ICR Review
Operations Evaluation Department

Report Number : ICRR10990

1. Project Data:		Date Posted :	08/08/2001	
PROJ ID:	P055137		Appraisal	Actual
Project Name :	Sal 3	Project Costs (US$M)	2200	775
Country:	Russian Federation	Loan/Credit (US$M)	1500	400
Sector(s):	Board: EP - Central government administration (37%), General industry and trade sector (24%), Sub-national government administration (13%), General energy sector (13%), Oil and gas (13%)	Cofinancing (US$M)	700	325
L/C Number:	L4382			
		Board Approval (FY)		99
Partners involved :	Government of Japan	Closing Date	12/31/1999	12/31/2000
Prepared by :	Reviewed by :	Group Manager :	Group:	
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2. Project Objectives and Components

a. Objectives

The project's objectives were to support further structural reforms in the same areas addressed by SALs 1 and 2, though in greater depth: (1) infrastructure monopolies, (2) private sector development, (3) fiscal management, and (4) financial sector. Although SAL 3 was restructured in July, 1999, the purpose of the restructuring was only to rephase the policy and institutional development reforms in view of the financial crisis of August 1998, to more closely tie tranche release to implementation of specific reforms and to backload the SAL to further reduce risk . The project's objectives and implementation were closely aligned with the IMF's EFF .

b. Components

(1) infrastructure monopolies: to improve efficiency, transparency and competitiveness of electricity, gas, oil, and railway sectors: (a) improve payments discipline, (b) enhance the environment for private investment, (c) reduce and eliminating the barriers to competitive supply and protecting against abuse of monopoly power, (d) ensure that prices better reflect costs and demand conditions, and (e) enhance arms-length regulatory oversight where competition was deemed insufficient to protect public interests . (2) private sector development: (a) promote transparent and competitive privatization, (b) establish institutions and policies to promote rules -based competition, market-based entry and exit, effective corporate governance and labor mobility, (c) create functioning markets for urban land and real estate, (d) implement financial accounting and auditing practices in line with international standards, and (e) liberalize the policy regime for international trade and foreign direct investment . (3) fiscal reforms: (a) eliminate non-payments of tax and expenditure arrears in budgetary accounts, (b) reform tax structures to reduce distortions, strengthen compliance, and boost tax collections, (c) improve tax administration, (d) reform extrabudgetary funds, (e) strengthen institutional arrangements for effective budget management, (e) reform intergovernment fiscal relations, and (vii) strengthen capacity for debt management and monitoring . (4) financial sector: (i) strengthen supervision and resolving problem banks, (b) enhance transparency in the banking sector with the introduction of international accounting standards and public disclosure requirements, and (iii) foster competition in the banking sector .

c. Comments on Project Cost, Financing and Dates

The project was part of a US$22.6 billion package of assistance to Russia . Project financing amounted to US$2,200 million, of which SAL 3 provided US$1,500 million and the Government of Japan, US$700 million.The loan was approved and made effective as a three tranche loan on August 6, 1998. The restructured SAL, approved by the Board on July 29, 1999, comprised five tranches: First tranche, US$300 million; second tranche US$100 million, third tranche, US$ 100 million, fourth tranche, US$ 400 million, and fifth tranche, US$ 600 million. Only the first tranche and the second tranches were released (at Board approval of SAL 3 and at Board approval of the restructured SAL 3, respectively). The loan closed on August 30, 2000, 8 months behind schedule, and the third, fourth, and fifth tranches, comprising US$ 1.1 billion, were cancelled. Only the first tranche of the Government of Japan cofinancing was released (along with the first tranche of the SAL 3) for US$325 million. The balance has been cancelled.

3. Achievement of Relevant Objectives:

(1) Infrastructure monopolies: financial discipline improved through improvements in cash collections, reduction in barter and arrears accumulation and other measures; (2) Concerning private sector development, virtually none of the relevant objectives have been achieved; (3) Fiscal management: (a) tax reform (i) the Duma adopted Part II of the Tax Code which broaden the VAT base, eliminates unwanted exemptions, moves towards a destination basis of the VAT base, increase specific tax rates, unifies multiple social extrabudgetary fund contributions into a lower unifies social tax of 35.6 percent of the wage payroll, compared to a total now of 39.5 percent. (ii) Tax administration has improved, and tax arrears to the Federal Government have declined from 4.1 % of GDP at end-1999 to 3.2 percent of GDP at 2nd-2000. (iii) Tax offsets which provided incentives for arrears buildups have been eliminated . (iv) Collection rates from large taxpayers improved and have been higher than 90 percent. (v) The regional network of tax inspectorates has been strengthened. (b) Extra-budgetary funds such as the road fund were consolidated into the budget, but more remains to be done. (c) Government has decided to establish an agency for monitoring and managing public debt. (4) Financial Sector. Some improvements were made in establishing the legal and institutional framework for restructuring the banking system.

4. Significant Outcomes/Impacts:

The fiscal system has been improved somewhat, a complex undertaking which will have implications for other major reforms which need to be pursued.

5. Significant Shortcomings (including non-compliance with safeguard policies):

(1) As noted in the ICR, capital outflows continued through 2000. From appraisal of SAL 3 in 1998 to closing in 2000, capital flight amounted to US$88.2 billion. These outflows appear to be continuing. (2) Reform of Infrastructure Monopolies. Most conditions remain unmet (including a legal framework for production-sharing arrangements in oil extraction, restructuring of RAO USE into independent generating companies, etc ., etc.) (3) Private Sector Development. Numerous legislative amendments required as loan conditions have not been met (such as Law on insolvency to eliminate court discretion in over-ruling creditors' bankruptcy decisions, Law on Joint Stock Companies providing further protection for shareholders, the legislative framework for foreign direct investment to bring it into conformity with international practice, the Law on Competition and Restricting Monopoly Activities, Law on Licensing, and the Labor Code. (4) Fiscal Management. A public procurement law has still not been passed. (5) Financial Sector Reform. Implementation of decisions by the Central Bank and the Agency for Restructuring of Credit Organizations (ARCO) have been frustrated by legal challenges. Government still does not have a clear strategy for Sberbank (which accounts for 75 percent of household deposits and 25 percent of the banking system credits to the private sector. Government response to a joint IMF, World Bank, and EBRD proposal to restructure the banking system was only superficial.

6. Ratings:	ICR	OED Review	Reason for Disagreement /Comments
Outcome:	Unsatisfactory	Unsatisfactory	
Institutional Dev .:	Modest	Modest	
Sustainability :	Likely	Likely	The fiscal reforms which were achieved, and the few reforms achieved in the three other areas of the SAL, are likely to be sustained.
Bank Performance :	Satisfactory	Satisfactory	An important reason for the satisfactory rating was the Bank's supervision and the restructuring of SAL 3 into a five tranche operation which limited the riskiness and the Bank's exposure.
Borrower Perf .:	Unsatisfactory	Unsatisfactory	Despite the restructuring of SAL 3 into five tranches, the government could not achieve most of the reforms to be supported by SAL 3 so that the final three tranches, comprising two-thirds of the loan, had to be cancelled.
Quality of ICR :		Exemplary	

NOTE: ICR rating values flagged with ' * ' don't comply with OP/BP 13.55, but are listed for completeness.

7. Lessons of Broad Applicability:

1. As stated in the ICR, the Bank should be realistic in expectations over the pace of reforms . Especially given the implementation record in Russia and Russia's special circumstances (federal structure, large number of regions, powerful business interests), the Bank needs to evaluate carefully the likelihood of reforms, and calibrate lending conditionality closely to this. The restructuring of SAL 3 was a realistic step in this direction. 2.The Bank needs to

pursue broad outreach programs in coordination with partners to build a broad base of support for essential reforms .

8. Assessment Recommended? ● Yes ○ No

Why? Although an audit of this loan would follow the CAE for Russia and the audits of SAL 1 and 2, a loan of this size for a major borrower should be audited to draw lessons for the Bank's continuing activities in Russia and to extract lessons for operations in other large borrowers .

9. Comments on Quality of ICR:

The ICR is clearly written, presents a great deal of information in very useable form, for which merits a rating of exemplary.