

MEMORANDUM ON ECONOMIC POLICIES OF THE GOVERNMENT AND THE BULGARIAN NATIONAL BANK

A. Introduction

1. **Bulgaria has come a long way in the last four years.** Since the disappointing early transition years that culminated in a severe financial crisis in 1996–97, macroeconomic stability has been achieved, output growth turned robust after years of decline, and inflation has decelerated to single digits. External debt has been kept under control, declining from nearly 100 percent of GDP in 1997 to 75 percent last year. The structure of the economy also witnessed major changes as most of the non-infrastructure enterprises and banks were privatized, trade and prices were liberalized, and the overhaul of the pension and health care systems was initiated.

2. **Building on this success, we aim to take Bulgaria to the next stage of development.** Our objective is to raise substantially incomes from the current low levels, which are 26 percent of the European Union (EU) average in per capita terms (based on purchasing power parity), and to ensure that the benefits of our economic reform are broadly shared across Bulgarian society. We also aim to continue to reduce poverty and bring down unemployment, which surged as major restructuring of the economy took hold, and has remained stubbornly high. In our view, the most effective means of doing so is to encourage economic growth while cementing macroeconomic stability, and to develop a fully competitive market economy that can withstand the global market forces. Successfully meeting these challenges will also help Bulgaria gain accession to the EU.

3. **We believe the policies described below, to which we are fully committed, will help us meet these challenges.** The memorandum contains a comprehensive statement of our objectives and policy intentions in the fiscal and financial sectors, labor markets, and structural reform. The measures covered by Fund conditionality are listed in Table 1 and Annexes I–VI.

B. Policy Framework

4. **Our policy framework is three-pronged:**

- **We will maintain the currency board arrangement (CBA) at least until accession to the EU.** 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 necessary steps to support it.
- **We will implement a cautious and flexible fiscal policy, which is key to safeguarding external viability under the CBA.** We aim to reach and maintain a balanced budget over the medium term by gradually reducing the budget deficit. This will help to bring down the public debt-to-GDP ratio at a rapid pace. Reforms in the public sector, including enhancing tax administration and improving budgeting and expenditure management and our

efforts to lower costs of maintenance and operations, will help ensure that the tax burden on businesses and individuals will continue to decline while spending is increasingly focused on high priority areas, including social assistance and public investment. Further, we will take those steps necessary to ensure that fiscal policy responds swiftly and decisively to shocks. We recognize that such policies are particularly important at this time of unsettled world markets, and given Bulgaria's vulnerability to fluctuations in its trading partners' demands, exchange rates, or short-term capital flows.

- **We will, in close cooperation with the World Bank, accelerate structural reform** to create a fully functioning and competitive market economy that has the flexibility to adjust to external shocks. Our priorities for 2002 include restructuring the education and health care systems, strengthening revenue collection and public expenditure management, finalizing the privatization programs for the banking and insurance sectors, implementing a new energy pricing regime and preparing a new Energy Act, and advancing trade liberalization. We intend to maintain the reform momentum in 2003 and, among others, complete the privatization of enterprises outside the utility and infrastructure sectors, accelerate the opening of the electricity and gas markets, and initiate the privatization of electricity distribution and generation.

C. Macroeconomic Objectives

5. **Our main medium-term objective is to attain rapid sustained growth of at least 5–6 percent, while keeping inflation low.** To attain such growth, we aim to maintain high productivity growth by continued restructuring of the economy and by raising further private savings and investment, including foreign direct investment, relative to GDP. Such sustained growth would help us make important progress in improving the well being of our citizens, reducing unemployment, and raising the living standards. The current account deficit, which reached about 6½ percent of GDP in 2001, is projected to decline to moderate levels, as the impact of the temporary adverse external shocks subside, the economy becomes more competitive, and investment is increasingly financed by private savings. We expect the external deficit to continue to be mostly financed by FDI, and thus reserves levels to remain comfortable, and the debt-to-GDP ratio to decline rapidly in the medium term. At the same time, inflation is expected to remain low, with price increases relative to our trade partners limited to productivity catch-up and further adjustments in administered prices.

6. **In the short run, we will intensify our efforts to limit the impact of the adverse external shocks on output growth and the external balances.** Output growth in 2002, while still robust, will likely be more moderate than previously expected, at around 4 percent, owing mainly to the temporary slowdown in EU demand and the financial crisis in Turkey. Given these external shocks, we will continue to ensure through tight fiscal and incomes policies that the current account deficit remains manageable, at below 6 percent of GDP in 2002–03.

	2001 Est.	2002 Proj.	2003 Proj.
GDP growth (real; in percent)	4.5	4.0	5.0
CPI inflation (end of period; in percent)	4.8	3.5	3.5
Gross official reserves (end of period; in billions of US\$)	3.6	3.6	3.6
(end of period; in months of imports)	4.8	4.4	4.1
External current account deficit (in percent of GDP)	6.4	5.9	5.8

D. Fiscal Policy and Fiscal Structural Reforms

7. **Our medium-term fiscal strategy supports the CBA, provides increased aid for the poor and appropriate incentives for private sector investment and job creation.** We envisage attaining a broadly balanced budget in 2003, and maintaining it in the medium term. We will continue to lower gradually the corporate tax burden, and will reduce payroll taxes as feasible, with a view to reduce the costs of enterprises and stimulate employment. We will partially compensate for these tax cuts by improving collection and broadening the tax base. On the expenditure side, we will limit non-interest expenditure to below 35 percent of GDP by rationalizing our expenditure and eliminating waste, while strengthening the social safety net for the poor and maintaining a strong public investment program. We will also accommodate within this limit the sizable fiscal costs related to transition, and EU accession and NATO membership requirements. We will pay special attention to sequencing, and will systematically put in place deficit-reducing measures prior to tax reductions or spending increases.

8. **In light of recent adverse external shocks, we tightened the fiscal stance by 0.6 percentage point of GDP relative to the budget in 2001, limiting the general government deficit to 0.9 percent of GDP, and are committed to contain the deficit to 0.8 percent of GDP in 2002.** To deliver the fiscal tightening in 2001, and to compensate for overruns in subsidies and public investment, we took several steps in the fourth quarter of 2001. We maintained most categories of discretionary spending at approximately 90 percent of budgeted levels, refrained from starting any new investment projects, cancelled the public sector wage increase planned for October 1, reduced central administrative staff by 10 percent, and continued to improve tax collection. The budget approved by Parliament in December, 2001 envisages a fiscal deficit of 0.8 percent of GDP in 2002 on a consolidated basis. However, we are prepared to deliver a tighter stance in 2002, should external developments or inflation warrant it. To this effect, we will continue with the practice of releasing only 90 percent of the budgeted discretionary allocations during the first three quarters of the year, with a view to extend it to the full year, if needed. In addition, we have

reserved a contingency fund worth 0.3 percent of GDP, which is only to be distributed in case macroeconomic developments do not substantially worsen relative to our projections. The total flexibility implied by these two measures in 2002 is about 1 percentage point of GDP.

9. **We have reduced the tax burden in 2002 to stimulate investment and improve living standards.** We have lowered the personal income tax by raising the threshold for the non-taxable income bracket by more than expected inflation (from 100 leva to 110 leva), reducing the rates for the middle brackets, and lowering the top marginal tax rate from 38 to 29 percent. We have also effectively lowered social security contributions of self-employed workers by keeping the minimum and maximum incomes subject to contributions at last year's levels. We have unified central corporate income tax rates at the lower rate of 15 percent, while maintaining the municipal corporate income tax rate at 10 percent, implying an effective corporate tax rate of 23½ percent. Further, we have introduced tax incentives for enterprises to hire workers from the pool of long-term unemployed or those in high-unemployment regions. In addition, we have shortened the VAT refund period from four to three months for non-exports, reduced by three-quarters to 500,000 leva the threshold of the required equity capital for optional VAT registration, lowered customs duties in line with international agreements, imposed zero VAT rate on export of software, and eliminated the capital gains tax on sale of shares and tradable rights on the Bulgarian Stock Exchange with a view to stimulate the development of the market. The total impact of these measures is projected at about 1 percent of GDP.

10. **At the same time we are broadening the tax base to move toward a more efficient system that also satisfies EU requirements and continuing our efforts to improve revenue collection.** We have removed the zero VAT rate from tourist packages sold abroad. However, to lessen the immediate impact of this change on the tourism industry, we have agreed to implement this measure in a phased manner by refunding 65 percent of the collected VAT this year, and to gradually eliminate the refunds over three years. We have also imposed VAT on all medicine, and limited the list of imported goods exempt from VAT for grant recipients. We have increased excise taxes on beer and tobacco goods with a view to gradual harmonization with EU levels, increased the excise tax on coffee, and introduced excise taxes on certain types of oils and banderoles for other excise goods declared for export. In addition, we have introduced a road tax, revised municipality fees, updated the property tax base to better reflect the true property values, and raised the patent tax rates to compensate for the accumulated inflation in the last three years. We will continue our efforts to bring down the stock of tax and social insurance arrears (indicative ceiling under the program).

11. **We are increasing non-interest expenditure in key areas, including social spending.** We are raising substantially the share of social expenditure in GDP to continue to support the needy: we are increasing heating assistance, raising child allowances in tandem with measures to target them to the most needy families (the adoption of a targeting plan that ensures consistency with the 2002 budget outlay is a benchmark for end-March 2002), and increasing pensions by 6 percent (with average increase in 2002 of 9 percent), well above the expected inflation levels. We are also maintaining a strong public investment program, in

particular in those areas related to the EU accession. With the support of EU accession funds, we are improving transport infrastructure, undertaking environmental projects to meet the requirements of EU directives, and investing in agriculture and rural development.

12. To achieve the deficit target while creating room for the tax cuts and higher social spending and adequate investment, we will accelerate needed structural reforms.

These reforms will allow us to limit spending in unproductive areas such as subsidies. We will maintain the share of the general government wage bill in GDP at approximately the 2001 level, which leaves room to increase public sector average wages by 5 percent twice—in January and in July—provided that public employment is rationalized through accelerated structural reforms. Through civil service reform designed to link wage increases to performance, we also expect wage dispersion to increase and services rendered to improve. We are taking steps to focus subsidies on socially important activities, make them more transparent, and target particularly needy consumers. In parallel, we are reducing overall subsidy needs, as we continue to implement reforms in energy, health, and transportation, and state-owned enterprises in other sectors (see below).

13. We will follow an ambitious public sector reform agenda, which is key to maintaining fiscal viability in 2002 and the medium-term.

- The **pension reform**, based on a three-pillar pension scheme, is designed to ensure adequate retirement income and restore the long-term viability of the pension system. Regarding the first pillar—the pay-as-you-go insurance—we expect the deficit to decline in the medium term as the retirement age is gradually increased and the rate of increase of pensions is limited to inflation or revenue growth, and we are prepared to adjust the parameters to ensure that the system remains viable. As of January 1, 2002, 2 percentage points of the social contributions are being transferred to the second pillar—the mandatory fully funded insurance—for those who are born on or after January 1, 1960. We intend to increase this rate according to a preannounced schedule to 5 percentage points by 2007. We will ensure that these funds, as well as those in the third pillar—the voluntary private pension system—are invested and administered efficiently by further improving the regulatory framework, and strengthening the supervisory capacity of the State Insurance Supervision Agency and the governance of pension insurance companies and pension funds. We will amend the investment guidelines and regulations for pension funds by September 2002 to improve risk diversification, including through gradually raising the ceiling on investment in foreign securities to 25 percent. To close a loophole that allows for unwarranted early withdrawal, we will draft legislative changes by March 2002, and expect Parliament to adopt them by June.
- As a result of changing demographics, we will restructure the **education sector**, while continuing to maintain enrollment rates, provide equal opportunities to all students, and improve the quality of education. Reductions in teacher employment will to the extent possible be carried out through

attrition and rationalization in urban areas, taking into account social and demographic factors. In addition, we will merge several schools to reduce the administrative and operational costs. With these measures, we expect to raise the student-teacher ratio towards the average level in OECD countries. These measures will be reflected in a redeployment plan for teachers that will be finalized and submitted to the Council of Ministers by end-March 2002 (structural benchmark). The plan will be discussed with the interested parties during the second quarter of the year and implemented before the start of the 2002–03 school year.

- We will continue the **health care reform**, aimed at providing better health care services, while rationalizing and improving the efficiency of the providers. The first stage, which transferred the financing of out-patient services to the newly-established Health Insurance Fund (HIF), has already started to yield better quality of services. In the ongoing second stage, hospital care will be increasingly financed by the HIF. In line with the reform strategy, we will increase the contribution of the HIF to 25 percent of total hospital costs in 2002, and more if the administrative capacity is sufficiently developed. We plan to raise the HIF's share above 50 percent in the medium-term, and to facilitate this, we will make the use of clinical pathways fully operational by March 2002, and finalize accreditation of all the hospitals by end-June 2002 to identify providers of high quality health services (structural benchmark). In addition, we will redirect around 10 percent of medical activities from hospitals to out-patient service providers, reduce expensive and non-effective activities in the hospitals, and privatize or close around 10 percent of hospitals in 2002. These measures will be detailed in a multi-year plan for hospital financing, which we will prepare by mid-2002.
- We are working with the **municipalities** to strengthen further their financial performance. Starting this year, we aim to ensure that funds transferred or revenues guaranteed by the state match the expenditure commitments of the municipalities mandated by the state. At the same time, we are giving greater autonomy to the municipalities to administer local fees and other non-tax revenues to finance the services they choose to provide. Under this new system the municipalities should regain their financial health and move towards balanced budgets in subsequent years. Should a municipality accumulate arrears, including those related to wages, despite these new measures, we will not extend the funds to cover the deficit and will apply the sanctions provided by law.

14. **We will emphasize administrative reforms**, which will help us better manage both revenues and expenditures:

- We are redoubling our efforts to establish the **Unified Revenue Agency (URA)**, and to strengthen **customs administration**, with a view to broaden

the revenue base and create room to lower further the tax and contribution rates. An inter-institutional commission that was established to carry out the URA project adopted a strategic plan in June 2001, which identified in detail the steps needed to establish the URA. In line with the plan, we have already started to modernize the information system, with assistance from the World Bank, and we expect to complete it by end-2003. We also have started to implement changes at the territorial and subdivisional levels to separate the collection of republican taxes from local taxes and charges. We have started to do joint audits, and drafted the legislative changes that allow for better exchange of information among revenue collection units. We expect parliament to adopt these changes by March 2002. We will submit to Parliament all other legislation to unify revenue collection, including, by end-June 2002, a law to establish the unified revenue agency (structural benchmark). We completed the consolidation of the large taxpayer offices into one office located in Sofia, controlling about 60 percent of the budget tax revenue, and we are improving accommodation of tax offices at the territorial level to allow for efficient tax collection. Regarding customs, we are taking several administrative and legislative measures to boost collection, facilitate legitimate trade, reduce internal and external fraud and corruption, and achieve sustainable reform in line with the requirements for accession to the EU. These measures include: increasing mobile anti-smuggling teams; strengthening information exchange with the customs administration of the EU member countries; establishing a central post-clearance control unit; optimizing the facilities at the border crossing points; holding joint inspections with the General Tax Directory; consolidating the number of offices; and establishing an internal audit unit. To implement these measures, we are receiving significant foreign assistance and have signed a three-year contract with the Crown Agents company.

- While the existing budgeting system worked well from the point of view of achieving fiscal targets, we have begun to **reform the budget preparation process** to focus more on spending composition and quality, and economic growth. Specifically, we will identify priorities and include them in the initial strategic phase as indicative allocations to budget units, based on a transparent decision framework. We will bolster expenditure estimates by creating baseline projections for each first level budget unit for the budget year plus three years, using clear and transparent rules. At the same time, we will increase discretion of budget units in managing their administrative costs, while continuing to maintain firm control from the center over the cost limits being provided to line ministries, and putting in place additional reporting requirements on use of funds in areas of particular concern. We will also improve further budget documentation to facilitate more informed discussion by including the impact of major initiatives for the budget year plus three years. We will improve the credibility and transparency of the macroeconomic framework by circulating it more widely, comparing it with other available

forecasts, clearly showing the sensitivity of the budget's major aggregates to variations in macroeconomic parameters, and discussing developments between the time the framework was issued and the presentation of the budget. We plan to advance the start of the 2003 budget preparation to the first quarter of 2002, and plan to make this new framework fully operational by the next budget cycle, for which we have started to receive technical assistance from the IMF.

- We will further **improve the treasury system** to better control and execute government expenditure. The ongoing treasury reform is well advanced, and by now, the treasury single account (TSA) includes all leva accounts of the budget organizations held in the BNB (around 80 percent of the cash resources). The payments of 24 of the 26 ministries and agencies and their sub-ministerial spending units (over 2500) are carried out through the system for Electronic Budgetary Settlement, while their revenues are centralized in the BNB. By December 2002 the funds of the autonomous budgets (BTV, BN Radio, judiciary system, and the HIF) as well as the suspense accounts in leva will also be included in the TSA (structural benchmark from December 2002 onward). In addition, the new chart of accounts is applied by all government agencies from the beginning of 2002, and all first level spending units now report through the new information system.

E. Labor Market Policies

15. **Appropriate labor market policies are key to safeguarding the CBA, and bringing down unemployment.** Our policies are geared toward ensuring strong productivity growth necessary for sustained increase in real wages, and maintaining financial discipline of the SOEs. Furthermore, we are making every effort to increase the flexibility of the labor market, and moving toward market-oriented solutions to generate jobs. Combined, these policies will help maintain competitiveness, increase employment and wages, and facilitate rapid adjustment of the economy to shocks.

16. **To help achieve these goals, we will strictly implement our incomes policy for the SOEs and minimum wage policy .** We have issued an incomes policy ordinance, which allows for higher wages only if staff count is reduced or productivity increased. We will monitor particularly closely the wage bill of 60 enterprises, including those with the largest losses and arrears, monopolies, and those receiving subsidies. We expect our incomes policy to limit the increase in the aggregate wage bill of these enterprises to no more than 2 percent (a ceiling on their aggregate wage bill is a quarterly performance criterion for 2002). We plan to freeze the wage bill at the level of the third quarter of 2001 for all those enterprises on the list that are incurring losses or having arrears, and for those receiving subsidies. Monopolies that increase profits, do not have arrears and do not receive subsidies will be allowed to increase their wage bill by up to 5 percent during 2002. In enterprises that exceed their wage bill ceilings, we will take measures to reverse the increase, and penalize its management. Regarding the minimum wage, after the 17 percent increase in October 2001, we will

maintain it at that level throughout 2002. After that, we will increase it annually in line with the average public wage increase.

17. **We will make every effort to continue to improve the functioning of the labor market.** We are pursuing active labor market programs with a view to create new jobs via promoting small and medium size businesses, and allowing unemployed workers to acquire new skills needed for available jobs. These programs, for which we have envisaged larger funds in the 2002 budget, include temporary employment opportunities, and tax incentives for companies that hire long-term unemployed. We have also initiated a loan guarantee program to allow banks to extend loans at market-based interest rates to small-enterprises in regions with high unemployment, but will ensure that the guarantees stay within the 20 million leva budget allocated to the Guarantee Fund for Micro-Crediting, and do not interfere with banks' lending decisions or impose a financial burden on banks. Furthermore, we are starting negotiations with the social partners to prepare amendments to the Labor Code aimed at modernizing and enhancing the flexibility of the labor market, including through the reduction of dismissal costs. We aim to submit these amendments to Parliament by June 2002.

F. Financial Sector Policies

18. **We are committed to strengthen bank intermediation, which shrunk markedly in the wake of the 1996–97 financial crisis, and develop further non-bank financial institutions, under appropriate supervision.** Credit to the private sector is at low levels, although it has begun to grow quite strongly. We are committed to generate the necessary environment that would yield higher levels of credit to the private sector to support the investment that is needed for strong and sustained growth. More broadly, well functioning financial markets would support the CBA, and help our efforts to join the EU. The measures we are taking to strengthen bank intermediation are market-based and aim to eliminate structural barriers to credit growth in the financial sector, including by strengthening corporate governance in the enterprise sector, improving accounting standards, and ensuring that the regulatory framework and its implementation remain sound. In this regard, we will draw on the conclusions and recommendations of the Financial Sector Assessment Program that was conducted in October-November 2001.

19. **We will expedite the full privatization of the financial sector.** We sold the government's stake in the Central Cooperative Bank to a strategic investor in November, 2001, and around 82 percent of the banking sector is now in private hands. Of the remaining state-owned banks, we plan to privatize Biochim Bank by mid-2002, and launch a new tender in the first half of 2002 to that effect. Further, we will adopt by end-March 2002 a privatization plan for DSK Bank—which preferably will involve a strategic investor—with a view to move to the implementation stage before the end of the year (structural benchmark). We will reopen the privatization procedure for the State Insurance Institute, and organize a re-appraisal of its value by March 2002, with a view to sell it by June 2002. For this purpose, we will by end-March 2002 issue a tender to privatize the Institute or, as an interim step toward such privatization, to transfer its management to a strategic investor (structural benchmark).

20. **We are taking measures to stimulate financial markets.** We are improving the provision and exchange of financial and credit record information, including through full implementation of the new accounting and auditing law. We will reinforce creditor rights and insolvency procedures by submitting to Parliament amendments to the civil procedure code, improving corporate governance, and strengthening the business environment more generally. We are committed to abstain from any measures that would interfere with bank lending to the private sector. To stimulate long-term lending, we intend to exclude long-term deposits in the banking system from minimum reserve requirements, while maintaining the level of the requirement at 8 percent for the deposits that continue to be covered. To stimulate the development of the securities markets, we are planning to float up to 30 percent of the shares in major companies that are still partially or fully state owned. Other measures we envisage include enacting amendments to the Law on Public Offering of Securities, introducing international accounting standards in 2003 for financial and publicly listed companies and in 2005 for all enterprises, harmonizing the taxation of financial instruments and services, and address deficiencies in minority shareholder protection. We will give priority to the implementation of the Real Time Gross Settlement System project and aim to finalize it by end-2002.

21. **We will continue to strengthen the oversight of the financial system.** We will undertake further steps to strengthen banking supervision, with a focus on improving institutional capacity and implementation. For this purpose, the BNB will be given broader powers to investigate the identity and suitability of direct and indirect shareholders of banks, both domestic and foreign. We will submit to Parliament the necessary amendments to the Banking Law by March 2002, and the BNB will change the relevant regulations shortly after the amendments are adopted. The supervisory mechanisms will be strengthened to prepare for a projected increase in lending activities and short-term capital flows associated with continued robust growth and EU accession. The BNB will continue to expand its expertise in modern risk management systems and ensure that commercial banks implant such systems tailored to their portfolios. At the same time, to improve the process of handling insolvent banks, including already closed banks, we will take all the steps necessary to have Parliament approve the Bank Bankruptcy Law as drafted in consultation with IMF staff by end-March 2002 (structural benchmark), and to adopt the associated secondary legislation. We will upgrade the supervision of insurance companies by strengthening the legislative and regulatory framework in the areas of corporate governance and internal controls, accounting and actuarial rules, standards of market conduct, and international supervisory coordination and cooperation and improving the quality of on-site inspections including by making them more frequent and more focused on risk assessment. To develop a system-wide perspective on assessing financial sector risks, by March 2002, a forum will be set up for periodic information sharing, coordination and cooperation among the heads of the financial supervision agencies and relevant government officials. We will intensify our efforts to combat money laundering. To this effect, we will by June 2002 submit to Parliament amendments to expand the scope of the Anti-Money Laundering Law to lawyers and exchange bureaus, introduce corporate liability for anti-money laundering offenses, and improve the options for freezing assets during the pre-trial phase. We also will by

March 2002 introduce measures to strengthen the independence and resources of the Financial Investigations Bureau and other anti-money laundering services.

G. Structural Reform

Enterprise restructuring and privatization

22. **While the enterprise sector has witnessed major changes in recent years, important structural impediments to growth remain.** Achievements so far in this area include privatizing more than half of state-owned assets, liquidating a number of non-viable enterprises, and selling more than half of minority share packages in non-strategic enterprises. However, there have been delays in the privatization of several large enterprises, including Bulgartabac and the Bulgarian Telecom Company (BTC). Moreover, the privatization process has at times been less than fully transparent, and a number of privatization deals, including many management-employee buyouts (MEBOs), did not produce the desired improvements in the privatized companies. Furthermore, resolution of unviable entities has been slow, as liquidation and bankruptcy procedures remain cumbersome. Restructuring and rehabilitation efforts of the state railway company (BDZ) and the energy sector remain to be completed.

23. **We are determined to complete the reform of the enterprise sector within two years, with a view to create a fully market-oriented and competitive economy.** First, we are already improving the transparency and quality of privatization overall. Second, we plan to finalize privatization of all viable non-infrastructure SOEs by end-2002, and make major progress in privatizing the infrastructure companies. Third, we will complete the liquidation of those SOEs that are not viable, and further improve the liquidation and bankruptcy procedures. Finally, we will implement rigorous rehabilitation plans for those companies that provide specific public services, particularly BDZ. More specifically:

- **We aim to guarantee transparency and a level playing field for all privatization participants.** We have submitted to parliament a new Privatization Law that removes all preferential terms for MEBOs (such as allowing the use of deferred payments), and restricts privatization methods to auctions, tenders, and public offering of shares, ending the practice of direct negotiations with buyers. On the administrative side, we will make the Privatization Agency (PA) the only body in charge of privatization deals. Also, we intend to publish on a monthly basis details regarding completed sales, including the identity of the buyer, price, deadlines and conditions of payment, and investment and employment commitments.
- **Our ambitious privatization agenda aims to conclude the remaining privatization of large enterprises by end-2002.** In the cases of Bulgartabac and BTC we have signed contracts with sales advisors, prepared the sales strategy, and expect to complete the sale of both companies before mid-2002. The privatization plan for 2002 also aims at selling, among others, the State Insurance Institute, 7 electricity distribution companies, 36 water power plants, the Bulgarian Rivershipping Company, and the Navigation Maritime Bulgare. Also, we will

complete the sale of all residual stakes in privatized companies, excluding packages held due to restitution or legal problems, by end-June 2002. We drafted legislative changes to open ports and airport operations to concession, and expect the concessions to start operating in 2002.

- **We are continuing to work on initiatives to improve the business climate.** We are taking steps to simplify the licensing, permit, and registration systems. This should encourage the establishment of more domestic and foreign businesses. We will refrain from targeting investment incentives—whether through the tax system or otherwise—based on the nationality of investors. In addition, we are improving the delivery of government services to businesses, as well as their accountability, with a “one stop shop” program, which limits the interface between the administration and business to a single office. Moreover, to help the judicial system better serve the business community, we are proceeding with reforms in this area, including training judges on financial procedures and computerization of the courts. Finally, we are amending the commercial code with a view to strengthen corporate governance and accelerate the liquidation and bankruptcy proceedings. These amendments should facilitate liquidating the assets of the enterprises that entered into liquidation in 1999.
- **We are committed to restructuring the state railways company.** Our overall strategy is for the railway operator to ultimately function on a commercial basis, with compensations limited to targeted groups, and adequate subsidies defined for public sector obligations; and the state to be responsible for development of the infrastructure. In line with this strategy, last year under the Special Action Plan for 2001, we raised freight and passenger fares by 20 and 15 percent, respectively, reduced overstaffing and operating costs, and sold surplus assets. However we incurred larger-than-projected losses largely because of lower-than-expected traffic and lack of sufficient progress in implementing the Special Action Plan. This year we are redoubling our efforts to continue restructuring and to keep subsidy needs within the budgeted 70 million leva. Specifically, in January we split infrastructure and operating services, and competition will be gradually introduced as envisaged in the new Railways Law. Moreover, we are rationalizing the staff structure closer to European standards, limiting wage increases, removing from operation surplus assets, and eliminating unprofitable lines. Within the course of the year, and with the help of external consultants and the World Bank, we will determine which activities should be operating at cost recovery levels, and which ones require government subsidies. We will ensure that the state has clear contracts with BDZ on the targeting and level of subsidies. Finally, we will complete within 2002 a long-term business plan that defines the next stage of restructuring.

Energy sector reform

24. **Establishing a more competitive and efficient energy sector is of key importance for accelerating economic growth and reducing fiscal risk.** With this objective in mind, we are revising our medium-term national energy strategy with a view to speeding up liberalization, increasing private sector participation, privatizing the production and

distribution companies, and increasing transparency and competition in the electricity and gas markets. We will ensure that these changes also meet EU accession requirements.

25. Parliament in November 2001 approved urgently needed amendments to the Energy Act. These amendments were designed to enable a further liberalization of the energy sector, as well as to clarify company-customer relations in the district heating sector to improve payments and collections. In line with these legislative changes, about 10 percent of the gas and electricity markets will be prepared to be opened by end-2002, allowing large users to contract supply directly. The November amendments also introduced important institutional changes, including by establishing a Ministry of Energy and strengthening the Regulatory Commission. The Council of Ministers will adopt all regulations envisaged in the current Energy Act by end-June 2002 with the exception of the regulations related to the opening of the gas and electricity markets, which will be adopted by end-March 2002. We will, in consultation with the World Bank, also clarify the implications of the new regulatory pricing regime provided for in the Act. In addition, the regulator will set and announce a timetable by end-April 2002 for the adjustment of household tariffs for gas and electricity to cost-recovery price levels, including an interim target date by which average household tariffs will equal average commercial tariffs (structural performance criterion). The regulator will by end-June 2002 make the new regulatory pricing regime fully operational, including by making available the proper accounting information to determine cost-recovery levels and adopting a transparent pricing mechanism (structural benchmark). In parallel, we have begun to prepare a new Energy Act and intend to have the Council of Ministers approve the final draft by end-June 2002 (structural benchmark). The new Energy Act will harmonize Bulgaria's energy legislation with EU Electricity and Gas Directives, including through introducing an authorization process for adding power generation capacity and allowing investors to take market risks by opening further the electricity and gas markets.

26. In addition to these legislative and regulatory initiatives we are undertaking major restructuring efforts in a number of areas of the energy sector. We will implement the restructuring plan for the district heating sector as adopted and in accordance with its timetable during the current and forthcoming heating seasons to stem the heavy financial losses and prevent further decay of the infrastructure. We will by end-June 2002 prepare a plan which envisages selling all the electricity distribution and—in a next step, following preparation for privatization—the generation companies to strategic investors. We will revise the restructuring program for the gas sector with a view to stimulating the development of the gas market and investment, award licenses for developing the low pressure segment of the market, continue the restructuring of the Bulgargaz transmission company, and finalize the preparations to enable third-party access to the transmission network. We will allow large users to contract gas supply directly, including from abroad to the extent external contractual obligations leave room for it. We will, by end-2002, complete the financial liquidation of unviable coal mines and finalize the privatization of viable mines. From 2003, budgetary support to the coal sector will be strictly limited to financing of the technical liquidation of closed pits and environmental rehabilitation.

External sector policies

27. **Building on the major progress made in recent years, we will pursue further trade liberalization in order to prepare for EU accession, and to create a more attractive environment for foreign investors.** To date we have eliminated non-tariff barriers and substantially reduced tariffs. We aim to further liberalize and simplify our trade regime, and eventually harmonize it with that of the EU. To this end, we will prepare a multiyear schedule, which we will adopt by end-June 2002 (structural benchmark). Guided by this schedule, we will reduce the unweighted average most favored nation (MFN) import tariff rate (currently at 12.7 percent) to 6 percent by 2006, with significant annual reductions, to eliminate the gap with the current EU average and further reduce distortions to international trade. The 2002 Customs Tariff we adopted already goes in this direction. We aim to privatize all remaining state-trading companies during 2002.

28. **We have begun to manage government debt with the objectives to lower the public sector debt-to-GDP ratio, reduce the portfolio risk, minimize roll-over risk, establish benchmarks in international and domestic capital markets, and keep sufficient liquidity in the Fiscal Reserve Account (FRA).** We have submitted to parliament a new Sovereign Debt Law, which provides a firm legal foundation and procedures for issuance of state debt and guarantees. We expect parliament to adopt the law by March 2002, and we plan to also review our debt management strategy by that point. In line with our intended debt strategy, we have already made significant progress in reducing Bulgaria's debt burden, with the end-year public external debt standing at around US\$ 8.7 billion, or 67 percent of GDP. We intend to achieve in 2002 a further significant reduction in the public external debt as a share of GDP, and debt ceilings consistent with this objective are performance criteria under the program. The issue of our first Eurobond in November 2001 has been successful, and if we access the market again, we will ensure that the choice of maturity, size, and currency denomination will continue to be based on the objectives of our debt management strategy. Our policies will also encourage the further development of the domestic market for sovereign debt issues and the definition of the yield curve. A sufficiently high stock of the FRA will be the key to maintaining market confidence and to our meeting external obligations when international capital markets are difficult or too costly to access. We will therefore maintain the FRA at a level in excess of 90 percent of anticipated annual debt service (performance criterion under the program). At the same time, we will seek to maximize its rate of return consistent with maintaining adequate liquidity and prudent risk.

29. **We believe that transparency and predictability are essential for our debt management strategy to be effective.** We will therefore continue to make all relevant data and information available in a timely and broad-based manner to domestic and foreign investors, also through making further efforts in adopting the IMF's Special Data Dissemination Standard. We will make public our medium-term debt service payments schedule. We will also appoint a contact person within the Ministry of Finance to communicate with foreign and domestic investors. The strengthening of our statistical standards with regard to external debt and reserves should further help in this regard.

Table 1. Bulgaria: Prior Actions and Structural Performance Criteria and Benchmarks, 2002¹

Measures	Program Timing	Level of Conditions
1. Parliament to adopt a 2002 State budget consistent with paragraphs 8–12.	Before IMF Board meeting	Prior action
2. Council of Ministers (CoM) to adopt an ordinance on income policies consistent with paragraph 16.	Before IMF Board meeting	Prior action
3. Announce a schedule to bring household electricity prices to full cost-recovery levels (paragraph 25).	End-April 2002	Performance criterion
4. Finalize the school redeployment plan, and submit it to CoM (paragraph 13).	End-March 2002	Benchmark
5. Adopt a child allowance allocation system, limiting allowances to most needy families (paragraph 11).	End-March 2002	Benchmark
6. Bank Consolidation Company (BCC) to adopt a privatization strategy for DSK Bank (paragraph 19).	End-March 2002	Benchmark
7. Issue a tender either to privatize the State Insurance Institute, or to transfer the management of the company to a strategic investor as an interim step toward privatization (paragraph 19).	End-March 2002	Benchmark
8. Parliament to adopt the Bank Bankruptcy law (paragraph 21).	End-March 2002	Benchmark
9. Submit to parliament a law to establish the unified revenue agency (paragraph 14).	End-June 2002	Benchmark
10. Complete accreditation process for all hospitals (paragraph 13).	End-June 2002	Benchmark
11. Have the Council of Ministers approve the final draft of a new Energy Act as described in paragraph 25.	End-June 2002	Benchmark
12. Make the new energy pricing regime fully operational (paragraph 25).	End-June 2002	Benchmark
13. Announce a reform of the import tariff schedule, to be phased over the period to January 2006, reducing the unweighted average MFN tariff to no more than 6 percent with significant annual reductions (paragraph 27).	End-June 2002	Benchmark
14. Further improve the Treasury Single Account (TSA) by ensuring that the funds of the autonomous budgets (BTV, BN Radio, judiciary system, and the HIF) as well as the suspense accounts in leva are also included in the TSA (paragraph 14).	December 2002 onward	Benchmark

1/ Paragraph numbers refer to the Memorandum of Economic Policies dated [...].