMI) for whom the “18-month rule” was to start to apply on January 1, 2008, down from 24,605 on November 20, 2007 and 29,954 in the end of July 2007. The majority of the difference is explained by GMI beneficiaries already enrolling on training and employment programs, such as subsidized employment by the EA under ALMPs and measures, literacy courses or professional qualification. In addition, the regional offices and affiliates of the EA helped 206 people to find jobs on the primary labor market; while 1,222 refused to participate in ALMPs and their registration as unemployed has been terminated for the following 12 months. As Figure 5 shows, the majority of remaining affected beneficiaries have low levels of education, resulting in likely low employability: 33 percent have no formal education and only 7.5 percent have secondary or higher than secondary education.

75. Based on the review of administrative data, the Employment Offices have held interviews with every affected beneficiary and have developed individual action plans. Some beneficiaries have already been placed on programs, as evident in the reduction of remaining affected beneficiaries between October and November 2007 (see Figure 5). As expected, those beneficiaries with better education have been easier to place: between October and November 2007, while the number of affected beneficiaries with secondary education and above fell by 36 percent, the number of beneficiaries with no education and with primary education fell by only 25 percent in the same period. According to EA data, very few beneficiaries have terminated their unemployment registration without participating in any EA program so far. The employment offices are not tracking these former beneficiaries and the reasons for such termination and it is not clear to what extent this is due to finding jobs on the primary market, ‘formalizing’ informal jobs or for other reasons. Action plans for the remaining 17,642 persons will be included in the 2008 Employment Action plan and budget.29

29 Owing to low levels of education and limited previous formal employment experience, the majority of the remaining clients are unlikely to find work on their own and will continue to rely on training and measures for subsidized employment envisaged in the Employment Promotion Act, or on national or regional programs for subsidized employment, and mostly on the “From Social Assistance to Employment” program.
The review of administrative data is being complemented with survey work initiated in April 2008, to provide a baseline for this policy change and conduct an impact assessment. The MLSP and the World Bank have set up a joint team to analyze data from the Multi-Topic Household Survey (MTHS) 2007, including social benefit incidence analysis which will provide a basis for changes in targeting and benefit eligibility. The DPL II is supporting the impact evaluation of this policy including (i) a simulation of how the welfare status of the household would change if the GMI support was stopped for the individual beneficiary or the whole household for 12 months; (ii) an assessment of the expected coping strategies with respect to the policy measure – for example activation (joining the labor market), going into the informal economy, opting for disability pension, continuing to rely on social assistance, reliance on intra-household or extended family transfers, etc.; and (iii) a study of the reasons why the affected GMI recipients do not enter the labor market – like a high reservation wage, disincentives to work related to the level of the benefit, the level of wage, taxation, the lack of adequate skills and qualification, the lost working habits, and other reasons which make the person unemployable.

Medium term actions (DPL III) and new areas of dialogue. The DPL policy dialogue in social protection has seen a deepening since DPL I but remains uneven across various directorates in MLSP. The DPL I social protection dialogue had been focused on employment policy in recognition of reform pressures in this area, and the collaboration with the employment policy directorate has since deepened. For example, the directorate has requested Bank’s technical assistance on the revised National Employment Strategy. On the other hand, dialogue with the social assistance directorate is still limited as the more recent developments in OECD and EU’s social policy have not been fully absorbed yet. In general social protection remains an area of uncertain reform commitment, in particular in the second half of the Government’s term in office. An increased interest in Bulgaria to introduce the concept of flexicurity could provide a window of opportunity for further engagement in this area, and close collaboration with DG Employment, Social Affairs and Equal Opportunities as well as DG Ecfin in the European Commission would help foster the reform process. The prospects for continuing dialogue in this sector relate to two main topics:

i. Continued support for a thorough revision of social assistance programs for DPL III, with the idea of strengthening targeting and work incentives. Responding to recent
demand for analytical support from the employment policy directorate, the social analyses
and forecasting directorate and the deputy ministers, the Bank proposes a sustained
engagement strategy through select and jointly undertaken pieces of analytical work,
including (i) review of the profile of GMI beneficiaries (PHRD assignment), (ii) social benefit
incidence analysis using MTHS 2007 data, and (iii) study on the spatial aspects of labor
supply. The MLSP has recently nominated a working group for joint pieces of analytical
work based on the MTHS, with the focus of analytical work on a poverty update, social
benefit incidence analysis and labor market analysis. This is reflected in the second trigger for
DPL III in the table below.

ii. The Bank is engaging with the Government in the area of conditional cash transfers
by analyzing the effectiveness of the current child allowance system. The Monthly
Child Support provided under the Act on Family Benefits for Children (child allowances)
became conditional to school attendance for school-age eligible children in March 2003.
While this measure has been credited with boosting enrollment and attendance, the
verification of attendance twice a year was perceived by MLSP and MES as insufficient to
guarantee sustained attendance. MLSP introduced a change in the enforcement of the
conditionality in September 2006, monitoring school attendance on a monthly basis and
disrupting the benefit for a month in case of 5 or more unexcused absences. MLSP has
requested the Bank’s support in the design and implementation of an assessment of the
possible impact of the tightened monitoring and subsequent sanctions on behaviors related to
school attendance which, according to MLSP affect between 7,000 and 9,000 families per
month. Analytical work funded by the DPL2 PHRD grant will review the current system and
the various associated conditionality elements, advise on how the conditionality elements can be
strengthened to maximize their effect, and share international experience with examples of different
approaches to CCTs. This is reflected in the first of the triggers for DPL III in the table below.

iii. The Government has also requested assistance to continue developing its capabilities
to undertake impact evaluations and evidence based policy making. This is a cross-
cutting area that spans various sectors and would be coordinated by the IFI Directorate in
the Council of Ministers. The Bank is preparing a menu of options to continue the dialogue
in this area.

<table>
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<tr>
<th>Proposed actions for overarching objective 1</th>
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<tbody>
<tr>
<td><strong>Overarching Objective:</strong> Increase employment and lay the foundations for long-term productivity growth by providing incentives for job creation and improving quality of education</td>
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<tr>
<td><strong>Issues/Problems</strong></td>
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<tr>
<td>Social welfare program design creates disincentives for job searching</td>
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78. **Expected outcomes (by 2009).** By the end of the DPL Program, the expected outcomes are:

i. An increase in the employment rate of younger workers to at least 25 percent (age 15-24,
Eurostat data) from the 2005 baseline of 21.6 percent, with intermediate status (2006) of 23.2
percent;
ii. An increase in the employment rate of older workers to at least 40 percent (age 55-64, Eurostat data) from the 2005 baseline of 34.7 percent (intermediate status (2006) of 39.6 percent);

iii. An increase in the activity rate of younger workers to at least 30 percent (age 15-24, Eurostat data) from the 2005 baseline of 27.9 percent (intermediate status (2006) of 28.9 percent);

iv. An increase in the activity rate of older workers to at least 45 percent (age 55-64, Eurostat data) from the 2005 baseline of 38 percent (intermediate status (2006) of 43 percent);

v. As an intermediate output that would result in a decrease in long term unemployment the relative share of individuals benefiting from training out of the total number of beneficiaries of active labor market programs increases, from the 2005 baseline of 19.4 percent to 30 percent, with intermediate value of 26.5 percent (December 2007), as well as an increase in absolute numbers of beneficiaries of training programs; and

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

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

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<th>Prior Action 4</th>
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<tr>
<td>Bulgaria has taken part in international assessment tests, like PISA 2006, PIRLS 2006, and TIMSS 2007. In addition, MES has administered sample testing of Matura in Bulgarian language and Literature, Math and Foreign languages, a new national placement test for 7th graders and a new census-based test of 4th graders</td>
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<th>Prior Action 5</th>
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<tr>
<td>The Ministry of Education and Science (MES) has trained at least 50 percent of school directors through the Institute of School Directors</td>
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79. The strategy to improve quality of education in Bulgaria consists of increasing training of educators, introducing modern technologies in the curriculum, gathering data on performance, and building capacity at the MES to assess quality and performance. The Government expects that improving education will also contribute in the medium term to the goal of increasing productivity and skills of workers. One important aspect of quality is to have the capacity to analyze and disseminate student performance data for the purposes of informing policy and teaching practices at the school level. At the outset of the DPL series, Bulgaria did not have the capacity to supervise and monitor education quality systematically, rewarding high performing schools and identifying failing schools, or targeting measures and concrete areas to improve the quality of teaching as needed. In this regard, it is not enough to
have the national capacity to measure learning outcomes, which Bulgaria is developing now. What really makes the difference is the capacity to use learning outcomes information for quality improvement and equity enhancing purposes. This includes the capacity to communicate the information to the wider public, the capacity of practitioners to learn from the results, and the capacity to make evidence-based policy choices. After the creation of a national agency for the evaluation of education quality (CKOKO) in Bulgaria, the availability of student achievement data at key stages of the schooling process together with international comparisons and benchmarking opens the possibility for policy makers and practitioners to focus on quality. The Government has made significant progress in this area: (i) the census-based 4th grade national assessment was administered in all primary schools in Bulgaria in May 2007, marking a historical milestone as it is the first national assessment of student achievement carried out in Bulgaria; (ii) in June 07 the new 7th Grade examination, piloted the previous year, was administered; and (iii) in December of 2007 the results of PISA 2006 and PIRLS 2006 were made public and in a few months data from TIMSS 2007 will also be available. In 2008, in addition to the 4th grade test, there will be another census-based national test of 5th grade students, meaning that the same cohort of students who were tested in the fourth grade will be assessed again. In fact, the MES plans to continue the assessment of this same generation of students until they reach the 8th grade four years from now. This is the first generation of students to study the new curriculum, including foreign languages and IT from the 2nd grade. In addition the Government is planning to develop a coordinated implementation plan for the effective use of national and international assessment data for school improvement purposes, and to identify training needs for teachers, school directors and local education administrators. Since the Government has actually performed above the agreed commitment in the original trigger as it implemented additional testing the trigger has been re-stated accordingly.

80. The pilot Matura examination—a standardized test to be used by universities as one of the criteria for admission—was carried out in April of 2007 with a sample of 3,700 students from 45 secondary schools. Taking into account that the introduction of the Matura has been highly controversial for over a decade and, as a result, continuously delayed, the fact that all stakeholders are now supporting the new examination bodes well for the successful implementation of the Matura in Bulgaria by 2009. Introducing the Matura examination is the key reform measure suggested by the recent World Bank Public Expenditure Review as the means to overhaul current policies on access to tertiary education in Bulgaria. In addition, a compulsory Matura, administered centrally, is seen by many as one of the main tools to reduce the gray market of private tutoring before entrance into higher education. Universities also recognize that the complexity and expense of organizing their own entrance exams limits their ability to diversify their course and program offers and places an unnecessary burden on their administration and academic staff (affecting, among others, research productivity).

81. As a preparation for the expansion of delegated budgets and school based management, the MES launched the Institute for the Training of School Principals on November 1, 2006. The Institute is playing a crucial role in the implementation of both quality assessment reforms – by training inspectors and principals in the effective use of assessment data for school improvement purposes – and the finance and governance reforms – training principals on delegated budgets. It has created 11 different programs and trained 2,915 school principals, including 305 in delegated budget management. In addition to principals and deputy principals,

30 TIMSS stands for Trends in International Mathematics and Sciences Study and PISA for Program for International Student Assessment.


32 Despite all the progress made, issues still remain concerning the future use of the Matura scores for admission in some specialized institutions and fields of study which are still planning to keep their own entrance examinations.
Directors of local inspectorate offices, evaluation experts and selected staff from Teacher Unions have also received training and a variety of issues including managing budgets in schools. The Inspection Directorate of the MES has kept the main responsibility for the training of Inspectors and this is why the trigger is reformulated as follows:

82. Medium term actions (DPL III) and new areas of dialogue. DPL III will support the consolidation of the policies initiated during the first two phases. The Government will have to use the information gathered to promote quality enhancing changes. It will also introduce the Matura, and commit to continue participating in international tests, and additional tests to be used for quality assessment. New areas of support have emerged for the medium term:

i. The DPL III could support reforms in higher education and vocational education. High quality vocational education can contribute to increased labor productivity growth. The government's National Program for the Development of School Education (2006-2015) mentions the need to reform VET, in particular the need to review the cost effectiveness of VET institutions, as well as the number of specializations taught at the school. Moreover, the Program calls for a transfer of schools from the state to municipalities since municipalities "...bear the direct responsibility for the comprehensive development of the region, they are best informed about the current status of the local economy and output and about the need to educate and train specialists within certain occupations." To move the Bulgarian VET system closer to the best practice examples in EU and OECD countries the government may wish to consider some of the following policies that could also be supported by DPL III: (i) introduce per student financing for VET; (ii) transfer ownership of VETs to municipalities; (iii) delay the introduction of VET until the completion of compulsory education as other EU countries have done in order to make workers more adaptable and mobile across jobs.

ii. Regarding higher education, the government's strategy in this area did not gather the necessary support in the Assembly. The Bank remains open to support the Government in implementing the strategy in the future.

83. Expected Outcomes. By the end of the DPL Program, the expected outcomes are:
i. Reports on Quality assessment prepared by CKOKO and made available to the public increase (from a baseline of 0 to a target of 5) (an intermediate output showing progress in building capacity for quality assessment —and ultimately improving quality if the information is used in critical ways)

ii. Placement of students in upper secondary institutions is done on the basis of objective ability testing (using the new 7th grade national test) (intermediate outcome that shows information is used for quality improvements).

iii. Matura examination results are used by Bulgarian universities as credential for admission (showing information on quality is being used critically)

iv. The percentage of Regional Inspectorates and of newly appointed principals reporting that student assessment data (regional and school-level, respectively) are being used as one of the key factors to decide on staffing, budget allocation and innovation programs increases (from a baseline of 0 in 2005 to a target of 60 percent)

v. Schools principals have the capacity to manage schools as shown in the number of principals receiving training

vi. 35 percent of subjects in the primary and secondary education curriculum have e-technology and multimedia content available to teachers and students.33

II Promote fiscal sustainability through efficiency gains in social sectors

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

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<tr>
<td>The role of the NHIF as a primary payer of hospitals is maintained and payment system has been improved to promote an efficient use of resources and financial sustainability of the national health insurance system</td>
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84. The Government initiated —with support of DPL I— a series of actions to control spending in hospitals. There are indications that hospital spending is one of the main drivers of growth in NHIF spending and that the system contains distortions that stimulate this growth. NHIF spends now 56 percent of its budget on hospitals, and there has been a 7 percent increase in the number of cases reported by hospitals.34 In addition out of 530,000 hospitalizations during the first half of 2007, 22 percent are re-hospitalizations — the same patients are treated under the same or different case in the same or different healthcare facilities.35 Achieving financial sustainability will require controlling spending in hospitals, and in order to tackle this, the Government has continued the implementation of policies originally supported by DPL I. First, it maintained a unified method of payment for hospital services. NHIF is now the main

33 This outcome is related to a trigger in the first phase of the program, see Policy Matrix for details.
34 Average monthly in 2007 as compared to 2006.
35 NHIF 2007 budget report to Council of Ministers.
purchaser of services for hospitals, using CCPs to pay for services.\textsuperscript{36} MoH only finances psychiatric wards, dialysis centers, and some emergency services. This sends clear signals to providers and limits the possibility of selectively billing either NHIF or the MoH depending on the prices paid, and eliminates duplicate administrative costs. Second, the Ministry and NHIF continued monitoring recovery plans signed with major hospitals in order to prevent the accumulation of debt. Total arrears in hospitals went down from BGN 184 Mn in 2005 to BGN 180 in 2007 — more importantly they have been decreasing as percentage of NHIF budget from 49 percent of budget in 2005 to 26 percent of budget in 2007. Third, the 2007 NHIF Budget Act introduced ceilings in the volume of services at the national level by type of CCP and granted authority to NHIF to reduce the prices of CCPs\textsuperscript{37} in case budget execution in hospitals becomes unsustainable.\textsuperscript{38} The NHIF also stepped up monitoring and analysis of the work of the medical institutions.\textsuperscript{39}

85. The Government has introduced additional measures to control hospital spending. The Government has introduced in the 2008 NHIF Budget Act a policy change that is among the most significant changes since the creation of the National Health Insurance Fund in 1998. Over the last ten years there have been many reports recommending changes to the current system for allocating resources to hospitals — a de facto fee-for-service, open ended budgeting and payment mechanism with lax regulation of new entrants into the system. Instead of paying an unlimited number of services to every qualifying facility, the 2008 Budget Act allocates funds to the Regional Health Insurance Funds (de-concentrated branches of the national fund) on a per-capita basis, with some adjustments made for recent referral patterns. The RHIFs are then to allocate their resources to the hospitals according to their historical (2006-2007) share of expenditures from the insurance fund (which would roughly capture quantity and case-mix of their patients). There are some reserves to be retained at the national (10\% of total) and regional (10\% of regional allocation) levels in order to account for new entrants to the market (with which the NHIF is legally obliged to contract), changes in referral patterns, and emergency cases. The contracts between the hospitals and the regional health insurance funds will have a financial limit. They will also estimate the number of services, by CCPs and according to the prevailing CCP price, for which the hospital will be providing services. The actual mix of services will be allowed to vary, as long as the overall financial ceiling remains the same. For particularly expensive CCPs (i.e. invasive cardiac surgery), the RHIF will pay for these services additionally from its reserves. The NHIF Budget Act was approved by the Parliament on December 17 2007. The wording of the trigger has been modified to group various activities related to financing into one trigger and group activities related to service provision into a separate trigger.

86. On the supply side, the Government is initiating measures to restructure the hospital sector to adapt it to modern practices that rely on — less expensive — outpatient care. An excessive number of providers creates pressure to increase volumes of services

\textsuperscript{36} CCPs are a variant of DRGs where each clinical care pathway sets guidelines for treating a particular case and a price for the overall treatment. When well designed the CCP system may present an advantage over DRGs in that may provide more clear care guidelines for each case, but it also has some limitations, like the lack of co-morbidities and other refinements that are incorporated in DRGs.

\textsuperscript{37} The experience in many European countries shows that setting prices is not enough to limit spending by health care facilities, as they can control volume of services and recover any reduction in prices by increasing admission rates. Therefore any meaningful way to control hospital spending has to address prices and volume of services.

\textsuperscript{38} This can only be a policy of last resort as it may create perverse incentives to increase volumes further and may penalize certain hospitals that remain within budget — as the law does not authorize NHIF to alter prices differentially across providers.

\textsuperscript{39} During the first half of 2007 over 621 inspections in medical institutions have been implemented and more than 40 contracts have been terminated.
delivered and therefore hospital spending. There is a large body of evidence suggesting that health care is particularly susceptible to supply-induced demand, especially when the costs are paid by a third party such as government rather than directly by consumers. Optimizing the hospitals network is a difficult political issue and therefore requires building consensus first by collecting evidence and communicating it to the public and major stakeholders. The first step has been to update the National Health Map, detailing the existing hospital infrastructure in the various regions and municipalities. Second, the government is commissioning a hospital masterplan to assess the needs of the population and compare them to actual services provided.40

Original trigger 7

The Government has completed the masterplanning exercise and taken first steps towards its implementation. It is also implementing additional measures to improve the financial balance of the national health insurance system, for example enforcing implementation of recovery plans in hospitals to limit growth of arrears and using accreditation of facilities as a tool for rationalizing services.

Status: partially completed

87. The hospital masterplanning exercise will propose new models for health care provision in Bulgaria. It will estimate the ideal location of facilities, the type of services that should be provided at each level, the organizational model for better management and accountability, and the costs necessary to implement the network optimization program. Based on that information it will then recommend alternative models to achieve a successful restructuring, including proposals to increase the private sector participation in the restructuring and functioning of hospitals, like Public-Private-Partnerships. Even though the entire process can last a decade, the Government is planning to start implementing the restructuring plan within the next two years, and is looking into other countries experience within the EU in order to take advantage of Structural Funds to finance part of the process.

88. The work on the masterplan has begun recently, after a six month-delay due to disagreements within the coalition party. The Government is committed to complete the following steps, which are part of the masterplan, by the time the operation is presented to the Board: (i) guidelines and recommendations on health service planning and evidence on optimal configuration of hospital services and benchmarks to be used in national and regional master-plans; and (ii) framework/guidelines for prioritizing investment needs that can later be applied to the investment needs of the restructuring strategy. The Council of Ministers will endorse this information through the appropriate mechanism. In addition the Government is attempting to introduce a measure that would facilitate the restructuring of the supply of services. The Ministry of Health has submitted legislation to the National Assembly to allow hospitals where the state is not a majority shareholder to privatize idle assets. And finally the NHIF is requiring new health facilities to go through the accreditation process before signing contracts with the Fund.

40 There have been some successful experiences with the restructuring of hospitals that followed this path, like the case of Estonia, where a restructuring plan was set up in 2000 with the goal of reducing the number of hospitals from 78 to 21 by 2015. Using demographic and epidemiological models the demand for health care was estimated, as well as optimal catchment areas by type of facility, so that for a given catchment area the maximum time limit to reach the hospital would be one hour. Based on these criteria Estonia identified 3 regional hospitals for tertiary care, 4 central hospitals, 11 country hospitals, and 3 smaller hospitals. Between 1993 and 2001 the number of hospitals went from 115 to 67, the number of beds decreased from 14,000 to 9,000, and average length of stay moved from 15 to 8.7 days.
The Government has taken the first steps towards implementation of the
masterplanning exercise by endorsing: (i) the guidelines and recommendations on
health service planning; and (ii) framework for prioritizing investment needs. It is also
using accreditation of facilities as a tool for rationalizing services

89. The Government has continued to refine pharmaceutical policy in Bulgaria. The
new drug law approved in December 2006 and supported by DPL I addresses technical aspects
—like registration, manufacturing, and clinical research— as well as administrative and economic
aspects —e.g. licensing of businesses, pricing, and reimbursement— based on European
regulatory standards. During 2007 the Government developed new by-laws that provide the
framework for a more efficient reimbursement. If properly implemented the by-laws should lead
to reduced bureaucracy for registration, pricing and reimbursement decisions for new drugs
(originals and generics), better access to drugs that have a high value for public health; and use of
the purchasing power of public payers to get the best possible prices and share the risk of over-
spending with suppliers. It should also lead to improved governance in the sector.

90. The key by-laws for pricing and approving new drugs were adopted by the
Council of Ministers in December 2007. The first Ordinance on pricing establishes an
improved mechanism for determining the maximum price of a prescription drug that can be
offered in Bulgaria by setting up a system referencing the Bulgarian maximum price to a set of
comparison countries in the EU (the maximum price in Bulgaria will be the lowest of the
reference countries in the case of patent drugs and 80% of the lowest of the reference countries
in case of generic drugs). The effect of this Ordinance should be a faster and more transparent
mechanism to make products available in the Bulgarian market (i.e. the application process is
defined and time requirements are established). The pricing mechanism may reduce the price
that Bulgaria pays for patent drugs pen that they wdl reference their price to some countries
that mark the lower end of price distribution in Europe, but this will have to be studied. The
second Ordinance on the Positive Drug List (those Drugs which will be eligible for public
reimbursement either under the National Programs or through the NHIF) groups drugs
according to the international non-patent name and in accordance with the anatomic and
therapeutic classification code (ATC) for a defined daily dose; defines a single maximum rate for
reimbursement for the entire group and thus does not favor one drug over another with the same
therapeutic value; and in accordance with defined pharmaco-economic principles, allows a higher
rate of reimbursement for those drug groups with more cost-effectiveness. This will be an
improvement from the current situation where drugs are listed by name and their allowable
reimbursement percentage seems to be subject to discretion. The next step in the process will be
to prepare a positive list based on the new guidelines, assess the actual application of the by-laws
on the ground, and evaluate their impact on changes in prices, volumes, and access to basic
drugs. The draft list according to the new procedure is expected to be ready in April 2008.

91. **Medium term actions (DPL III) and new areas of dialogue.** In the medium term the
Government will continue implementing stabilization measures to improve the financial balance
of the NHIF and start implementing the structural reforms in the hospital sector. One of the
triggers of DPL III therefore calls for a decrease in hospital arrears, which should be the result of
applying the policies controlling hospital spending. In addition the DPL III should consolidate
the structural reforms in the supply of health care through the completion of the hospital
masterplan and beginning of its implementation. The Bank and the Government have identified
additional areas where policy changes are needed. Specifically:

i. **Additional changes in payment mechanisms.** Now that the Government has taken the
first essential step in changing the system for allocating resources to hospitals it is necessary
to fine-tune the payment systems, for example improving upon the per capita distribution of
resources across regions to later contract services with hospitals. In addition the negotiation
mechanism with providers (doctors and hospitals) needs to be improved to increase
efficiency further. The Bank is already providing technical assistance in this area through the
PHRD grant and the health sector reform project. One technical assistance activity will
review the current negotiation process and recommend changes to avoid the current
situation, a bilateral bargaining between the NHIF and the Bulgarian Medical Union in which
the NHIF cannot take advantage of its intended role as strategic purchaser of services.

ii. **The government has yet to reach an agreement among its coalition partners on a
rational co-payment policy for health services.** Currently there seems to be a significant
portion of the population making out of pocket payments (see paragraph 103). The current
coopayment structure has to be reviewed in light of two potentially contradictory facts: first,
out of pocket payments—many of which are co-payments—may be creating a barrier to
access for some groups. Second, there seems to be evidence of unnecessary demand for
some services like hospitals. One of the goals of universal health insurance is to protect
individuals from large negative shocks to their health, covering catastrophic or large health
related payments. At the same time unnecessary demand for services should be limited by
introducing adequate co-payments. The PHRD grant is financing a study to define a basic
benefit package together with a rational co-payment policy and options to develop
supplementary health insurance that should address the abovementioned problems.41

iii. **The Government is studying options to increase the role of the private sector in the
health insurance market.** This is a controversial issue as reflected by the difficulty in
reaching consensus in the context of the discussion of the health strategy. Currently NHIF
holds a monopoly in health insurance coverage, and there exists a very limited private sector
participation in supplementary health insurance. The options under discussion now vary

41 According to the Health Insurance Law, every visit to the GP, the specialist (with a referral) or the dentist the
insured patients pay a user fee equal to 1% of the Minimum Salary (currently minimum salary is BGN 160/month,
e.g. fee is BGN 1.6). Every day of hospital stay is paid at 2% of the Minimum Salary. If the insured person is
hospitalized for more than 10 days in a given calendar year, the person is only paying user fee for the first 10 days of
his/her stay. User fees are NOT paid by a number of groups, including but not limited to: children up to 18,
pregnant women, people in social homes and orphanages, conscript military, medical school graduates, people on
social assistance, etc. When lab tests are being conducted at the referral of the GP, specialist or dentist, the patient
pays at the lab a fee for collection of bio-material, not higher than 2 lev per lab visit regardless of the number of
tests for that visit. Fee for collection of material is waived for people with no income, those in social facilities, in
child orphanages and social care homes; and a user fee equal to 1% of the min salary. Finally, co-payments for
medications for home treatments entail a complex system of full or partial reimbursement, based on a Positive Drug
List approved by MoH and a special Reimbursement List of NHIF.
widely and include (i) maintaining the current NHIF monopoly; (ii) defining a basic package that NHIF would cover universally and adding complementary private insurance to cover services not included in the basic package; (iii) opening NHIF services to competition; and (iv) developing further the supplementary health insurance, whereby private companies offer improved services also covered by the NHIF. In addition to the PHRD supported study on supplementary insurance and co-payments, the Bank has provided assistance on this topic through the organization of a health policy roundtable to discuss different models prevailing in Europe, and it stands ready to support the Government further once a consensus is reached on the extent of private sector participation.

| Proposed actions for overarching objective 2
<table>
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<tbody>
<tr>
<td><strong>Overarching Objective 2: Promote fiscal sustainability through efficiency gains in social sectors</strong></td>
</tr>
<tr>
<td><strong>Issues/Problems</strong></td>
</tr>
<tr>
<td>Health service provision is inefficient and the financial sustainability in the National Health Insurance system is threatened</td>
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92. **Expected outcomes.** By the end of the DPL Series (2009), the expected outcomes are:

i. Financial projections of spending and revenues show the health system is financially sustainable as proxied by decrease in arrears (percent of total NHIF budget); Baseline 2005: 49 percent; value 2007: 26 percent; target: 25 percent

ii. Percentage of payments to hospitals channeled through NHIF remains constant or increases. Baseline: 55 percent (January-December 2005); target: 80 percent; value 2007: 75 percent;

iii. The proportion of spending on outpatient care relative to inpatient care has increased by 5 percent;

iv. With hospital spending under control the system becomes more efficient as shown by a convergence in inpatient admissions to the European average; average of EU in 2005: 18.03 per 100 (in Bulgaria 21);

v. Increase in efficiency through changes in payment mechanisms to hospitals, as reflected in a decrease in average length of stay over time. In 2006: 6.59; in 2007: 6.32
vi. The percentage of the Bulgarian population reporting access to pharmaceuticals increases (MTHS shows that 66 percent of population had access to all the needed medications in 2007)

vii. NHIF data showing that pharmaceutical spending is within budget and growing at a rate not higher than twice GDP growth. (2005-06 GDP growth: 6.1; pharmaceutical spending by NHIF: 11.0; GDP growth 2006-07: 6.4; pharmaceutical spending: 10.3)

viii. In the long term the measures supported by the program should contribute to increasing quality and access to basic health care, but will require complementary actions in the medium term. First, the changes in pharmaceutical regulations are intended to increase the speed of adoption of new drugs but at the same time make pricing decisions more rational and based on cost-effectiveness. By reducing reference prices and profit margins for pharmacists, drugs should become more affordable to the entire population. Second, the restructuring of hospitals is taking into account the epidemiological profile and the needs of different catchment areas and populations, and therefore resources are going to be allocated where they are needed the most. Third, it is widely acknowledged that hospital wards should have a certain number of cases every year for medical professionals to maintain their expertise and provide quality care. By restructuring hospitals, the wards with extremely low caseloads would eventually be closed and quality would improve. Also the masterplan would result in the creation of day surgery centers that could provide better quality for outpatient cases that are currently treated in hospitals. Finally, increase in monitoring by NHIF would result not only in tightening financial discipline but also assuring that quality protocols are followed as per the agreed requirements of care.

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

<table>
<thead>
<tr>
<th>Prior Action 9</th>
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<tbody>
<tr>
<td>The Government has maintained the unified standard and per student financing, and introduced delegated school budgets as a national policy</td>
</tr>
</tbody>
</table>

Status: completed

As envisioned under the DPL1, the Government has continued with the implementation of the financing reform in schools, and since January 1, 2007 municipalities started to receive all funds to cover both salary and non-salary expenditures for general education in municipal schools on a per student basis (as a “unified standard”). This move is a first important step in providing better incentives for municipalities to increase access, improve quality, and optimize their school network. The new financing system set four different financing standards for four different types of municipalities. Figure 6 presents the groups and per student standards. The first group consists of the municipalities which have over (or equal to) 70,000 people in the municipal center. The remaining municipalities (which all have less than 70,000 inhabitants living in their municipal centers) are divided into three groups: (i) municipalities with the population density greater than

42 The term “unified standard” is used in Bulgaria to describe the amount of money which municipalities receive per student enrolled in their general education schools. “Unified” indicates that it combines both wage and non-wage salaries in one amount. The amount, however, is not uniform; it can take one of four values, varying by municipal characteristics such as “mountainous”, “large metropolitan urban area”, “low population density” etc.

(or equal to) 65 per square kilometer; (ii) municipalities with the population density less than 65 per square kilometer; and (iii) small mountainous municipalities (a subgroup of (i) and (ii)) with more than three settlements, and less than 10,000 inhabitants in their municipal center. In 2008 the value of the standard will increase 23 percent relative to the 2007 level to reflect increases in salaries following the teachers strike.

Figure 6: Groupings of municipalities, along with baseline amounts and adjustment coefficients for 2007

Large municipalities: population ≥ 70,000 in the municipal center

15 municipalities: baseline amount BGN 796

70 municipalities: baseline amount x 1.2, or BGN 958

139 municipalities: baseline amount x 1.12, or BGN 894

40 municipalities: baseline amount x 1.07, or BGN 849

Underpopulated municipalities: population < 70,000 in the municipal center and a population density ≥ 65 persons per square meter

Small mountainous municipalities: population < 10,000 in the municipal center and ≥ 3 separate settlements

Other municipalities: population < 70,000 in the municipal center and population density < 65 persons per square meter

Source: World Bank staff

94. A special budget allocation of BGN 35 million was introduced in 2007 for a package of measures to support municipalities in the process of consolidating schools, and a similar fund worth BGN 27 million is being set up for school year 2008. To access this financing in 2007 municipalities had to present detailed plans on how students in the closed-down schools would be transported to and accommodated within remaining schools, to ensure that school closures are carefully planned and discussed within communities. A similar mechanism is in place for the 2008 period. Financing is awarded to municipalities based on the number of students in closed schools and reduced number of classes. For closed schools with no more than 20 pupils, a municipality will receive BGN 80,000; for schools with 20 to 44 students BGN 150,000, and for schools with more than 44 pupils BGN 250,000. The main criteria are the share of closed schools in total schools per municipality, the share of students in closed schools in total students per municipality and share of reduced classes in total classes. The eligible purposes for the usage of the funds are infrastructure investments - improvements in the material base of the school, including fixing up the building, additional class rooms, and improvements and construction of school canteens. The funds do not cover subsidies for food in the canteen or other expenses which are already covered through different MES programs (e.g. transport). Fifty percent of the funds are provided up front, upon agreement on the proposal and 50 percent after the closure of the school. A database with a geographical mapping of settlements and schools
across the entire country has been developed to determine which schools are too far away from the next school to ask pupils to commute — i.e. schools that need to be protected. So far 11 out of 28 regions have been reviewed and 20 schools identified — out of 1,200 schools. Using data from the NSI, the World Bank estimates that the number of school closures has risen considerably in recent years as shown in Table 6.

Table 6 Number of schools and number of school closures

<table>
<thead>
<tr>
<th></th>
<th>2002/03</th>
<th>2003/04</th>
<th>2004/05</th>
<th>2005/06</th>
<th>2006/07</th>
<th>2007/08e</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of schools</td>
<td>2720</td>
<td>2696</td>
<td>2657</td>
<td>2631</td>
<td>2551</td>
<td>2436</td>
</tr>
<tr>
<td>of which: rural</td>
<td>1533</td>
<td>1512</td>
<td>1476</td>
<td>1471</td>
<td>1379</td>
<td>1259</td>
</tr>
<tr>
<td>School closures, total</td>
<td>24</td>
<td>39</td>
<td>26</td>
<td>100</td>
<td>130</td>
<td>130</td>
</tr>
<tr>
<td>School closures, rural</td>
<td>21</td>
<td>36</td>
<td>5</td>
<td>92</td>
<td>120</td>
<td>120</td>
</tr>
</tbody>
</table>

Source: National Statistical Institute and World Bank Estimates for 2007/08

95. To further minimize the risk that drop outs increase as a result of school closures (especially among vulnerable groups), a number of initiatives are planned for the school year 2007/2008. Even though the analysis of previous school closures by the MES has not found evidence of drop outs increasing as a result of school closures, the accelerating pace of the consolidation process suggests that vigilance is warranted. Therefore, the Ministry plans to continue providing additional financing through the above mentioned package of measures in 2008 to minimize risks of higher drop-outs throughout the period of school closures. The MOF is also considering requiring municipalities to demonstrate that measures have been taken to target vulnerable groups.

96. In 2008, the Government has begun implementing one of the two remaining prongs of the finance and governance strategy — expanding delegated budgets to municipal schools and kindergartens as well as State schools (i.e. ensuring a rule-based funding scheme from municipalities to schools). The unified standard will help speed up school consolidation which, in turn should help increase the currently low class sizes. However, per capita financing to municipalities alone cannot be expected to achieve the objective of improving use of resources at the school level and creating a governance system with better incentives to lower dropout rates and improve the quality of education. The Government is working to ensure that education funds to municipalities are transferred onwards to schools in a transparent and rule-based manner, i.e. through the use of "delegated budgets". According to

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44 The third prong in the strategy, i.e. school based management, is planned for 2009.
45 Such shift is commonly referred to as expanding the use of "delegated budgets". However, there is some confusion regarding what "delegated budget" means in Bulgaria. The confusion arises from the fact that municipalities which have experienced with "delegated budgets" have introduced them in very different ways. Bulgaria began introducing delegated school budgets and school based management in the late 1990s (with EC support). By 2006, about 40 municipalities out of 264 had some form of delegated school budgets. Since each municipality developed its own system, there are substantial differences between them. However, a common feature is that budget delegation is limited in practice, and the school director has discretion only over all or parts of the non-staff budget. In the few instances where salaries are said to be delegated, it only means that the school manages the payment of salaries, not the determination of the number of staff or their salaries as these are determined by MES regulations. The shift to a delegated non-staff budget has been successful: municipalities and school directors consider their spending on the non-staff part of the budget more efficient than before. For further details on the evaluation of delegated school...
the 2008 Budget Act, municipalities allocate the education funds to their schools based on the same formula as the municipality receives the funds (i.e. the unified standard). However, special circumstances may warrant some departures from this general guidance (e.g. special needs of disadvantaged students at a particular school may warrant more spending on a particular school, or the expected closure of a school may also disrupt the basic funding formula). According to the Budget Act the allocation rule is to be based on municipal formulae, based on the unified standard and the number of students and children in schools and kindergartens. Additional components of the formula can be objective geographic and demographic factors that define differences in expenditure for educating one student or factors that reflect national or local educational policy. The number of staff and number of classes or groups cannot be used in the formula. From January 1, 2008, municipalities are required to pass on 100 percent of education financing from the central budget on to the schools. Out of this, 80 percent will be allocated according to the number of students in each school, while 20 percent can be reallocated across schools in recognition of special financing needs.

97. **Addition of New Prior Action.** In order to assure continuity in the implementation of policies complementing the introduction of per student financing throughout the entire DPL program, the incentive mechanism for school consolidation has been included in a new prior action for DPL II and a trigger for DPL III.

<table>
<thead>
<tr>
<th>Proposed new prior action</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government has maintained the package of measures and incentives to support the implementation of the unified standard and school consolidation</td>
</tr>
<tr>
<td>Status: completed</td>
</tr>
</tbody>
</table>

98. **Medium term actions (DPL III) and new areas of dialogue.** DPL III will focus on implementing school-based management. With DPL I and II having introduced funding schemes that provide better incentives to focus on quality, access and efficiency, the DPL III will focus on aligning the legislation governing education with the new financing system, and continue to train planners and educators to operate within a decentralized system. Given that some municipalities are further ahead than others, the third DPL will also have a chance to assess strengths and weaknesses of the unified standard and delegated budgets and propose changes. Two possible enhancements to the funding framework will be possible to consider by then, both of which seek to align funding more closely with the ultimate objective sought by the education system: producing the highest possible number of graduates with the desired level of competency. First, with external assessment data available by then, it will be possible to consider linking funding to learning outcomes. Second, with municipalities and school directors more attuned to receiving funding on a per capita basis, it will be possible to discuss linking funding to the number of graduates instead of merely to enrollments. School based management would involve relaxing the regulation governing class sizes and teacher work loads and shifting financial management of the school to the principals, including responsibility in hiring and firing of teachers and setting salaries.

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

99. **Expected Outcomes.** By the end of the DPL Program, the expected outcomes under the finance and governance are:

i. Increased efficiency as shown by halting the decreasing trend in pupil-teacher ratio in public schools (for grades 1-13) observed since 2002.\(^{46}\) That is, the pupil-teacher ratio remains roughly unchanged at its 2006 level (13.1).\(^{47}\)

ii. Increased efficiency as shown by reductions in average drop-outs as a percent of total enrolments in small mountainous municipalities (proxies for regions that struggle with largest declines in population) (from baseline of 3.7, 5.1 and 4.2 percent for grades 1-4, 5-8 and 9-13, respectively, in 2005)

iii. Percent of municipal education budget delegated to schools increases (from baseline of 0 to target of 100 percent; value 2006-2007: 80 percent)

iv. Percent of municipal schools financed through unified standard increases (from baseline of 0 to target of 100 percent; value 2007/2008: 100 percent)

100. Table 7 summarizes the expected impact of the policies supported by the DPL series on various outcomes. The table explains how the proposed actions are expected to achieve the stated outcomes, and distinguishes between long term outcomes, i.e. those that are related to the policies but will take longer to materialize and therefore will not be measured during the lifetime of the DPL program; the outcomes that will be measured during the life of the program; and the intermediate outputs which can be measured as proxies for the outcomes they are related to. In addition the table explains how some complementary measures would be necessary to achieve certain outcomes (especially those which are long term)

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\(^{46}\) Pupil-teacher ratios in public schools declined continuously from 14.2 in 2002 to 13.1 in 2006 according to NSI school-based data.

\(^{47}\) Source: NSI detailed school-by-school data. Total number of students in public schools (grades 1-13) and teachers in 2006: 771,156 and 54,442, respectively. Maintaining roughly constant pupil-teacher ratio is no small feat, given that the school age population is expected to decline by 10 percent between 2006 and 2009, according to UN (medium variant) projections.
<table>
<thead>
<tr>
<th>Issues/Problems</th>
<th>DPL 2 policies</th>
<th>Transmission mechanism</th>
<th>Outcomes</th>
</tr>
</thead>
<tbody>
<tr>
<td>LOW EMPLOYMENT, HIGH PERCENTAGE</td>
<td>The Government has removed the automatic portability of the seniority bonus, transforming it into a bonus for relevant professional experience</td>
<td>Seniority bonus creates a distortion in cost of hiring labor and reduces labor mobility. Removing it should provide more incentives for employers to hire productive labor from other sectors, increase mobility and contribute to productivity increase</td>
<td>An increase in the employment rate of younger workers to at least 25 percent (age 15-24, Eurostat data) from the 2005 baseline of 21.6 percent, with intermediate status (2006) of 23.2 percent; An increase in the employment rate of older workers to at least 40 percent (age 55-64, Eurostat data) from the 2005 baseline of 34.7 percent, with intermediate status (2006) of 39.6 percent; An increase in the activity rate of younger workers to at least 30 percent (age 15-24, Eurostat data) from the 2005 baseline of 27.9 percent, with intermediate status (2006) of 28.9 percent;</td>
</tr>
<tr>
<td>OF LONG TERM UNEMPLOYED, AND HIGH RATES OF INFORMALITY IN THE LABOR MARKET</td>
<td>The MLSP has restructured active labor market programs as per the Employment Action Plans 2007 and 2008 to strengthen on the job qualification and professional training programs and service delivery linked to private sector skill needs</td>
<td>ALMPs, by providing re-training and actively advising long term unemployed would increase employment rate and decrease long term unemployment. The focus of ALMPs on the young, the old, and the less educated should move the employment rate in those groups closer to EU average</td>
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<tr>
<td>SOCIAL WELFARE PROGRAM DESIGN</td>
<td>The Government has prepared an ex ante assessment of the impact of measures to strengthen work incentives in the social assistance system, and based on its conclusions has developed an employment activation program including individual action plans for social assistance beneficiaries</td>
<td>Impact evaluation will provide valuable information to be used in re-targeting the program so that only vulnerable groups receive it</td>
<td>An increase in the activity rate of older workers to at least 45 percent (age 55-64, Eurostat data) from the 2005 baseline of 38 percent, with intermediate status (2006) of 43 percent; As an intermediate output that would result in a decrease in long term unemployment the relative share of individuals benefiting from training out of the total number of beneficiaries of active labor market programs increases, from the 2005 baseline of 19.4 percent, as well as an increase in absolute numbers of beneficiaries of training programs; Progress to date: 26.5 Increase in contribution compliance in 2006 (as a proxy for the incentive to job creation and reducing informality associated with the reduction in social security contribution rate by 6 percentage points in January 2006), evident in a lower actual decrease in contribution revenue (94.1 percent in 2006, 2005=100) compared to that implied by the rate cut (79.3 percent, 2005=100) (linked to DPL 1 action).</td>
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<tr>
<td>CREATES DISINCENTIVES FOR JOB SEARCHING</td>
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<tr>
<td>Issues/Problems</td>
<td>DPL 2 policies</td>
<td>Transmission mechanism</td>
<td>Outcomes</td>
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<tr>
<td>QUALITY OF EDUCATION HAS BEEN DECLINING AND THE INSTITUTIONAL CAPACITY FOR QUALITY ASSESSMENT IS LACKING</td>
<td>Bulgaria has taken part in international assessment tests, like PISA 2006, PIRLS 2006, and TIMSS 2007. In addition, MES has administered sample testing of Matura in Bulgarian language and Literature, Math and Foreign languages, a new national placement tests for 7th graders and a new census-based test of 4th graders.</td>
<td>Testing provides objective information on quality of education. Collecting information, and using it to make evidence based policy changes is a necessary condition to improve quality of education. It should be accompanied by other policies like providing the incentives for schools to use that information to make the necessary changes to make improvements, including managerial authority to make those changes at the local level. Some of these accompanying policies will be implemented under DPL III. By implementing tests the MES will develop capacity to assess quality.</td>
<td>Reports on Quality assessment prepared by CKOKO and made available to the public increase (from a baseline of 0 to a target of 5) (an intermediate output showing progress in building capacity for quality assessment —and ultimately improving quality if the information is used in critical ways)</td>
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<td></td>
<td>The Ministry of Education and Science (MES) has trained at least 50 percent of school directors through the Institute of School Directors</td>
<td>The training of Regional Inspectors, Principals and other key education managers and administrators will allow them to pro-actively use assessment data to improve the quality of education by focusing on school improvement plans and interventions, spotting failing schools, identifying teacher training needs and necessary curriculum adaptations</td>
<td>Placment of students in upper secondary institutions is done on the basis of objective ability testing (using the new 7th grade national test) (intermediate outcome that shows information is used for quality improvements). Matura examination results are used by Bulgarian universities as credential for admission (showing information on quality is being used critically). The percentage of Regional Inspectorates and of newly appointed principals reporting that student assessment data (regional and school-level, respectively) are being used as one of the key factors to introduce innovation programs increases Schools principals have the capacity to manage schools as shown in the number of principals receiving training</td>
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<tr>
<td>Issues/Problems</td>
<td>DPL 2 policies</td>
<td>Transmission mechanism</td>
<td>Outcomes</td>
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<tr>
<td><strong>Overarching objective 2: promote fiscal sustainability through efficiency gains in social sectors</strong></td>
<td></td>
<td></td>
<td>Financial projections of spending and revenues show the health system is financially sustainable at proposed levels. SVR percent increase by year (percent of total NHIF budget); Baseline: 2005: 49 percent; value 2007: 26 percent; target: 25 percent. Percentage of payments to hospitals channeled through NHIF remains constant or increases. Baseline: 55 percent (January-December 2005); target: 80 percent; value 2007: 75 percent; The proportion of spending on outpatient care relative to inpatient care has increased by 5 percent; to be completed.</td>
</tr>
<tr>
<td>The role of the NHIF as a primary payer of hospitals is maintained and payment system has been improved to promote an efficient use of resources and financial sustainability of the national health insurance system</td>
<td>Unifying payment should avoid duplication of administrative costs and provide more order into hospital spending. The changes in the payment system for hospitals are providing NHIF with an additional tool to control spending and therefore improving prospects for financial sustainability. As the new payment system introduces a limit in the budgets for hospitals, it also creates an incentives for the institutions to use resources more efficiently.</td>
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<tr>
<td>The Government has taken the first steps towards implementation of the masterplanning exercise by endorsing: (i) the guidelines and recommendations on health service planning; and (ii) framework for prioritizing investment needs. It is also using accreditation of facilities as a tool for rationalizing services</td>
<td>The hospital masterplan will estimate the ideal location of facilities, the type of services that should be provided at each level, the organizational model for better management and accountability. By emphasizing newer modalities of care like one day surgery and transforming some facilities from acute to long term care it should reduce costs of operating the system and be more responsive to population needs in different regions.</td>
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<tr>
<td>The Government further adopts and implements measures that would improve pharmaceutical approval, pricing, and reimbursement policies to increase the efficiency of public spending on pharmaceuticals and access to essential drugs (e.g. Unify drug lists into one single list based on INN name and ATC/DDD classification)</td>
<td>Changes in pharmaceutical procurement and reimbursement will promote the faster introduction of new drugs in the market and reduce prices as the reference system for new drugs looks at the cheapest price in a number of European countries. In order to fully result in improved access to basic drugs the Government will have to assess the impact of the changes in legislation and implement accompanying measures, like promoting the use of generics by the public (generally cheaper) and prescribing physicians (being motivated to follow the best prescribing guidelines).</td>
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HEALTH SERVICE PROVISION IS INEFFICIENT AND THE FINANCIAL SUSTAINABILITY IN THE NATIONAL HEALTH INSURANCE SYSTEM IS THREATENED.
<table>
<thead>
<tr>
<th>Issues/Problems</th>
<th>DPL 2 policies</th>
<th>Transmission mechanism</th>
<th>Outcomes</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Government has maintained the unified standard and per student financing, and introduced delegated school budgets as a national policy</td>
<td>With funding being linked to the number of students enrolled (and not the number of teachers), municipalities will have a strong financial incentive to optimize its school network. As a result, average class sizes should be expected to rise, and efficiency increase. Mitigation mechanism should prevent school consolidation from increasing drop out rates especially among vulnerable groups. In fact, other things equal, drop-outs should decrease because: Per student financing should provide incentive for municipalities to attract and retain students to schools as that is the only way they receive funds. Under per capita financing, each student that drops out implies a substantial fiscal loss to municipalities, especially the small ones. With strong incentives to retain students, municipalities will more aggressively try to discourage early school leavers.</td>
<td>Increased efficiency as shown by the halting of the decreasing trend in pupil-teacher ratio in public schools (for grades 1-13) observed since 2002, that is, the pupil-teacher ratio remains roughly unchanged at its 2006 level (13.1). Increased efficiency as shown by the improvements in average drop-outs as a percent of total enrolments in small mountainous municipalities (proxies for regions that struggle with largest declines in population) (from baseline of 3.7, 5.1 and 4.2 percent for grades 1-4, 5-8 and 9-13, respectively, in 2005) Percent of municipal education budget delegated to schools increases (intermediate output) baseline: 0 value: 2006-2007: 80 percent target: 100 percent Percent of municipal schools financed through unified standard increases (intermediate output) baseline: 0 target: 100 percent</td>
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ANNEX 2: LETTER OF DEVELOPMENT POLICY

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

September 30, 2008

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

Dear Mr. Zoellick:

1. We appreciate this opportunity to request continuing support from the World Bank for the implementation of our medium term reform agenda and, on behalf of the Government of Bulgaria, we request a Second Development Policy Loan (SIR DPL II) for US $150 million equivalent with a deferred drawdown option (DDO) to continue the series of three development policy loans as per the Country Partnership Strategy (CPS) between the World Bank and the Republic of Bulgaria approved by the World Bank Board on June 13th, 2006. We believe that this series of development policy loans continues to provide the appropriate vehicle for Bank support in addressing our medium term policy and institutional reform agenda, and in supporting the country in its full integration into the European Union after the recent accession on January 1, 2007.

2. Following completion of the measures from SIR DPL I, we are continuing to use the support of the Bank for advancing the reforms in the social sectors and SIR DPL II continues to focus on these sectors. The program is consistent with the Country Partnership strategy and its strategic areas:

- **Raising productivity and employment in support of private sector-led growth along the lines of the EU's Lisbon Agenda**: The three programmatic DPLs (FY07-09) will support the productivity and employment agenda by focusing on: (i) the reform of the labor framework and social protection system to increase employment by lowering payroll taxes, reducing social assistance dependency, reforming disability benefits, and increasing formal employment through more flexible work arrangements and better incentives to participate in the formal economy and (ii) the reforms in the education sector to strengthen the institutional capacity to monitor and improve quality and increase accountability to lay the foundation for long-term productivity growth.

- **Fiscal sustainability and improved capacity for absorption of EU funds**: The DPL series will focus on improving the efficiency of the health, education, pension and social assistance systems to support their financial sustainability and effectiveness. In health, the focus will be on improving financial sustainability of the National Health Insurance Fund (NHIF), restructuring of the hospital sector, and improved efficiency in the pharmaceutical sector. In education, the DPLs will support finance and governance...
reforms that would help improve both the quality of education, and how efficiently the resources available for education are being used. The reforms in these sectors will also open windows of opportunity to utilize EU funds as new programs are being created or old programs reformed.

3. Poverty reduction and social inclusion are not explicitly addressed in the DPL program but many of its policies are expected to have an impact on poverty.

4. We expect that at the end of the DPL series some positive outcomes will be achieved, specifically (i) an increase in the employment rate of younger workers (15 to 24) to at least 25 percent and older workers (55 to 64) to at least 40 percent, (ii) a sustainable spending level for hospitals, (iii) a basic package of drugs available to the majority of the population and a faster process to introduce new pharmaceutical products; and (iv) a more efficient school financing mechanism.

5. We have maintained macroeconomic stability as a precondition for the effectiveness and sustainability of the above program. We will maintain the Currency Board Arrangement (CBA) until accession to the Eurozone. The CBA has served Bulgaria well, providing a stable monetary environment, contributing to low inflation, and boosting confidence. We are fully committed to take all of the necessary steps to support it. We will continue to implement a cautious and flexible fiscal policy, which is a key to safeguarding external viability under the CBA. We have aimed to reach, and then maintain, a broadly balanced fiscal stance in the medium term, remaining prepared to adjust our fiscal policy in case of further widening of the external current account deficit.

6. In the course of implementing SIR DPL I and while preparing SIR DPL II, we have developed and implemented various components of our reform program that will be completed by the end of this series of three loans. The final design of SIR DPL II has benefited from a strong monitoring and evaluation system, implemented in coordination with the Bank and built during the preceding series of Programmatic Adjustment Loans (PALs). This has enabled us to take actions necessary to ensure the sustained implementation of policies and the successful outcomes of institution-building efforts. The programmatic approach of the PALs was transferred to the DPLs as it provides us with the flexibility to make sound adjustments in our program and to build on new information and additional experience in institutional design and implementation in moving towards the successful achievement of our strategic objectives and program outcomes.

7. This Letter of Development Policy summarizes the elements of our program supported by SIR DPL II and with expected follow up in DPL 3, while the reform program outcomes and the critical steps taken to achieve those outcomes are summarized in the accompanying Matrix of Performance Benchmarks and Desired Outcomes.

8. The DPL overarching objectives related also to the Country’s strategic priorities and the approved CPS are:

**Overarching Objective 1: Increase employment and lay the foundations for long-term productivity growth by providing incentives for job creation and improving quality of education**
9. Through actions under this objective the DPL series will solve several problems.

10. **First, Low employment, high percentage of long term unemployed and high rates of informality in the labor market are an issue.** Our government, through the Ministry of Labor and Social Policy in particular, has started to implement policies under the flexicurity framework in the context of rapidly falling unemployment and emerging labor shortages. After amending the Labor Code in 2006 to increase flexibility in working conditions (working time and fixed and part-time contracts) and align it with the EU working time directive the Government has implemented additional policies to reduce distortions and increase flexibility in the labor market. The Government has implemented a further 3 percentage point decrease in social insurance contributions. And, as of January 1, 2008 the Government reduced the share of the employer in the public pension contribution to 60 percent and increased the share of the employee to 40 percent. In order to reduce distortions to labor mobility over the medium term the government has removed the portability of the seniority bonus by transforming it into a bonus which recognizes professional experience in a certain area. Following the results of an impact evaluation of ALMPs, MLSP started restructuring the active labor market programs (ALMPs) mix in the 2006 and 2007 annual employment action plans to strengthen their focus on on-the-job qualification and on linking training to private sector skill needs. The 2007 and 2008 Employment Action Plans restructure ALMPs further, placing additional emphasis on training and improving skills among the young, the old and those with low educational attainments.

11. **Second, we will tackle the problem of the Social Welfare Program design creating disincentives for job searching.** Aiming to promote employment activation in times of rising labor demand at all levels of the skills distribution, the MLSP has introduced measures to tighten eligibility of social assistance for working age individuals who are capable to work. The DPL series is not supporting this policy but its ex ante assessment and impact evaluation, analyzing the profile of the affected GMI beneficiaries and the reasons for staying unemployed in the long term, so that the Government can make informed policy changes to the program in case of negative welfare effect. Based on the review of administrative data, the Employment Offices have held interviews with every affected beneficiary and have developed individual action plans.

12. By the end of the DPL Program, the expected outcomes are:

vii. An increase in the employment rate of younger workers to at least 25 percent (age 15-24, Eurostat data) from the 2005 baseline of 21.6 percent, with intermediate status (2006) of 23.2 percent;

viii. An increase in the employment rate of older workers to at least 40 percent (age 55-64, Eurostat data) from the 2005 baseline of 34.7 percent, with intermediate status (2006) of 39.6 percent;

ix. An increase in the activity rate of younger workers to at least 30 percent (age 15-24, Eurostat data) from the 2005 baseline of 27.9 percent, with intermediate status (2006) of 28.9 percent;

x. An increase in the activity rate of older workers to at least 45 percent (age 55-64, Eurostat data) from the 2005 baseline of 38 percent, with intermediate status (2006) of 43 percent;

xi. As an intermediate output that would result in a decrease in long term unemployment the relative share of individuals benefiting from training out of the total number of beneficiaries of active labor market programs increases, from the 2005 baseline of 19.4 percent with
intermediate value of 26.5 percent (December 2007), as well as an increase in absolute numbers of beneficiaries of training programs; and

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

13. **Third, we will address the problem that quality of education has been declining and the institutional capacity for quality assessment is lacking.** The strategy to improve quality of education in Bulgaria consists of increasing training of educators, introducing modern technologies in the curriculum, gathering data on performance, and building capacity at the MES to assess quality and performance. The Government expects that improving education will also contribute in the medium term to the goal of increasing productivity and skills of workers.

14. The SIR DPL 2 will support our strategy to strengthen the Ministry of Education and Science’s (MES') institutional capacity to assess the impact of curricular and other reforms on the quality of education. This has the potential to radically switch priorities in policy making for the education sector, bringing the quality of student learning to the top of the policy agenda. The Centre for Control and Assessment of the Quality of Education (CKOKO) will institutionalize and sustain the goals of an efficient, transparent, and outcome-oriented education system. The DPL series will be supporting four different testing activities in Bulgaria: a) a new placement test at the end of 7th grade which has the potential to radically overhaul current patterns of student access to upper secondary school; b) designing and piloting a new Matura, i.e., secondary school-leaving examination; c) new tests (sample or census-based) to be used strictly as system-wide evaluation of education quality; and d) managing Bulgaria’s participation in international achievement tests. As part of DPL I we have approved a three-year plan for CKOKO, and our Council of Ministers approved action plan for the implementation of the National Strategy for the Introduction of Information Technologies in Bulgarian Schools and begins implementation.

15. By the end of the DPL Program, the expected outcomes are:

vii. Reports on Quality assessment prepared by CKOKO and made available to the public increase (from a baseline of 0 to a target of 5) (an intermediate output showing progress in building capacity for quality assessment —and ultimately improving quality if the information is used in critical ways)

viii. Placement of students in upper secondary institutions is done on the basis of objective ability testing (using the new 7th grade national test) (intermediate outcome that shows information is used for quality improvements).

ix. Matura examination results are used by Bulgarian universities as credential for admission (showing information on quality is being used critically)

x. The percentage of Regional Inspectorates and of newly appointed principals reporting that student assessment data (regional and school-level, respectively) are being used as one of the key factors to decide on staffing, budget allocation and innovation programs increases (from a baseline of 0 in 2005 to a target of 60 percent)
xi. Schools principals have the capacity to manage schools as shown in the number of principals receiving training.

xii. 35 percent of subjects in the primary and secondary education curriculum have e-technology and multimedia content available to teachers and students.

Overarching objective 2: Promote fiscal sustainability through efficiency gains in social sectors

16. Under this overarching objective we will address two main problems.

17. First, the inefficiency in health service provision and less than universal access to care, as well as threats to the financial sustainability in the National Health Insurance system. Our Government initiated—with support of DPL I—a series of actions to control spending in hospitals. The government has introduced in the 2008 NHIF Budget Act an indicative ceiling in the budget of hospitals using historical figures and population needs. This should control spending by hospitals and close the open ended nature of the budgeting system used in the past. On the supply side, we are initiating measures to restructure the hospital sector to adapt it to modern practices that rely more on outpatient, less expensive care. We started a hospital masterplanning exercise, which will propose new models for health care provision in Bulgaria. It will estimate the ideal location of facilities, the type of services that should be provided at each level, the organizational model for better management and accountability, and the costs necessary to implement the network optimization program. We also continued to refine pharmaceutical policy in Bulgaria. The new drug law approved in December 2006 and supported by DPL I addresses technical, administrative, and economic aspects based on European regulatory standards. The key by-laws for pricing and introduction of new drugs were adopted by the Council of Ministers in December 2007.

18. By the end of the DPL Series (2009), the expected outcomes are:

ix. Financial projections of spending and revenues show the health system is financially sustainable as proxied by decrease in arrears (percent of total NHIF budget); Baseline 2005: 49 percent; value 2007: 26 percent; target: 25 percent

x. Percentage of payments to hospitals channeled through NHIF remains constant or increases. Baseline: 55 percent (January-December 2005); target: 80 percent; value 2007: 75 percent;

xi. The proportion of spending on outpatient care relative to inpatient care has increased by 5 percent;

xii. With hospital spending under control the system becomes more efficient as shown by a convergence in inpatient admissions to the European average; average of EU in 2005: 18.03 per 100 (in Bulgaria 21);

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

xiv. The percentage of the Bulgarian population reporting access to pharmaceuticals increases (MTHS shows that 66 percent of population had access to all the needed medications in 2007)

xv. NHIF data showing that pharmaceutical spending is within budget and growing at a rate not higher than twice GDP growth. (2005-06 GDP growth: 6.1; pharmaceutical spending by NHIF: 11.0; GDP growth 2006-07: 6.4; pharmaceutical spending: 10.3)
19. The second problem is that Current governance and financing system for schools provide only weak incentives to focus on quality, drop-out rates, and efficiency of spending. As envisioned under the SIR DPL I, we continued with the implementation of the financing reform in schools, and since January 1, 2007 municipalities started to receive all funds to cover both salary and non-salary expenditures for general education in municipal schools on a per student basis (as a “unified standard”). A special budget allocation of BGN 35 million was introduced in 2007 for a package of measures to support municipalities in the process of consolidating schools, and a similar fund worth BGN 27 million is being set up for school year 2008. To further minimize the risk that drop outs increase as a result of school closures (especially of vulnerable groups), a number of initiatives are planned for the school year 2007/2008. In 2008, we have begun implementing one of the two remaining prongs of the finance and governance strategy — expanding delegated budgets to municipal schools and kindergartens as well as State schools (i.e. ensuring a rule-based funding scheme from municipalities to schools).

20. By the end of the DPL Series (2009), the expected outcomes are:

v. Increased efficiency as shown by halting the decreasing trend in pupil-teacher ratio in public schools (for grades 1-12) observed since 2002. That is, the pupil-teacher ratio remains roughly unchanged at its 2006 level (13.1).

vi. Increased efficiency as shown by improvements in average drop-outs as a percent of total enrolments in small mountainous municipalities (proxies for regions that struggle with largest declines in population) (from baseline of 3.7, 5.1 and 4.2 percent for grades 1-4, 5-8 and 9-12, respectively, in 2005)

vii. Percent of municipal education budget delegated to schools increases (from baseline of 0 to target of 100 percent; value 2006-2007: 80 percent)

viii. Percent of municipal schools financed through unified standard increases (from baseline of 0 to target of 100 percent; value 2007/2008: 100 percent)

21. We would like to reiterate that the Bulgarian Government is committed to continuing reforms and, in particular, to sustaining and continuing the reform agenda needed for the full integration into the EU as defined above, now that Bulgaria is a member of the Union. A new government program has just been drafted and adopted by the Government coalition partners, which further defines the specific actions in the months ahead. We look forward to the World Bank’s support to Bulgaria in its development program including through development policy loans focusing on the future reform agenda for successful integration into the EU.

Sincerely yours,

[Signatures]

Petar Dimitrov
Minister of Economy and Energy

Plamen Oresharski
Minister of Finance

Sofia, Bulgaria
September 2008
## ANNEX 3: OPERATION POLICY MATRIX

<table>
<thead>
<tr>
<th>Issue/problem</th>
<th>Actions DPL I</th>
<th>Prior Actions DPL II</th>
<th>Triggers third phase</th>
<th>Desired outcomes 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Macroeconomic stability is necessary for sustained growth</td>
<td>Maintenance of a satisfactory macroeconomic policy framework</td>
<td>Maintenance of a satisfactory macroeconomic policy framework</td>
<td>Maintenance of a satisfactory macroeconomic policy framework</td>
<td>A stable macroeconomic framework which would provide the necessary conditions for achievement of identified outcomes in the social sector.</td>
</tr>
<tr>
<td>Low employment, high percentage of long term unemployed, and high rates of informality in the labor market</td>
<td>The government has enacted amendments to the labor code to increase flexibility of working time and fixed term and part-time contracts. The government has enacted amendments to the social insurance code to lower the contribution rate for pension insurance by 6 percentage points from 29 to 23 percent.</td>
<td>The Government has removed the automatic portability of the sensory bonus, transforming it into a bonus for relevant professional experience.</td>
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<td></td>
<td>The government has enacted amendments to the employment promotion act to introduce a monthly bonus for unemployed recipients of social assistance who find employment at their own initiative.</td>
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<tr>
<td></td>
<td>The MLSP has restructured active labor market programs as per the Employment Action Plans 2007 and 2008 to strengthen the job qualification and professional training programs and service delivery linked to private sector skill needs.</td>
<td>The Council of Ministers has approved the updated National Employment Strategy. The Government has enacted amendments to the Employment Promotion Act to raise the skills and competitiveness of the employed through incentivizing adult education and on the job qualification and training. The Government has enacted amendments to the Vocational Education Act, Employment Promotion Act and Act on Foreigners in the Republic of Bulgaria to open opportunities for second chance education for early school leavers, low skilled and people without education. In order to improve investment climate and promote job creation the Government is implementing a national policy to institutionalize Regulatory Impact Assessments.</td>
<td>An increase in the activity rate of younger workers to at least 25 percent (age 15-24, eurostat data) from the 2005 baseline of 21.6 percent, with intermediate states (2006) of 23.2 percent; An increase in the employment rate of older workers to at least 40 percent (age 55-64, eurostat data) from the 2005 baseline of 34.7 percent, with intermediate states (2006) of 39.6 percent; An increase in the activity rate of younger workers to at least 30 percent (age 15-24, eurostat data) from the 2005 baseline of 27.5 percent, with intermediate states (2006) of 28.9 percent; An increase in the activity rate of older workers to at least 45 percent (age 55-64, eurostat data) from the 2005 baseline of 38 percent, with intermediate states (2006) of 43 percent; As an intermediate output that would result in a decrease in long term unemployment the relative share of individuals benefiting from training out of the total number of beneficiaries of active labor market programs increases, from the 2005 baseline of 19.4 percent, as well as an increase in absolute numbers of beneficiaries of training programs; Progress to date: 26.5 Increase in contribution compliance in 2006 (as a proxy for the incentive to job creation and reducing informality associated with the reduction in social security contribution rate by 5 percentage points in January 2006), evident in a lower actual decrease in contribution revenue: 94.1 percent in 2006, 89.5% in 2007, 84.2% in 2008 compared to that implied by the rate cut (93.3 percent, 2005–100) (linked to DPL II action).</td>
<td></td>
</tr>
<tr>
<td>Social welfare program design creates disincentives for job searching</td>
<td>The government has developed and piloted one new project and scaled up one national program and two encouragement measures stipulated in the employment promotion act to encourage labor market integration of people with disabilities.</td>
<td>The Government has prepared an ex ante assessment of the impact of measures to strengthen work incentives in the social assistance system, and based on its conclusions has developed an employment activation program excluding individual action plans for social assistance beneficiaries.</td>
<td>The Government has conducted an assessment of the effectiveness of employment activation incentives in the social assistance system.</td>
<td></td>
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</table>

71
<table>
<thead>
<tr>
<th>Issues/problems</th>
<th>Actions DPL I</th>
<th>Prior Actions DPL II</th>
<th>Trigger third phase</th>
<th>Desired outcomes 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quality of education has been declining and the institutional capacity for quality assessment is lacking</td>
<td>The MES has approved the 2007-2009 program of activities to be implemented by COKO and COKO has implemented a pilot sample-based national assessment of student performance in grade 7</td>
<td>Bullets has taken part in international assessment tests, like PISA 2006, PIRLS 2006, and TIMSS 2007. In addition, MES has administered sample testing of Matura in Bulgarian language and Literature, Math and Foreign languages, a new national placement test for 7th graders and a new census-based test of 4th graders</td>
<td>The Matura examination (national secondary school-leaving certification test) in all subjects is implemented nationally</td>
<td>Reports on Quality assessment prepared by COKO and made available to the public increase (from a baseline of 0 to a target of 5) (an intermediate output showing progress in building capacity for quality assessment —and ultimately improving quality if the information is used in critical ways). Placement of students in upper secondary institutions is done on the basis of objective ability testing (using the new 7th grade national test) (intermediate outcome that shows information is used for quality improvements). Matura examination results are used by Bulgarian universities as credentials for admission (showing information on quality is being used critically). The percentage of Regional Inspectors and of newly appointed principals reporting that student assessment data (regional and school level, respectively) are being used as one of the key factors to introduce innovation programs increases. Schools principals have the capacity to manage schools as shown in the number of principals receiving training.</td>
</tr>
<tr>
<td>Overarching objective 2. promote fiscal sustainability through efficiency gains in social sectors</td>
<td>Council of ministers has: (i) approved an action plan for the implementation of the national strategy for the introduction of information technologies in Bulgarian schools, and (ii) started to implement such action plan</td>
<td>The Ministry of Education and Science (MES) has trained at least 50 percent of school directors through the Institute of School Directors</td>
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<tr>
<td>Health service provision is inefficient and the financial sustainability in the National Health Insurance system is threatened</td>
<td>In order to improve the financial balance of the national health insurance system, the government has: (i) increased the health insurance premium revenue; (ii) unified payment mechanisms for hospitals; (iii) included limits in the volume of services to be paid by NHIF to hospitals in the draft NHIF budget law for 2007; and (iv) signed recovery plans with universities, national and regional hospitals with a state majority ownership.</td>
<td>The role of the NHIF as a primary payer of hospitals is maintained and payment system has been improved to promote an efficient use of resources and financial sustainability of the national health insurance system.</td>
<td>Financial projections of spending and revenues show the health system is financially sustainable as projected by decrease in arrears (percent of total NHIF budget). Baseline: 2005: 49 percent; value 2007: 26 percent; target: 25 percent. Percentage of payments to hospitals channelled through NHIF remains constant or increases. Baseline: 55 percent (January-December 2005); target: 80 percent; value: 2007: 75 percent. The proportion of spending on outpatient care relative to inpatient care has increased by 5 percent, to be completed. With hospital spending under control the system becomes more efficient as shown by a convergence in inpatient admissions to the European average, average of EU in 2005: 18.03 per 100 (in Bulgaria 21). Increase in efficiency through changes in payment mechanisms to hospitals, as reflected in a decrease in average length of stay over time. In 2006: 6.59; in 2007: 6.32. The percentage of the Bulgarian population reporting access to pharmaceuticals increases (M131S shows that 66 percent of population had access to all the needed medications in 2007). NHIF data showing that pharmaceutical spending is within budget and growing at a rate not higher than twice GDP growth. (2005-06: GDP growth 6.1; pharmaceutical spending by NHIF: 11.0; GDP growth 2006-07: 6.4; pharmaceutical spending 10.3)</td>
<td></td>
</tr>
<tr>
<td>The government has submitted legislation to the parliament to improve pharmaceutical approval, pricing and reimbursement policies to increase the efficiency of public spending on pharmaceuticals and access to essential drugs.</td>
<td>The Government has taken the first steps towards implementation of the masterplanning exercise by endorsing (i) the guidelines and recommendations on health service planning, and (ii) framework for prioritizing investment needs. It is also using accreditation of facilities as a tool for rationalizing services.</td>
<td>The government is implementing structural reforms to improve the efficiency of the hospital sector, for example consolidating hospitals according to the masterplan.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Issue/problems</td>
<td>Actions DP II</td>
<td>Prior Actions DP II</td>
<td>Triggers third phase</td>
<td>Desired outcomes 2009</td>
</tr>
<tr>
<td>-------------------------------------------------------------------------------</td>
<td>---------------------</td>
<td>------------------------------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Current governance and financing system for schools provide only weak incentives to focus on quality, drop-out rates, and efficiency of spending.</td>
<td>Council of Ministers has approved: (1) a new financing formula (&quot;unified standard&quot;), for allocating funds to municipalities for their school networks; and (2) the plan for a phased introduction of the new financing formula.</td>
<td>The Government has maintained the unified standard and per student financing, and introduced delegated school budgets as a national policy.</td>
<td>Process of consolidating state schools and transferring them to municipalities continues. School-based management is rolled out nationally.</td>
<td>Increased efficiency as shown by the halting of the decreasing trend in pupil-teacher ratio in public schools (for grades 1-13) observed since 2002, that is, the pupil-teacher ratio remains roughly unchanged at its 2006 level (33.3). Increased efficiency as shown by the improvements in average drop-outs as a percent of total enrollments in small mountainous municipalities (proxies for regions that struggle with largest declines in population) (from baseline of 3.7, 5.1 and 4.2 percent for grades 1-4, 5-8 and 9-13, respectively, in 2005) Percent of municipal education budget delegated to schools increases (intermediate output) baseline: 0, value 2006-2007: 80 percent, target: 100 percent. Percent of municipal schools financed through unified standard increases from baseline: 0 to target: 100 percent (intermediate output).</td>
</tr>
</tbody>
</table>
ANNEX 4: BULGARIA FUND RELATIONS NOTE

As of September 9, 2008


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

*IMF team*: Messrs. Bakker (head) and Lybek, Ms. Zhou (all EUR), Ms. Rahman (PDR), Mr. Fernandez-Ansola (Senior Regional Resident Representative), and Ms. Mihaylova (Resident Economist).

*Previous Article IV consultation:* The previous consultation was concluded on August 2, 2006, and the reports were posted at [www.imf.org](http://www.imf.org) on August 8, 2006.

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

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

I. **Membership Status:** Joined 09/25/1990;

   | Article VIII |

II. **General Resources Account:**
   - Quota: 640.20
   - Fund holdings of currency: 606.77
   - Reserve position: 33.43

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<th>$SDR million</th>
<th>%Quota</th>
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<tr>
<td>640.20</td>
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<tr>
<td>606.77</td>
<td>94.78</td>
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<td>33.43</td>
<td>5.22</td>
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III. **SDR Department:**
   - Holdings: 4.12

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<thead>
<tr>
<th>SDR million</th>
<th>%Allocation</th>
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<tr>
<td>4.12</td>
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IV. **Outstanding Purchases and Loans:** None.

---

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

<table>
<thead>
<tr>
<th>Type</th>
<th>Date of arrangement</th>
<th>Expiration date</th>
<th>Amount approved (SDR million)</th>
<th>Amount drawn (SDR million)</th>
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<tbody>
<tr>
<td>Stand-by</td>
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<td>03/31/2007</td>
<td>100.00</td>
<td>0.00</td>
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<td>Stand-by</td>
<td>02/27/2002</td>
<td>03/15/2004</td>
<td>240.00</td>
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<td>EFF</td>
<td>09/25/1998</td>
<td>09/24/2001</td>
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VI. Projected Payments to Fund: None.

VII. Implementation of HIPC Initiative: Not Applicable.

VIII. Implementation of Multilateral Debt Relief Initiative (MDRI): Not Applicable.
ANNEX 5: COUNTRY AT A GLANCE

<table>
<thead>
<tr>
<th>POVERTY and SOCIAL</th>
<th>Europe &amp; Central Asia</th>
<th>Upper-middle-income</th>
</tr>
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<tbody>
<tr>
<td>2006</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Population, mid-year (millions)</td>
<td>7.7</td>
<td>460</td>
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<tr>
<td>GNI per capita (Atlas method, US$)</td>
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<td>4,786</td>
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<tr>
<td>GNI (Atlas method, US$ billions)</td>
<td>30.6</td>
<td>2,206</td>
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Average annual growth, 2000-06

<table>
<thead>
<tr>
<th></th>
<th>Bulgaria</th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Population (%)</td>
<td>-0.8</td>
<td>0.0</td>
<td>0.8</td>
</tr>
<tr>
<td>Labor force (%)</td>
<td>-0.8</td>
<td>0.5</td>
<td>1.3</td>
</tr>
<tr>
<td>Most recent estimate (latest year available, 2000-06)</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Poverty (% of population below national poverty line, latest estimate)</td>
<td>13</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Urban population (% of total population)</td>
<td>70</td>
<td>64</td>
<td>75</td>
</tr>
<tr>
<td>Life expectancy at birth (years)</td>
<td>73</td>
<td>69</td>
<td>70</td>
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<tr>
<td>Infant mortality (per 1,000 live births)</td>
<td>12</td>
<td>28</td>
<td>26</td>
</tr>
<tr>
<td>Child malnutrition (% of children under 5)</td>
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<td>5</td>
<td></td>
</tr>
<tr>
<td>Access to an improved water source (% of population)</td>
<td>99</td>
<td>92</td>
<td>93</td>
</tr>
<tr>
<td>Literacy (% of population age 15+)</td>
<td>96</td>
<td>97</td>
<td>93</td>
</tr>
<tr>
<td>Gross primary enrollment (% of school-age population)</td>
<td>102</td>
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<td>112</td>
</tr>
<tr>
<td>Male</td>
<td>103</td>
<td>103</td>
<td>106</td>
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KEY ECONOMIC RATIOS and LONG-TERM TRENDS

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<tr>
<td>GDP (US$ billions)</td>
<td>20.3</td>
<td>9.9</td>
<td>27.2</td>
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<tr>
<td>Gross capital formation/GDP</td>
<td>35.9</td>
<td>8.1</td>
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<tr>
<td>Exports of goods and services/GDP</td>
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<td>Gross domestic savings/GDP</td>
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<tr>
<td>Gross national savings/GDP</td>
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<tr>
<td>Interest payments/GDP</td>
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<td>5.0</td>
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<td>Total debt/GDP</td>
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<td>Total debt service/exports</td>
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<td>18.6</td>
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<td>Present value of debt/GDP</td>
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<td>Present value of debt/exports</td>
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<td>57.1</td>
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<tr>
<td>(average annual growth)</td>
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<tr>
<td>GDP</td>
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<td>9.0</td>
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STRUCTURE of the ECONOMY

<table>
<thead>
<tr>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>(% of GDP)</td>
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</tr>
<tr>
<td>Agriculture</td>
<td>13.1</td>
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</tr>
<tr>
<td>Industry</td>
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<tr>
<td>Manufacturing</td>
<td>21.7</td>
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<td>Services</td>
<td>50.0</td>
<td>74.5</td>
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<td>Household final consumption expenditure</td>
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<td>11.9</td>
<td>18.0</td>
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<tr>
<td>General govt final consumption expenditure</td>
<td>43.5</td>
<td>5.0</td>
<td>76.4</td>
<td>83.0</td>
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<table>
<thead>
<tr>
<th></th>
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<tr>
<td>(average annual growth)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agriculture</td>
<td>5.5</td>
<td>2.6</td>
<td>-9.5</td>
<td>-1.9</td>
</tr>
<tr>
<td>Industry</td>
<td>4.6</td>
<td>4.9</td>
<td>4.7</td>
<td>8.3</td>
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<tr>
<td>Manufacturing</td>
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<td>6.6</td>
<td>11.3</td>
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<tr>
<td>Services</td>
<td>5.1</td>
<td>5.4</td>
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<tr>
<td>Household final consumption expenditure</td>
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<td>4.5</td>
<td>5.0</td>
<td>9.7</td>
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<tr>
<td>General govt final consumption expenditure</td>
<td>4.1</td>
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<td>2.5</td>
<td>2.4</td>
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<tr>
<td>Gross capital formation</td>
<td>-</td>
<td>16.1</td>
<td>27.6</td>
<td>17.6</td>
</tr>
<tr>
<td>Exports of goods and services</td>
<td>4.9</td>
<td>8.4</td>
<td>13.1</td>
<td>15.1</td>
</tr>
</tbody>
</table>

Note: 2006 data are preliminary estimates.
This table was produced from the Development Economics LDB database.
* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.
**PRICES and GOVERNMENT FINANCE**

<table>
<thead>
<tr>
<th></th>
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</tr>
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<tr>
<td>Domestic prices (%) change</td>
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<tr>
<td>Consumer prices</td>
<td>2.7</td>
<td>12.1</td>
<td>5.0</td>
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<tr>
<td>Implicit GDP deflator</td>
<td>1.3</td>
<td>12.0</td>
<td>3.8</td>
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<tr>
<td>Government finance (% of GDP, includes current grants)</td>
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</tr>
<tr>
<td>Current revenue</td>
<td>...</td>
<td>35.9</td>
<td>42.0</td>
</tr>
<tr>
<td>Current budget balance</td>
<td>...</td>
<td>-13.7</td>
<td>8.0</td>
</tr>
<tr>
<td>Overall surplus/deficit</td>
<td>...</td>
<td>-15.4</td>
<td>3.1</td>
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**TRADE**

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>(US$ millions)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total exports (fob)</td>
<td>9,096</td>
<td>4,689</td>
<td>11,778</td>
</tr>
<tr>
<td>Investment goods</td>
<td>1,377</td>
<td>708</td>
<td>9,354</td>
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<tr>
<td>Manufactures</td>
<td>614</td>
<td>5,218</td>
<td>5,842</td>
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<tr>
<td>Total imports (cif)</td>
<td>10,292</td>
<td>4,927</td>
<td>18,224</td>
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<tr>
<td>Food</td>
<td>402</td>
<td>334</td>
<td>402</td>
</tr>
<tr>
<td>Fuel and energy</td>
<td>1,820</td>
<td>1,745</td>
<td>3,681</td>
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<tr>
<td>Capital goods</td>
<td>4,523</td>
<td>919</td>
<td>5,012</td>
</tr>
<tr>
<td>Export price index (2000=100)</td>
<td>109</td>
<td>117</td>
<td>128</td>
</tr>
<tr>
<td>Import price index (2000=100)</td>
<td>73</td>
<td>120</td>
<td>140</td>
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<tr>
<td>Terms of trade (2000=100)</td>
<td>150</td>
<td>98</td>
<td>90</td>
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**BALANCE of PAYMENTS**

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</thead>
<tbody>
<tr>
<td>(US$ millions)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exports of goods and services</td>
<td>10,070</td>
<td>6,608</td>
<td>16,178</td>
</tr>
<tr>
<td>Imports of goods and services</td>
<td>10,934</td>
<td>6,153</td>
<td>20,881</td>
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<tr>
<td>Resource balance</td>
<td>-564</td>
<td>455</td>
<td>-4,503</td>
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<tr>
<td>Net income</td>
<td>-163</td>
<td>396</td>
<td>-181</td>
</tr>
<tr>
<td>Net current transfers</td>
<td>67</td>
<td>104</td>
<td>1,018</td>
</tr>
<tr>
<td>Current account balance</td>
<td>-966</td>
<td>164</td>
<td>-3,305</td>
</tr>
<tr>
<td>Financing items (net)</td>
<td>332</td>
<td>-915</td>
<td>3,666</td>
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<tr>
<td>Changes in net reserves</td>
<td>626</td>
<td>751</td>
<td>-362</td>
</tr>
<tr>
<td>Memo:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reserves including gold (US$ millions)</td>
<td>...</td>
<td>793</td>
<td>8,695</td>
</tr>
<tr>
<td>Conversion rate (CEC, local/US$)</td>
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<td>1.792</td>
<td>1.5</td>
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**EXTERNAL DEBT and RESOURCE FLOWS**

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<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(US$ millions)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| Total debt outstanding and disbursed | ... | 10,386 | 16,786 | ...
| IDA | 453 | 1,453 | 1,331 | ...
| Total debt service | ... | 1,273 | 5,787 | ...
| IDA | 43 | 126 | 320 | ...
| Current account balance | ... | 0 | 0 | ...
| Composition of net resource flows |
| Official grants | ... | 98 | ... | ...
| Private creditors | ... | -300 | 1,164 | ...
| Foreign direct investment (net inflows) | ... | 109 | 2,614 | ...
| Portfolio equity (net inflows) | ... | 2 | 92 | ...
| World Bank program |
| Commitments | ... | 80 | 150 | 0 |
| Disbursements | ... | 52 | 200 | 38 |
| Principal repayments | ... | 13 | 85 | 276 |
| Net flows | ... | 40 | 115 | -237 |
| Interest payments | ... | 30 | 40 | 44 |
| Net transfers | ... | 10 | 74 | -231 |

**Memo:**

The World Bank Group: This table was prepared by country unit staff; figures may differ from other World Bank published data.
ANNEX 6: POVERTY AND SOCIAL IMPACT of DPL II SUPPORTED POLICIES

101. The health sector reforms should contribute to increasing access to basic care through the new pharmaceutical policy. The new pricing and registration should lower the price of drugs by setting a mechanism to reference prescription drug prices based on the lowest price across other countries in Europe that have already achieved low drug prices. However, the new procedures are also expected to increase the speed of introduction of new drugs in the market, which tend to have higher prices. The final effect on overall spending in drugs is thus ambiguous but it is expected that basic drugs, which are not based on new technologies, should in general become cheaper and more affordable. The recent household survey provides information on the accessibility of pharmaceuticals that should serve as a baseline. Even though there are differences across consumption quintiles, it seems that accessibility is not a major problem (less than 2 percent of those who needed medication were not able to afford them). However there is significant room for improvement. In addition, the new regulations also changed the procedure to determine the State reimbursement policy, grouping products according to the therapeutic value, prioritizing the therapeutic groups that have higher socio-economic value for higher rates of state reimbursement. Together, these measures allow for the state to increase the cost-benefit of its spending and set up the necessary conditions for patients to receive prescriptions for the cost-effective pharmaceuticals. These actions will need to be supplemented with measures aimed at changing the behavior of the patients (i.e. trusting generics) and of prescribing physicians (i.e. being motivated to follow the best prescribing guidelines) in order to have the most positive impact. Since the first reimbursement list following the new guidelines will be effective in April 2008, its effect cannot be studied until 2009.

<table>
<thead>
<tr>
<th>Consumption Quintile</th>
<th>None</th>
<th>All</th>
<th>Some</th>
<th>Only the Most Needed</th>
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</thead>
<tbody>
<tr>
<td>Poorest</td>
<td>1.7</td>
<td>55.2</td>
<td>27.3</td>
<td>15.7</td>
</tr>
<tr>
<td>2</td>
<td>1.7</td>
<td>64.7</td>
<td>19.9</td>
<td>13.7</td>
</tr>
<tr>
<td>3</td>
<td>1.6</td>
<td>66.3</td>
<td>15.5</td>
<td>16.5</td>
</tr>
<tr>
<td>4</td>
<td>2.5</td>
<td>68.7</td>
<td>13.0</td>
<td>15.9</td>
</tr>
<tr>
<td>Richest</td>
<td>2.1</td>
<td>78.1</td>
<td>9.1</td>
<td>10.8</td>
</tr>
<tr>
<td>Turkish Minority</td>
<td>1.2</td>
<td>63.5</td>
<td>21.6</td>
<td>14.0</td>
</tr>
<tr>
<td>Roma Minority</td>
<td>2.8</td>
<td>45.5</td>
<td>28.5</td>
<td>23.3</td>
</tr>
<tr>
<td>National Average</td>
<td>1.9</td>
<td>66.0</td>
<td>17.5</td>
<td>14.6</td>
</tr>
</tbody>
</table>

Source: 2007 Bulgaria Multi-Topic Household Survey

102. The policy actions which aim at increasing sustainability of the health system by changing the hospital payment method (from an open-ended fee-for-service model to a model with a limited financial commitment) is not intended to restrict necessary hospitalizations. As mentioned before, there is an indication of large increases in hospitalizations during 2007, but there has been no significant demographic or

49 The DPL I Program Document provided some examples of inefficient reimbursement policies before the introduction of these policy changes.

50 April 2008 is the earliest date it will go into effect. Due to the effort that will need to be taken to establish a new drug list according to the new procedures, the April 2008 may be delayed until end-2008. In which case, the policy will go into effect in 2009.
epidemiological change in the morbidity profile of the population that could explain such increase alone. The increase in hospitalizations is largely a reaction of the health providers to both sustain their official and possibility for unofficial income, especially given that the national health insurance expenditures are being spread to an increasing number of providers. According to NHIF data between 2000 and 2007 hospital admissions increased about 26 percent and spending increased by 964 percent in real terms. Many of those services being provided could be handled on an outpatient basis which is both more affordable and safer for the patient.\footnote{See paragraph 25 for an example of this.} In fact, as Table 9 shows most people seek care outside hospitals. The NHIF will maintain reserve funds in 2008 and will be monitoring providers to ensure that access is not unreasonably denied to patients, given the change limiting the financial commitment to hospitals. The current structure of the hospital system also does not serve the population, with too many acute beds and an insufficient supply of long-term care.\footnote{In 2006, Bulgaria had more than 1000 beds (1024) in comparison to 570 in the EU15 and 701 in the EU8.} The open-ended access to the Bulgarian hospital market is also not conducive to proper patient care. The Masterplan being developed would set guidelines for restructuring hospitals with attention to the needs of populations in different regions of the country, ensuring that appropriate services of good quality are within reasonable geographic access to the patients.

103. **The preliminary analysis of the household survey shows that about 90 percent of the population has health insurance, with variation across quintiles from 78 to 96 among the poorest and richest respectively.** About 96 percent of individuals are also enrolled with a primary care physician (between 90 and 97 percent in the poorest and richest quintiles respectively). According to the survey data two issues of concern do not seem to be significant: first, the incidence of informal payments is rather small, and the amounts paid are also small as percentage of total out of pocket; second, the health insurance system seems to be doing an effective job at protecting individuals against catastrophic payments. One way to assess this is to look at the percentage of people who fall into poverty as a result of out of pocket payments in health. About 70 percent of the population declared having made out of pocket payments for health during the last 12 months (40 percent in the last month), paying approximately BGN100 during the year (about BGN15 in the last month). But less than 1 percent of those declared having made informal payments. This information is preliminary and has to be validated by cross-checks with other questions in the survey and other upcoming studies on informal payments in the health sector, therefore it should be treated with caution. Regarding the impoverishing effect of health care, depending on the assumptions, between half a percent and two percent of the population is estimated to have fallen into poverty as a result of out of pocket payments for health. This suggests that more could be done to protect certain groups against the impact of catastrophic payments for health. The MTHS should provide details on the characteristics of the individuals who fall into poverty due to out of pocket payments so that adequate interventions can be designed.
Table 9 Of those who were ill/suffered an accident and sought medical treatment, the location where they sought medical treatment (% of respondents by vulnerable groups).

<table>
<thead>
<tr>
<th>Consumption Quintiles</th>
<th>Home</th>
<th>Diagnostic Center</th>
<th>Health Center</th>
<th>Hospital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poorest</td>
<td>35.0</td>
<td>33.0</td>
<td>15.5</td>
<td>16.5</td>
</tr>
<tr>
<td>2</td>
<td>29.7</td>
<td>28.8</td>
<td>12.6</td>
<td>27.0</td>
</tr>
<tr>
<td>3</td>
<td>23.0</td>
<td>35.4</td>
<td>12.4</td>
<td>26.5</td>
</tr>
<tr>
<td>4</td>
<td>22.6</td>
<td>47.6</td>
<td>6.0</td>
<td>23.8</td>
</tr>
<tr>
<td>Richest</td>
<td>22.2</td>
<td>41.7</td>
<td>2.8</td>
<td>31.9</td>
</tr>
<tr>
<td>Turkish Minority</td>
<td>17.1</td>
<td>42.1</td>
<td>6.6</td>
<td>26.3</td>
</tr>
<tr>
<td>Roma Minority</td>
<td>27.3</td>
<td>37.4</td>
<td>12.1</td>
<td>19.2</td>
</tr>
<tr>
<td>National Average</td>
<td>26.9</td>
<td>36.4</td>
<td>10.6</td>
<td>24.8</td>
</tr>
</tbody>
</table>

Source: 2007 Bulgaria Multi-Topic Household Survey

104. The main poverty and social impact risk in the Government's education reform program is that drop outs of disadvantaged students could increase as a result of school closures. The changes supported under in the finance and governance reforms provide better incentives to municipal officials to improve the efficiency of spending by merging classes within schools and/or merging schools. Indeed, preliminary evidence for 2006 and 2007 suggest that municipalities are responding to the incentives embedded in the new financing system and are closing down schools at a faster past than in previous years (see Table 6). In theory, a school closure could either raise or lower drop outs. On the positive side, the closure frees up additional resources for the municipality to spend on improving the overall quality of the schools in the municipality, helping to lower the risk that students leave. On the negative side, the closure of a school disrupts the life of students, teachers and parents and for disadvantaged students — already at high risk of dropping out — and the disruption may be the tipping point. Moreover, the closure usually implies that students would have to travel further and incur a higher cost of transportation (if not in monetary terms, at least in terms of a longer time period spent away from home).

105. The key question is whether there are adequate measures in place to ensure that drop outs do not rise — especially of the most vulnerable — as a result of these closures. The PSIA assessed this in two ways: first, the PSIA reviewed the measures currently in place to prevent such rise. Second, given that school closures have taken place at different pace across Bulgaria, historical data was used to examine whether there is an association between school closures and drop outs. The information available on dropouts across Bulgaria suggests that the country is well-equipped to handle an accelerated pace of school closures. First, historical data for the past 6 years — a period where almost 200 general education schools were closed (out of around 3,000) — suggests that other factors beyond school closures have more of a correlation with drop outs. More likely, ethnicity and poverty

---

53 Under the new system, municipalities receive all funds for education based on a per capita formula (as opposed to pre-2007 where only maintenance expenditures were on a per capita formula). Thus, municipalities have an incentive to use their teaching workforce optimally (i.e. strive to get as large classes as possible, within the class size norms). Merging class within a school is one way to do so. However, this option is usually only available in schools beyond a certain size. The only way to get larger class sizes in smaller schools is to introduce multi-grade teaching or merge schools.

54 Obviously, when examining such relationship, other factors that could explain differences in drop outs across districts — such as differences in poverty rates, differences in ethnic composition of population, etc — had to be controlled for.
are more important underlying factors for children dropping out of school in Bulgaria, a hypothesis supported by data on years of completed schooling by ethnicity and drop outs (see Figure 7). Second, more than a decade of declining student numbers has generated experience in municipalities across the country in dealing with the problem.

Figure 7 Students from a disadvantaged background are more likely to leave school early

<table>
<thead>
<tr>
<th>Years of education completed by ethnicity (20-28 yr olds)</th>
<th>Years of education completed by poor (20-28 yr olds)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Roma</td>
<td>Non Poor</td>
</tr>
<tr>
<td>Bulgarian</td>
<td>Poor</td>
</tr>
<tr>
<td>Turkish</td>
<td></td>
</tr>
</tbody>
</table>

Source: Household Survey 2003

106. **Historical data on school closures show that districts with relatively more school closures do not seem to have relatively higher drop outs.** For the analysis, a rich data set was created by combining two household surveys – one from 2003 and one from 2007 and covering a total of more than 20,000 individuals – with information on schools obtained from the National Statistical Institute’s annual census of schools. The data were used to examine whether districts that had closed down relatively many schools were more likely to have a larger proportion of the sampled population in the age group 10-16 not in school. Given that “the proportion of the sampled population in the age group 10-16 not in school” is an imprecise measure of drop-outs, the analysis was also done using an alternative – but also imperfect – measure of drop outs, namely, principals’ reported number of students leaving school. This analysis shows no association between schools closures and drop outs. Figure 8 shows a scatter plot with the extent to which districts closed schools on one axis, and a measure of drop-outs on the other axis. Each dot in the figure represents a district, with every district being represented twice: once for the period 2003 and once for 2007 (with school closures being measured between the 2003 and 2000 for 2003 and between 2005 and 2003 for the 2007 data point). The figure shows that there is no obvious

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55 To be precise, for each of Bulgaria’s 28 districts, the number of schools in 2003 was compared to 2000, and the number of schools in 2005 was compared to 2000. The variable examined was the percentage change in the number of general education schools between 2003 and 2000 and 2005 and 2003 for each of the 28 districts. Thus, a total of 56 data points were obtained.

56 The reason why this is also an imperfect measure is that, potentially, the student leaving one school could reappear in another school.
association between the two: districts that drastically reduced their number of general education schools managed to do so with virtually all of its 10-16 years in schools, and districts that did have a relatively low share of its 10-16 year olds in school were not necessarily those that reduced the number of schools the most. This result was confirmed using a regression analysis, examining the statistical relationship between the two variables, and taking into account that districts across Bulgaria differ in important dimensions that could potentially impact the extent to which young people are in school.\textsuperscript{57}

Figure 8 Districts that closed down a large number of schools were not necessarily those with the highest drop outs (each data point is a district, with every district appearing twice: in 2003 and in 2007)

107. Education officials at both the central and municipal level have gained significant experience from school closures during the past decades, and are incorporating the lessons into policies. In some instances, municipalities had to close down more than half of their schools during the past decade, and officials both at the central and municipal level gained important experience in the process. Reflecting these experiences, the process of closing down a school is fairly elaborate and a number of safeguard measures are built into the process. For instance, a school closure proposal has to include a discussion of how transportation of students affected will be addressed. Moreover, to aid policy makers, Bulgaria has a relatively sophisticated education management information system that allows the ministry to track the enrollment of individual students (i.e. it is a data base where every student has an ID and is tracked, as opposed to EMIS systems where only the sum of students enrolled at a particular school is tracked). Finally, anticipating that the number of

\textsuperscript{57} A multivariate OLS regression was run with the share of the 10-16 year olds in school as the dependent variable and the change in the number of schools as a regressor. In addition, a number of district characteristics were included: share of population living in municipal centers, share of population of being Roma, share of population being Turkish, change in population size of district, district poverty rate, number of settlements, population density, and average student-teacher ratio.
school closures would increase, MES and MOF agreed to earmark additional funds to municipalities undertaking a school closure as described in Section V.

108. The main poverty and social impact risk in the Government’s social protection reform program stems from the tightening of eligibility for Guaranteed Minimum Income (GMI), with a cancellation of eligibility for able bodied working age individuals after 18 months of benefit receipt, with ineligibility for the following 12 months. The DPL program is not supporting the policy change, but an assessment of its impact, as a prior action in DPL2. According to this agreement the National Statistical Institute conducted a survey of affected beneficiaries in March-April 2008. Its results were taken and will be taken into consideration in on-going adjustment of the programs offered to affected beneficiaries by the EA as well as the service provision. The survey looked at the following:

i. profile of the beneficiary – age, gender, educational level, health status, work experience, family status, number of dependents;

ii. ethnic profile of the affected beneficiaries;

iii. residential characteristics of the affected beneficiaries (urban/rural);

iv. reasons for being on social assistance, period(s) during which the social assistance has been received, level of the received GMI benefit, supplement of GMI by other individual benefits and/or payments (e.g., unemployment benefit, survivors’ pension, stipend), etc.

v. profile of the beneficiaries’ families and/or households – number, age, gender and employment status of family/household members, urban vs rural location, educational and health status, number of children, retired or family members with disabilities, incomes, consumption, etc.

vi. simulation of how the welfare status of the household would change if the GMI support is stopped for (a) the individual beneficiary for 12 months; (b) the whole household for 12 months;

vii. assessment of the expected coping strategies with respect to the policy measure – activation (joining the labor market), going into the informal economy, opting for disability pension, continuing to rely on social assistance, reliance on intra-household or extended family transfers, etc.; and

viii. study of the reasons why the affected GMI recipients do not enter the labor market – high reservation wage, disincentives to work related to the level of the benefit, the level of wage, taxation, etc., low skills and qualification, lost habits to work and other reasons which make the person unemployable.

109. A preliminary analysis of this policy in the context of DPL 2 preparation suggests that (i) the majority of GMI beneficiaries are poor and highly vulnerable across a number of dimensions, which makes their true activation — as opposed to merely canceling their benefit and placing them in public works programs — a sizable challenge, (ii) the loss of the GMI benefit is substantially deepening the already deep poverty among beneficiaries, but adds relatively little to the poverty headcount; (iii) the activation measures, if effective, could get individuals out of poverty by raising their chances in the labor market and thus increasing their potential earnings in excess of the benefit; and (iv) the EA needs to focus on developing effective activation mechanisms with close monitoring of beneficiaries and

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enhanced cooperation with the social assistance offices and community based organizations and specialized service providers. The following paragraphs explore these issues.

110. Beneficiaries of GMI, despite receiving the benefit, are a specifically vulnerable group. The analysis in this section is based on data from the Multi-Topic Household Survey (MTHS) which was conducted in the spring of 2007.\(^58\) MTHS data presented in Figure 9 shows that the poverty incidence among GMI beneficiaries, despite the benefit, remains very high, with a poverty rate among GMI beneficiaries of 55.5 percent, compared to 9.4 percent for those not on GMI\(^59\). In addition to the simple headcount measure of poverty, which does not indicate whether all poor are equally poor, we estimate the poverty gap which reveals how far below the poverty line people are. While the poverty gap for non-beneficiaries, at 2.1 percent, is low, the gap for GMI beneficiaries is a deep 16.3 percent. Remarkably, the poverty gaps for both beneficiary and non-beneficiary Roma are staggering. Poverty severity, closely related to the poverty gap but giving a higher weight to those further away from the poverty line, is 6.2 percent for GMI beneficiaries compared to 0.7 for non-beneficiaries. Moreover, more than 80 percent of GMI recipients reported difficulties with meeting food, clothes and heating needs respectively, compared to between 30 and 40 percent among those not on the benefit. Close to 40 percent of GMI beneficiaries reported they have unpaid bills. Table 10 shows average characteristics of GMI beneficiaries based on the MTHS. It reveals that GMI beneficiaries live in larger households with more adults on average and tend have more than double the number of children than non-beneficiaries. At the same time, they reside in more precarious housing – smaller living space and fewer rooms. Almost 35 percent have no hot water, close to 50 percent have a leaking roof and 40 percent have broken windows.

Figure 9: The majority of GMI beneficiaries is poor and face deep poverty, even with the benefit
Poverty Rates and Poverty Gap, 2007

\(^58\) The share of the population in Bulgaria on GMI was about 1.1-1.2 percent in the spring of 2007, the time of data collection for the MTHS, while 1.37 percent of respondents of the MTHS stated that they receive GMI.

\(^59\) The poverty line is defined as BGN 186.3 per adult equivalent.
Table 10: Characteristics of GMI beneficiaries

<table>
<thead>
<tr>
<th></th>
<th>GMI</th>
<th>Non-GMI</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Individual characteristics</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean age</td>
<td>37.3</td>
<td>43.0</td>
</tr>
<tr>
<td>Mean years of schooling</td>
<td>6.3</td>
<td>11.3</td>
</tr>
<tr>
<td><strong>Household characteristics</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean household size (persons)</td>
<td>4.8</td>
<td>3.5</td>
</tr>
<tr>
<td>Mean number of children</td>
<td>1.5</td>
<td>0.7</td>
</tr>
<tr>
<td>Mean number of adults</td>
<td>3.0</td>
<td>2.2</td>
</tr>
<tr>
<td><strong>Living space</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean availability of hot water (%)</td>
<td>34.3</td>
<td>86.5</td>
</tr>
<tr>
<td>Mean number of rooms</td>
<td>2.6</td>
<td>3.0</td>
</tr>
<tr>
<td>Mean living area (sqm)</td>
<td>63.8</td>
<td>78.4</td>
</tr>
<tr>
<td>Mean likelihood of a leaking roof (%)</td>
<td>47.0</td>
<td>15.0</td>
</tr>
<tr>
<td>Mean likelihood of broken windows (%)</td>
<td>39.8</td>
<td>9.2</td>
</tr>
<tr>
<td>Mean likelihood of unpaid bills</td>
<td>39.1</td>
<td>13.3</td>
</tr>
</tbody>
</table>

Source: Staff calculations based on MTHS 2007

111. **MTHS analysis suggests that activating GMI beneficiaries will be a sizable challenge, owing to their specific vulnerabilities and characteristics.** Specifically, the majority of GMI beneficiaries:

- **are from the Roma minority.** According to the MTHS, 74.5 percent of the respondents reporting to receive GMI were Roma, compared to 9.6 percent ethnic Turkish and 15 percent ethnic Bulgarian. Experience from Bulgaria and other countries in the region indicates that the exclusion faced by Roma is typically so profound that it requires specifically designed interventions to promote access of long-term unemployed and welfare recipient Roma to the labor market.

- **have low educational attainment.** More than 80 percent of surveyed beneficiaries have primary education or less. This suggests that activation interventions through the EA will have to focus on basic training, including literacy, as well as skills upgrading components of subsidized employment programs.

- **are long-term unemployed and a sizeable share are outside the labor force.** 66.7 percent of surveyed GMI beneficiaries who are unemployed reported to have been unemployed for more than 12 months, compared to 47.8 percent of those unemployed not receiving the GMI. While 20 percent of GMI beneficiaries reported to be working, almost a third reported not being part of the labor force.
112. **At the same time, many GMI beneficiaries appear to have only had limited exposure to the Employment Agency prior to the introduction of the “18 month rule”**. According to data from the MTHS, 27.4 percent of respondents who consider themselves part of the labor force and who reported receiving GMI stated they were not registered at the Employment Office (EO). That was caused by a regulatory exemption from the rule for compulsory nine-month registration at the Employment Office (EO). It referred to the following categories of persons: parents looking for a child up to the accomplishment of the third year of life; disabled persons with working capacity reduced by 50 and above 50 percent; persons, taking care for a seriously ill family-member or co-habiting person; mentally diseased persons; persons above the age of 18, who attend the regular form of education in a school of the national secondary educational system and secondary vocational schools. For any other beneficiaries of the program, the uninterrupted registration at the EO is a precondition for social assistance entitlement. It could be concluded that the prevailing part of GMI-beneficiaries under the program did maintain their EO-registration solely for the purpose of entitlement without to seek actively a job, including involvement in training and retraining, because before the amendment, the Social Assistance Act provided for the release of this type of assistance without limitation in the period of uninterrupting entitlement.

113. **While the majority of affected beneficiaries will go onto training and subsidized job programs, the biggest risk of the measure is faced by those beneficiaries who drop out altogether from the EA or who were not registered in the first place**. Subsidized job programs typically offer minimum wage plus social security contributions, therefore, not making beneficiaries and families worse off. To date, the numbers of drop-outs have remained low, as explained in paragraph 74 (1,742 between September and October and 1,222 between October and November 2007, together

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60 The MTHS was conducted in the spring of 2007 and prior to the EA's engagement of all individual affected GMI beneficiaries after July 2007.

61 Out of 74 individuals, 10 have been offered a job by the EO, of which 9 took the job. In addition, 2 were offered training and found a job afterwards.
amounting to about 10 percent of the initial number of 29,954 affected beneficiaries). The EA is not tracking the profile or destination of such beneficiaries, and it is not clear to what extent their drop-off is due to finding employment in the labor market or other reasons. The DPL2 dialogue with the MLSP, EA and the SAA have focused on the development of improved administrative data management to allow tracking beneficiaries as well as increased collaboration of SAA and EA at the local level.

114. The loss of GMI risks raising the poverty level further for those who drop out of the EA before they re-qualify for GMI and do not participate in training or subsidized employment. Simulations using MTHS data presented in Table 11 show that the loss of benefit will increase the poverty headcount by almost 5 percentage points. However, more importantly, the loss of benefit will substantially further deepen poverty among current GMI beneficiaries – it will add 10 percentage points to the poverty gap overall. GMI on average represents 17.6 percent of household consumption.

<table>
<thead>
<tr>
<th>Table 11: Comparative Poverty Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poverty Rate</td>
</tr>
<tr>
<td>GMI</td>
</tr>
<tr>
<td>Bulgarian</td>
</tr>
<tr>
<td>Turkish</td>
</tr>
<tr>
<td>Roma</td>
</tr>
<tr>
<td>non GMI</td>
</tr>
<tr>
<td>Bulgarian</td>
</tr>
<tr>
<td>Turkish</td>
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<tr>
<td>Roma</td>
</tr>
</tbody>
</table>

Source: staff calculations based on MTHS 2007

115. The effectiveness of the “18 month rule” in activating beneficiaries into the labor market with minimal adverse social impact will depend on the interaction of social work interventions and EA activation programs. As shown, GMI beneficiaries in working age face multiple and mutually reinforcing vulnerabilities. For example, experience from Bulgaria and other countries in the region suggests that Roma long-term unemployed often face particularly severe forms of social exclusion and isolation, often necessitating a tailored approach in partnership with community-based organizations to act as intermediaries between public services and the beneficiary. Effectively addressing these will require a complex approach. With a majority of affected families likely to remain partly on GMI, covering the second adult and the children, should family income remain below the

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62 Note that the biggest poverty increase applies for GMI beneficiaries of the Turkish minority. Interestingly, the GMI beneficiaries of the Turkish minority are less poor than those not receiving benefits. The reverse is true for both ethnic Bulgarians and ethnic Roma.

63 The average amount of GMI per adult equivalent for GMI beneficiary households was BGN 30.9, while the average amount of for individual GMI recipients was BGN 47.5. The eligibility threshold for GMI per adult is BGN 55.

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threshold even after the first adult’s activation, the local Social Assistance Offices (SAO) will have a key role following up on cases of beneficiary drop-off.

116. The employment policy reform supported by the DPL program —namely shifting ALMPs from simple subsidized employment towards more training and qualification-focused program mix— is not expected to have any adverse social or poverty effects. As levels of remuneration for participation on ALMPs do not vary between those with and without a training and qualification focus, the change of the program mix is therefore not leading to income changes for beneficiaries. The greater availability of private sector-run subsidized employment and training is expected to have a greater effect in promoting the employability in the primary labor market of job seekers, and to reduce their reliance on subsidized public works programs. Improved primary labor market access for the less disadvantaged job seekers as well as continued availability of subsidized employment for those with limited or no chances in the primary labor market represents a net welfare enhancement from the perspective of the currently registered long-term unemployed job seekers.
ANNEX 7: FIDUCIARY ASPECTS

Budget formulation

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

Budget execution, including cash and debt management

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

Public sector accounting and reporting

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

**Internal control and internal audit**

120. The CFAA reported that the structural reforms were at an early stage and identified a number of key steps to be taken in the areas of financial internal controls and public sector internal audit. Bulgaria made changes in the Public Internal Financial Control framework through the introduction of three new Acts in consultation with the EC, with supporting guidelines, which cover financial management and control, internal audit and financial inspection at all levels of Government. The new legislative framework introduced managerial accountability, with specific responsibilities for the heads of public sector organizations and a wider interpretation of financial management and control applicable to all managers. The internal audit function is now completely decentralized to the budget units. Functional independence is assured through the internal audit function reporting to the management/line minister. An Internal Control Directorate has been established in the MoF (consisting of Central Harmonization Units for financial management control and internal audit). Training and capacity building continues with all internal auditors required to be certified by July 2008.

**External audit**

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

**Procurement**

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

**Foreign exchange environment**

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

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

Overall, the 2004 Safeguards Assessment report concluded that the risk was low. The BNB’s audited financial statements, together with the audit opinion are published in the BNB’s annual report and on the BNB website. The audit reports for the last 6 years (2001-2006) have unqualified opinions. Past audits and the positive assessment by the IMF indicates that there are no additional fiduciary safeguards considered necessary as far as management of the foreign exchange is concerned.
ANNEX 8: NATIONAL REFORM PROGRAM

For challenge: Improving the quality of human capital through improved access of all to quality education and training (incl. life-long learning) with a view to increase productivity and better match skills with labor market needs

Measures:
A) Reducing the number of drop-outs and integrating the early school leavers into the educational system

Description of problem: The share of children in mandatory school age not covered by the educational system or having dropped out of it is high. The share of the children from risk groups, in particular those from the Roma minority, is the highest. This leads to disproportions in the educational attainment, resulting in the fact that relatively compact groups are marginalized from the social life and are additionally impeded in their integration.

Quantitative target: Reducing the share of drop-outs to 15% by 2009

Type of action: Elaboration and adoption of a program containing specific measures for preventing the drop-outs in the mandatory school age.

Status: In progress.

Ministry in charge: Ministry of Education and Science

Timeline: 2008

Impact expected on other main challenges (synergies): Increasing the number of active population, better matching of skills and labor market needs.

B) Building a modern and efficient system for standardized external evaluation in secondary education

Description of problem: The declining quality and efficiency of the educational system in the secondary education are also linked with the lack of a system for national external evaluation and of an efficient system for internal evaluation of the educational quality. This does not allow comparing the achievements of the graduates from the different schools.

Target: To establish a modern and efficient system for standardized external evaluation in secondary education

Type of action: Mandatory evaluation of the knowledge and skills of the students in each educational stage and degree by means of national standardized exams (incl. introducing the state matriculation)

Status: In progress.

Ministry in charge: Ministry of Education and Science

Timeline: 2009

Impact expected on other main challenges (synergies): Increasing the quality of educational services, improving the qualification of teachers.

C) Development of vocational education and training in compliance with the labor market needs

Description of problem: About 20% of the population (aged 18-24) has lower than secondary education and does not plan to continue its education or to raise its qualification. The measures for their reintegration in the educational system, as well as for their inclusion

65 Yellow – supported by DPL; Green – possible area for DPL support

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in different qualification programs and courses, are not sufficient.

**Target:** To increase the educational level and the acquisition of professional qualification by the concerned population groups.

**Type of action:** Establishment of a system for professional orientation and consultations, development of short-term modules for acquisition of professional qualification for the students leaving the education system after graduating from the 10th grade; creating legislative and other supportive conditions for carrying out school practices and internships in companies.

**Status:** Forthcoming

**Ministry in charge:** Ministry of Education and Science together with the Ministry of Labor and Social Policy, in cooperation with organizations of employers and businesses.

**Timeline:** 2008

**Impact expected on other main challenges (synergies):** Increasing the economic activity and the labor productivity of the population, stimulating the competitive pressures on the labor market. Social inclusion of marginalized groups.

D) Developing lifelong learning forms

**Description of problem:** According to the 2003 Lifelong Learning Survey results, the total share of people aged 25-64 participating at least in one form of training (formal, informal or self-study) is only 16%, which is about 2.5 times lower than the EU25 average.

**Quantitative target:** To increase the share of people participating in various forms of lifelong learning

**Type of action:** Elaboration of a National Strategy for Lifelong Learning

**Status:** In progress.

**Ministry in charge:** Ministry of Education and Science together with the Ministry of Labor and Social Policy

**Timeline:** 2007

**Impact expected on other main challenges (synergies):** Acquisition of key skills, ensuring greater flexibility and adaptability of the labor force; reduction of illiteracy and increase of employability of the labor force with low educational attainment level or without qualification; promotion of on-the-job training. Increasing the revenues from social security contributions.

E) Improving the quality and efficiency of higher education

**Description of problem:** The Bulgarian higher education does not correspond to the contemporary requirements and standards. Despite the fact that its quantitative dimensions are comparable with the EU averages, a significant share of the higher education graduates do not have the knowledge and skills required by the labor market. The large number of higher schools creates conditions for insufficient financing of the higher education system, while at the same time reducing the efficiency per unit of budgetary expenditure.

**Target:** To optimize the network of higher schools; to meet labor market requirements;

**Type of action:** Elaboration, broad-based discussion and adoption of a strategy for the development of higher education, as well as an annual update of a program containing specific measures for its realization, the implementation of which will be reported also to the National Assembly; Completion of the establishment and development of the career centers in the higher schools; Increasing the share of students in natural sciences, mathematics, engineering and informatics.

**Status:** In the process of elaboration.
Establishment and development of a National System for Regular Monitoring of the Labor Market

**Description of problem:** Sufficiently reliable information on the characteristics of labor demand and supply is missing. This creates hindrances for planning of the academic process, as well as for the business and the government sector in hiring specialists with suitable qualification.

**Target:** Availability of reliable information concerning the characteristics of labor demand and supply on the national and regional markets.

**Type of action:** Elaboration and introduction of a mechanism for regular nation-wide monitoring and analysis of the labor market with space and time dimensions.

**Status:** Forthcoming

**Ministry in charge:** Ministry of Education and Science together with the Ministry of Labor and Social Policy

**Timeline:** 2008

**Impact expected on other main challenges (synergies):** Increasing employment by means of facilitating the link between businesses and educational institutions.

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**For challenge: Activating labor supply**

Measures:

A) Continuing the implementation of the National Program “From Social Assistance to Employment”

**Description of problem:** Since 2003 there has been a sustainable trend of decreasing the number of long-term unemployed but they are still more than a half of all registered unemployed. According to National Employment Agency data, the average number of long-term unemployed in 2006 was 203 812 or 57.2% of the total number of registered unemployed. 71.7% of the long-term unemployed had primary or lower education and 73.6% had no qualification and trade.

**Quantitative target:** To provide employment to 33 000 unemployed persons in 2007

**Type of action:** Active labor market program

**Status:** In progress.

**Direct budgetary costs:** EUR 41 million (source of financing — the state budget)

**Ministry in charge:** Ministry of Labor and Social Policy

**Timeline:** by end of 2007

**Impact expected on other main challenges (synergies):** Increased revenues of the social security system.
B) Implementation of the measures envisaged in the Law on Employment Promotion

**Description of problem:** Although the number of unemployed has been decreasing in the last few years, the share of unemployed among certain groups remains high: young persons, disabled persons, persons in pre-retirement age and persons with low educational attainment.

**Quantitative target:** To provide employment to 24 061 persons and training to 23 200 persons in 2007.

**Type of action:** Active labor market measures

**Status:** In progress

**Direct budgetary costs:** EUR 17.08 million (source of financing – the state budget).

**Ministry in charge:** Ministry of Labor and Social Policy

**Timeline:** until the end of 2007

**Impact expected on other main challenges (synergies):** Increased revenues of the social security system

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C) National Program „Assistants to Disabled People“

**Description of problem:** The registered unemployed on social benefits are among the most vulnerable groups on the labor market.

**Quantitative target:** Employment for 12 400 unemployed persons in 2007.

**Type of action:** Active labor market program

**Status:** In progress.

**Direct budgetary costs:** EUR 18.8 million (source of financing – the state budget).

**Ministry in charge:** Ministry of Labor and Social Policy

**Timeline:** until the end of 2007
ANNEX 9: IMF RISK ASSESSMENT

Box 4  **Bulgaria: External Stability Risk Assessment**

IMF Staff estimates of the equilibrium current-account deficit center around 8 percent of GDP:

- The macroeconomic balance approach, based on panel data for 38 industrial and transition countries for 1992–2006, suggests that Bulgaria's current-account deficit norm is somewhat above 5 percent of GDP. However, this estimate is backward-looking and might underestimate the sustainable current-account deficit in a setting of globalized financial markets and EU convergence.

- External sustainability considerations based on stabilizing the net international investment position (IIP) at a medium-term level of about 80 percent of GDP, but ignoring EU capital grants, point to a sustainable current-account deficit of about 8 percent of GDP.

- Bulgaria is likely to receive EU capital grants amounting to about 2 percent of GDP, and the sustainable current-account deficit could be correspondingly higher as these grants will not add to Bulgaria's external liabilities.

Notwithstanding the presently large current-account deficit relative to equilibrium, the real effective exchange rate appears fairly valued:

- Different measures of Bulgaria's real effective exchange rate have all appreciated over recent years, but the pace of appreciation has been in line with experiences in other transition economies.

- Purchasing-power-parity and dollar wage-cost comparisons in industry across countries also yield no strong evidence of overvaluation.

- Estimates of the real equilibrium exchange rate (CPI based) as a function of relative productivity and the net foreign asset position during 1996–2006 indicate that the actual real exchange rate has appreciated largely in line with the estimated equilibrium real exchange rate.

- Recent export volume growth (11 percent during 2004-06) remained solid, and export market shares have increased in all major export destinations. However, a constant market share analysis at SITC 1-digit product level indicates some erosion of competitiveness relative to other low- and middle-income countries during 2004–05, albeit coming on the back of large gains during 2001–03

*Source: Staff Report for the 2007 Article IV Consultation, IMF, November 29, 2007.*
ANNEX 10: LETTER FROM GOVERNMENT OF BULGARIA EXPLAINING THE CHOICE OF INSTRUMENT

REPUBLIC OF BULGARIA
MINISTRY OF FINANCE

Our ref. No. 91-00-196
Sofia, March 17, 2008

MR. FLORIAN FICHTL
COUNTRY MANAGER
WORLD BANK OFFICE
IN BULGARIA
36, DRAGAN TSANKOV BLVD.
1057 SOFIA, BULGARIA

MS. PETYA VASSILEVA
ACTING DIRECTOR
COORDINATION OF EU AND IFI AFFAIRS DIRECTORATE
COUNCIL OF MINISTERS

MR. HERMAN WIJFFELS
EXECUTIVE DIRECTOR
THE WORLD BANK
WASHINGTON, D.C.
USA

Re: Second Social Sectors Institutional Reform Development Policy Loan (SIR DPL 2) – Type of Loan

DEAR MR. FICHTL,

In connection with the forthcoming negotiations on the Second Social Sectors Institutional Reform Program Development Policy Loan (SIR DPL 2), we would like to inform you with the present letter about the preferred option with respect to the terms of the future loan. Having in mind the recent improvements of the borrowing instruments offered by the International Bank for Reconstruction and Development (the Bank) and our current fiscal position, we consider the Deferred Drawdown Option (DDO) to be the most suitable instrument for the purposes of SIR DPL 2.

Our decision to apply this option with respect to the Second Social Sectors Institutional Reform Program Development Policy Loan (SIR DPL 2) is dictated by several fundamental factors, most significant among which are the fiscal surplus achieved during the last several years and the accumulation of a considerable fiscal reserve. The higher levels of the fiscal
reserve permit a more flexible debt planning and management in the short term and in the medium term perspective. On the other hand, the Deferred Drawdown Option will ensure our prompt access to borrowed funds whenever necessary to secure liquidity in the future, while it will also provide the opportunity to continue our fruitful cooperation with the World Bank. This option will guarantee the continuation of the constructive political dialogue between the Bank and the Bulgarian authorities in a longer-term perspective by means of committing the international financial institution with the monitoring of the sequencing of the implementation of the agreed social sphere policies within a stable macroeconomic environment.

The current economic situation in Bulgaria, as well as the established medium term fiscal goals do not presume an immediate need of borrowed funds, but Bulgaria appreciates very highly the Bank's expertise and would like to be able to use it in the future, as well as to have the opportunity for an immediate access to liquidity in case of need.

In connection with the advance clarification of the financial terms of the SIR DPL 2 loan in case of using the deferred drawdown option (DDO), we attach a completed form of the Worksheet for Loan Choices, which will be finally confirmed by us during the forthcoming official negotiations. We propose that the loan should be EUR denominated, with an initial preference for a 17-year maturity, including a five-year grace period and level repayments with respect to the principal, with variable spread interest-rate and with advance payment of the front-end fee from our own proceeds.

Enclosure: Completed Worksheet for Loan Choices Form (in English).

Looking forward to continuing our fruitful cooperation,

Yours sincerely,

PLAMEN ORESHARSKY

MINISTER OF FINANCE
### ANNEX 11: STATUS OF BANK GROUP OPERATIONS IN BULGARIA

<table>
<thead>
<tr>
<th>Project ID</th>
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<th>Undisb.</th>
<th>Orig.</th>
<th>Frm. Rev'd</th>
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### BULGARIA STATEMENT OF IFC's Held and Disbursed Portfolio

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<th>Loan</th>
<th>Equity</th>
<th>Quasi</th>
<th>Partic.</th>
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<th>Equity</th>
<th>Quasi</th>
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### Approvals Pending Commitment

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<th>Partic.</th>
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