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**MEMORANDUM OF THE PRESIDENT
OF THE
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
THE INTERNATIONAL DEVELOPMENT ASSOCIATION
AND THE
INTERNATIONAL FINANCE CORPORATION
TO THE
EXECUTIVE DIRECTORS
ON A
COUNTRY ASSISTANCE STRATEGY PROGRESS REPORT
OF THE
WORLD BANK GROUP
FOR
INDIA**

January 15, 2003

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CURRENCY EQUIVALENTS

Currency unit: Rupees (Rs.) as of October 31, 2002
US\$1 = Rs. 48.41

GOVERNMENT FISCAL YEAR

April 1—March 31*

ABBREVIATIONS AND ACRONYMS

AAA	Analytic and Advisory Activities	GoI	Government of India
ADB	Asian Development Bank	GSDP	Gross State Domestic Product
AP	Andhra Pradesh	GTZ	German Development Corporation
APL	Adaptable Program Loan	IBRD	International Bank for Reconstruction and Development
ARPP	Annual Report on Portfolio Performance	ICRIER	Indian Council for Research on International Economic Relations
AusAID	Australian Agency for International Development	IDA	International Development Association
AML	Anti-Money Laundering	IFC	International Finance Corporation
BOP	Balance of Payments	ILEP	International Federation of Anti Leprosy Associations
BJP	Bharatiya Janata Party	IMF	International Monetary Fund
CAE	Country Assistance Evaluation	IMR	Infant Mortality Rate
CAS	Country Assistance Strategy	IT	Information Technology
CDF	Comprehensive Development Framework	KfW	Kreditanstalt für Wiederaufbau
CDS	City Development Strategy	JBIC	Japan Bank for International Cooperation
CIDA	Canadian International Development Agency	MDGs	Millennium Development Goals
CII	Confederation of Indian Industry	MIGA	Multilateral Investment Guarantee Agency
CMR	Child Mortality Rate	MP	Madhya Pradesh
CRISIL	Credit Rating and Information Services of India Limited	MUTP	Mumbai Urban Transport Project
CPI	Consumer Price Index	MYRADA	Mysore Rural Agricultural Development Agency (an NGO)
DANIDA	Danish International Development Assistance	NCAER	National Council of Applied Economic Research
DFID	Department of International Development (U.K.)	NGO	Non-Governmental Organization
DPEP	District Primary Education Program	NHAI	National Highway Authority of India
DPIP	District Poverty Initiatives Project	NHFS-2	National Family Health Survey
EU	European Union	NPA	Non-Performing Advances
FDI	Foreign Direct Investment	NSS	National Sample Survey
FSAP	Financial Sector Assessment Program	OED	Operations Evaluation Department
GDP	Gross Domestic Product	O&M	Operations and Maintenance
GDPfc	Gross Domestic Product at factor cost	PER	Public Expenditure Review
GEF	Global Environmental Facility		
GNFS	Goods and Non-factor Services		

* Note: Fiscal years indicated by numerals only—e.g., 2000/01—refer to the Government of India fiscal year (April 1—March 31). Fiscal years indicated by “FY”—e.g., FY01—refer to the Bank Group’s fiscal year (July 1—June 30).

PPIAF	Public-Private Infrastructure Advisory Facility	UNDAF	UN Development Assistance Framework
PSBs	Public Sector Banks	UNDCP	United Nations International Drug Control Program
PSP	Private Sector Participation	UNDP	United Nations Development Program
PSU	Public Sector Undertakings	UNESCO	United Nations Educational, Scientific and Cultural Organization
PWD	Public Works Department	UNFPA	United Nations Population Fund
QRs	Quantitative Restrictions	UNICEF	United Nations Children's Fund
RBI	Reserve Bank of India	UNIFEM	United Nations Development Fund for Women
RWSS	Rural Water Supply and Sanitation	UP	Uttar Pradesh
SDC	Swiss Agency for Development & Cooperation	USAID	U.S. Agency for International Development
SEB	State Electricity Board	VAT	Value-Added Tax
SEWA	Self Employed Women Association (NGO)	WHO	World Health Organization
SIDA	Swedish International Development Agency	WBI	World Bank Institute
SME	Small and Medium Enterprise	WPI	Wholesale Price Index
SSPR	Structural and Social Policy Review	WTO	World Trade Organization
TA	Technical Assistance	WWF	World Wide Fund for Nature
TB	Tuberculosis		
ULB	Urban Local Body		
UNAIDS	Joint United Nations Program on HIV/AIDS		

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INDIA COUNTRY ASSISTANCE STRATEGY PROGRESS REPORT

1. The last full Country Assistance Strategy (CAS) [R-2001-0037/1](IFC/R2001-0037/1) was discussed by the Board on April 5, 2001. This progress report provides an update on recent political, economic and policy developments; reviews CAS implementation; and discusses emerging issues. The report has been prepared by IBRD/IDA and IFC, in consultation with MIGA.¹

I. POVERTY AND DEVELOPMENT: GOALS AND CHALLENGES

2. Poverty reduction remains India's most compelling challenge, notwithstanding good progress in the 1990s. Based on new information (1999/00²), the GoI estimates that poverty fell from 36% of the population in 1993/94 to 26% by the end of the decade, with rural poverty falling from 37.3% to 27.1% and urban poverty falling from 32.4% to 23.6% over the same period.³ However, changes in the survey methodology used to calculate the most recent estimates render them not comparable to earlier official poverty estimates. This has generated a debate on poverty levels and trends in India. Recent work⁴ suggests that poverty fell at a slower pace—from 36% to 29% of the population—than suggested by official estimates. These issues were fully discussed in a joint GoI/Bank workshop on "Poverty Measurement, Monitoring and Evaluation" in January 2002. Differences on data notwithstanding, broad consensus exists that poverty fell in the 1990s. However, India is still home to 260-290 million poor people—poverty in India is of global significance. The draft Tenth Five-Year Plan, currently under preparation by the Indian Planning Commission, emphasizes the key goals of poverty reduction and human development, recognizes the importance of the Millennium Development Goals (MDGs), and identifies an explicit set of development goals and monitorable targets.

3. How likely is it that India will achieve the stated goals for poverty reduction and development by their target dates of 2015? Box 1 presents progress made with the MDGs in the 1990s. Significant reduction in poverty and improvements in literacy and school enrollments were achieved in the 1990s: poverty fell by 1.2 percentage points a year and the enrollment rate among primary-aged children grew by 1.0 percentage point a year. Forecasting the likelihood of India achieving the MDGs by their target dates is difficult because the desired outcomes will require coordinated interventions across many sectors. Nevertheless, a comparison between *actual* progress in the 1990s and *needed* progress to achieve MDGs is useful. As figure 1 shows, targeted reductions in poverty will be achieved if poverty levels continue to fall by at least 0.7 percentage points a year. However, the rate of progress in the primary school enrollment rate must accelerate to 1.5 percentage points a year to achieve the relevant MDGs. Compared to poverty and education, progress in health indicators was slower in the 1990s and a rapid acceleration is necessary if India is to reach the stated goals by 2015. It is worth noting that all 15 largest states (accounting for over 90% of India's population), including the three large and poorer states—Uttar Pradesh (UP), Bihar and Madhya Pradesh (MP), showed progress in reducing poverty (including rural poverty) and by and large improving social indicators. However, as better-performing states have made faster progress, poverty and illiteracy have become more concentrated in India's large and poorer states. Thus, while UP, Bihar and MP accounted for 41% of India's poor in the early 1990s, this figure had risen to nearly 50% by the end of the 1990s. The MDGs will not be achieved without widening economic opportunities and overcoming barriers to more rapid poverty reduction and better human outcomes in

¹ The report has been discussed with the Government of India, but the Government does not necessarily endorse all its contents, judgments and opinions.

² National Sample Survey (NSS) 55th Round, covering July 1999 to June 2000.

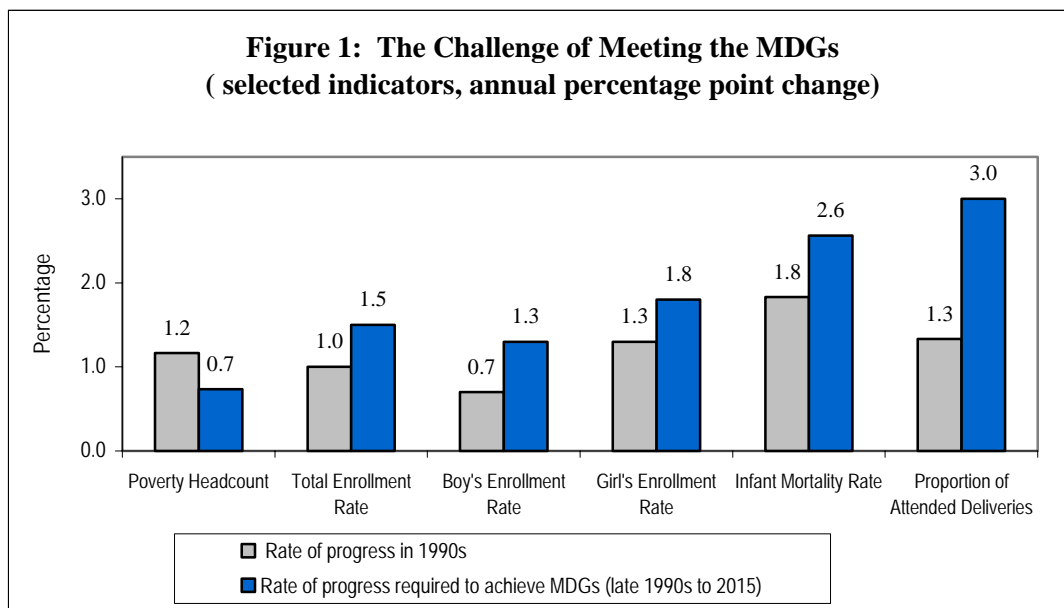
³ Planning Commission, Government of India, February 2001.

⁴ See, for example, "Adjusted Poverty Estimates in 1999-2000" by Angus Deaton, Princeton University, 2001. Also "Recent Debates on the Database for Measurement of Poverty in India: Some Fresh Evidence" by Suresh Tendulkar and K. Sundaram, Delhi School of Economics, 2001.

these poorer states. An important focus of the Bank's work with the GoI over the next year will be to analyse the actions that will be needed to achieve the MDGs (see para. 92).

Box 1: Achieving the Millennium Development Goals—India's Progress in the 1990s	
Key Targets	Current Levels and Recent Trends in India
Halve, between 1990 and 2015, the proportion of people whose income is less than US\$1/day.	Based on official estimates, poverty fell from 36% (1993/94) of the population to 26% by the end of the 1990s. Estimates based on an alternative methodology, the international poverty line (US\$1/day), also suggest good progress (from 46% in the early 1990s to 39% in 1999).
Enroll all children in primary school by 2015.	Enrollment rate of primary aged children rose in the 1990s, with considerable progress evident in some of India's poorest states. According to the National Sample Survey (NSS), enrollment rate rose from 71% (1993/94) to 77% (1999/00).
Make progress towards gender equality and empowering women by eliminating gender disparities in primary and secondary education by 2005 and at all levels of education by 2015.	The gap between the enrolment ratios between 1993/94 and 1999/00 for boys and girls was reduced from 11 to 8 percentage points for 6-10 year olds and from 17 to 10 percentage points for 11-14 year olds (progress made by some of India's poorest states is noteworthy). Female share of enrolments for secondary school increased from 33% in 1990 to 38% in 1998 and remained at 37% for tertiary education over the same period.
Reduce infant and child mortality rates by two-thirds between 1990 and 2015.	Infant and child mortality rates fell slowly in the 1990s. The child mortality rate (CMR) fell from 109 per 1,000 live births to 95, while the infant mortality rate (IMR) fell from 78 per 1,000 live births to 68 between 1992/93 and 1998/99. Progress was more rapid in the 1980s.
Reduce maternal mortality ratios by three-quarters between 1990 and 2015.	Maternal mortality remains high at 540 maternal deaths per 100,000 live births, and there is little evidence of decline in the past decade. 34% of births were attended by a trained birth attendant in 1992/93, rising to 42% in 1998/99.
Have halted by 2015 and begun to reverse the spread of HIV/AIDS, incidence of malaria and other major diseases.	Evidence suggests that around 4 million people in India are infected by HIV/AIDS and the rate of infection is increasing. Deaths due to TB remain high at 500,000 deaths per year. Although access to reproductive health services is on the rise, 52% of Indian couples of child-bearing age still do not use contraceptives. Of those using contraceptives, most do not use reversible methods.
Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve by 2015, the proportion of people without sustainable access to safe drinking water.	The cost of environmental degradation is high (6-8% of GDP), and an estimated 10% of deaths are due to water-borne disease. While pollution management is improving in some areas, degradation of India's natural resources (soil, forests, fisheries, coastal zones, biodiversity) remains high. Access to safe drinking water is on the rise, although continuous access remains a concern.

Source: The poverty figures are taken from the Planning Commission of India, 1999-2000 and "Adjusted Poverty Estimates in 1999-2000" by Angus Deaton, Princeton University, 2001. The US\$1/day estimates are based on World Bank estimates, 2002. The data source for row 2 is taken from NSS 52nd round (1993/94) and NSS 55th round (1999/00). The source for rows 3, 4, 5 and 7 is the NFHS-1 and NFHS-2. Figures in row 6 are based on World Bank estimates 2002. The figures in the last row are from Brandon C and Hommann K (1996) "The Cost of Inaction: Valuing the Economy-Wide Cost of Environmental Degradation in India" in *Modeling Global Sustainability*, Fu-Chen Lo, ed., United Nations University Press, Tokyo and *The Global Burden of Disease* by Christopher J.L. Murray and Alan D. Lopez, Harvard University Press, 1996.



Source: Poverty measures from “Adjusted Poverty Estimates in 1999-2000” by Angus Deaton, Princeton University, 2001; NSS 50th and 55th Round, Schedule 10 for enrollment estimates; NFHS-1 (1992/93) and NFHS-2 (1998/99) for IMRs and attended birth estimates.

II. RECENT POLITICAL, ECONOMIC AND POLICY DEVELOPMENTS

4. The FY01 CAS noted that India had experienced relatively strong growth of 5% to 5.5% per annum over two decades, which reforms in the 1990s had made more sustainable. The CAS also highlighted several vulnerabilities: (a) excessively high fiscal deficits, resulting in one of the highest levels of public debt in India’s history; (b) a slowdown in the implementation of structural reforms due to political developments; and (c) a financial system that was successful at mobilizing savings but not efficient at allocating them. This picture remains broadly unchanged but the following developments are worth highlighting.

Political Developments

5. The National Democratic Alliance government led by the Bharatiya Janata Party (BJP) remains in power, but the BJP has lost a number of state-level elections to the country's biggest political party, Congress, which now rules in 14 states. The BJP rules in just four states, as a junior member of coalitions in another two, while its allies rule three. While a broad political consensus for reform exists, a series of scandals in 2001 related to corruption in defense procurement, stock market manipulation and mismanagement of the country's largest state-owned mutual fund may have distracted the central government from its ambitious reform agenda. After the events of September 11, 2001, and a terrorist attack on the Indian Parliament in December 2001, tension with Pakistan has increased, further distracting the central government from important domestic matters. Sectarian violence in Gujarat starting in February 2002 shook India, and the long-term consequences are yet to be fully understood. These developments appear to have resulted in delays in Parliament’s consideration of important policy changes—from reduction of government ownership in the banking system to the fiscal responsibility legislation—and a slow down in reforms (para. 10).

Economic and Policy Developments

6. India's economic growth has been strong but below the Government-set target. Economic growth was estimated at 5.4% in 2001/02, up from 4% in 2000/01. The service sector, the least regulated in the economy, continues to be the strongest while manufacturing, the most regulated, is the weakest. Raising economic growth to the GoI's objective of 8% per year is unlikely to be achieved without substantial progress in fiscal consolidation and faster structural reform.

7. Inflation is temporarily subdued. In 2001/02 WPI inflation was about 3.4% and CPI inflation about 4.3%. The fall in WPI inflation over the last 3 years reflected the waning effects of earlier energy price hikes and flat manufacturing goods prices. The easing of monetary policy since early 2001 provides ample liquidity to meet potential revival in private credit demand. Management of the exchange rate and reserves during the past year has been broadly appropriate. While accumulating reserves, the central bank has partially sterilized the impact of capital inflows on domestic liquidity to contain inflation and maintain a relatively constant real effective exchange rate.

8. Persistent and large fiscal deficits remain a major concern, as they may result in higher inflation, push up interest rates, further crowd out private investment, weaken the health of the financial system and increase vulnerability to macroeconomic risks (para. 95). The fiscal position has deteriorated markedly: the general government deficit increased from 8.8% of GDP in 1998/99 to 10.3% in 2001/02, and the general government debt rose from 68% of GDP in 1998/99 to 81% in 2001/02 (consolidated public debt up from 77.6% to 91%). At the central government level the fall in the tax to GDP ratio, the rise in debt service costs, and the steep increase in the salaries of civil servants have been the main contributors to the deterioration of public finances. The states account for about one-half of India's national fiscal deficit: large increases in the salaries of civil servants and growing power sector losses have been powerful forces behind the deterioration of the states' finances.

9. The deteriorating fiscal situation has not spilled over to the balance of payments which remains strong. Exports, which slowed in 2001/02, have since picked up with 17% of growth rate in the first quarter of 2002/03. The current account is near balance and the capital account remains favorable. The resilience of software exports, the transfers from non-resident Indians, the slowdown in import demand and lower world oil prices all were important determinants of the low current account deficit. And together with the US\$10 billion surplus on the capital account last fiscal year, these factors led to an all-time high in the foreign exchange reserves (US\$64 billion as of October 18, 2002, or equal to about 12 months of imports). High foreign exchange reserves and a low external debt-to-GDP ratio (about 20% of GDP) imply a solid external position. The latter, coupled with the fact that India has a relatively flexible exchange rate regime and a high ratio of net international reserves to the money base (about 86% as of September 2002) discourage speculation against the Rupee.

10. Structural reforms have moved at a mixed pace. The ambitious reform plan set out by the 2001/02 Budget has fallen short of full implementation. The 2002/03 Budget sought to consolidate reforms. However, the pace of reforms may continue to be influenced by political developments (para. 5).

- *External liberalization has continued.* Remaining quantitative restrictions (QRs) were dismantled in March 2001, and the weighted average tariff rate was reduced from 35% in 2001/02 to an estimated 29% in 2002/03. Export quotas on agriculture products have been removed except those for jute and onions. The GoI plans to further liberalize the capital account.
- *The pace of domestic liberalization is mixed.* Liberalization of the sugar sector has continued. The fertilizer subsidy was reduced from 0.45% of GDP in FY 1999/2000 to 0.28% in FY 2002/03. Restrictions on FDI have been further relaxed. The pricing of petroleum products and private entry into the distribution and marketing of these products have been recently liberalized. However, only 54 of 813 items have been removed from the Small-Scale Industries Reservation

list. A recent report by a GoI high-level committee on the reform of long-term food grain policy is being discussed within the Government (para. 38).

- *Privatization has moved faster.* After 10 years of limited progress, the government has raised more than US\$1.9 billion in the last 16 months by selling 30 public sector units, including several industrial enterprises, India's former monopoly provider of international telecoms and a number of public sector hotels. The GoI has set a target of US\$2.5 billion to be raised from privatization in 2002/03.
- *Progress has been made in banking reform but the system remains inefficient, and reduction of government ownership has not advanced.* Loan recovery efforts have led to a steady decline in banks' net non-performing advances (NPAs)⁵. The net NPA ratio (net NPAs as a share of total advances) declined from 6.8% in 1999/00 to 6.2% in 2000/01 for the banking system, and 7.4% to 6.7% for the 27 public sector banks (PSBs). Further progress has been recently made in addressing the NPAs (para. 22). Prudential supervision has also been strengthened and the entry of foreign banks has been eased. However, the financial system remains inefficient,⁶ and the GoI's continued domination of the banking system (with the PSBs accounting for 80% of banking assets) has led to weak management and the absence of a commercially-driven credit culture. The proposed bill to reduce the GoI's minimum shareholding in the PSBs to 33% from its current 51% has not been enacted.
- *Incentives for states and cities to undertake reforms have been strengthened.* For example, the GoI's Fiscal Reform Facility provides additional funding to states on the basis of improved fiscal performance. The 2002/03 Budget expanded the scope of incentive-based fiscal transfers to urban reforms. Efforts are also being made in the power sector to provide incentives for reforms. Although these initiatives still account for a very small portion of central resource transfers to states, they represent significant steps toward strengthening incentives for state reforms (para. 89).

11. **Medium-term economic prospects.** According to the latest forecasts, growth is projected to decline to below 5% for 2002/03, due to severe drought. There are signs of recovery in industry, but industrial growth faces risks from rising oil prices and a faltering global recovery. Inflation pressures are expected to remain subdued, although rising oil prices pose a risk, if sustained. The external position is expected to remain comfortable for 2002/03, with rising international reserves and higher reserves to short-term debt, and declining ratios of external debt to GDP and debt service to exports. On the other hand, the general government deficit is expected to continue to be above 10% of GDP for 2002/03, owing largely to continuing expenditure pressures such as spending on drought relief and rising interest payments.

12. There are a number of factors which have helped contain to date the risks of persistent large fiscal deficits, including the strong external position, low inflation, the low level of external debt, domestic nominal interest rates at or below nominal GDP growth rates, capital controls which have helped insulate domestic markets from short-term capital flows, and relatively strong domestic savings and remittances from non-Indian residents. Nonetheless, the rising fiscal deficits and public debt pose real risks (see para. 95 for a discussion of the risks arising from a lack of fiscal adjustment). Growth beyond 2002/03 could well exceed the 5-6% a year level observed in recent years if significant fiscal consolidation and aggressive structural reforms are pursued by the center and state governments; on the other hand, if fiscal

⁵ Advances are defined to include total loans and other advances, including cash credit, overdrafts, and bills purchased and discounted.

⁶ Indian banks continue to invest in government securities far in excess of statutory requirements because they are perceived as risk-free assets at a time when liberalization has increased the risks associated with commercial lending. This is especially the case for the PSBs because their managers are hesitant to take commercial risks.

deficits do not come down, weakness in the domestic financial market persists and reforms are stalled, growth is likely to slow significantly.

III. PROGRESS IN CAS IMPLEMENTATION

13. The FY01 CAS was based on India's strategy for poverty reduction, the fundamental elements of which are contained in the Ninth Five-Year Plan. Accordingly, the CAS defined the Bank Group's program priorities around the Ninth Plan themes of strengthening the enabling environment for growth, and supporting critical interventions of special benefit to the poor and disadvantaged. Progress in the Bank Group program against these broad themes is assessed in the following two sections (III. A-B), covering support to the GoI on key national issues and to states on critical sectoral reforms. Recognizing the need for selectivity, especially in a country as large and full of potential as India, the CAS also argued for an emphasis on assistance to states that are implementing wide-ranging reform programs, as a complement to a strong but focused program of support to the GoI on key national issues. Progress in providing support to the Bank's three focus states and in expanding comprehensive state reforms beyond sectoral reforms are assessed at the end of this section (III. C).⁷

III A. STRENGTHENING THE ENABLING ENVIRONMENT FOR GROWTH

14. To support India's Ninth Plan goal of strengthening the enabling environment for growth and development, the FY01 CAS delineated roles for the Bank Group with respect to the parallel and complementary tasks of improving government effectiveness (through fiscal and governance reform, and decentralization) and promoting private-sector led growth (through financial sector development, improved competitiveness, the provision of adequate infrastructure and an acceleration of rural growth). This section reports on progress on each of these fronts.

Fiscal Reform, Governance Reform and Decentralization

15. In line with the CAS, the thrust of the Bank's support to fiscal and governance reform efforts has been concentrated at the state level through both analytic work and investment and adjustment lending (see section III C). States are an increasing part of the combined center-state deficit (about half), and fiscal adjustment is a core component of the Bank's sub-national lending and analytic work. Building on public expenditure reviews (PERs) completed for five states before the CAS, two additional PERs have been completed and two more have been initiated. Initial progress has been made at the state level, both in terms of outcomes, with deficits starting to fall in some reforming states, and institutional reforms. At the national level, a conference on fiscal sustainability co-sponsored by the Bank and the GoI, among others, was held in May 2001. In consultation with the GoI, the Bank is planning further analytic work to examine fiscal sustainability, focusing on the impact of high debt/GDP ratio on key economic variables. To help prepare for the introduction of a value-added tax (VAT), the Bank organized a national training workshop in January 2002 at the request of the GoI.

16. On the governance front, in addition to extensive involvement at the state level (see III C), the Bank has started to work with the GoI by financing TA on strengthening citizens' charters and other service delivery-related reforms. An IDF grant is under implementation to supplement the efforts of the Office of the Comptroller and Auditor General (C&AG) in developing a strategy for modernizing C&AG's institutional capacity, including audit functions. The Bank is also engaged in a dialogue with the Ministry of Railways, the second largest ministry in terms of procurement, to introduce a pilot for E-procurement under a trust fund. The GoI is currently undertaking strong initiatives for anti-money laundering (AML), including: the Prevention of Money Laundering Bill which is being submitted to the Parliament; the Reserve Bank of India's intensive efforts to initiate AML regulations for banks such as

⁷ Annex B9 presents a more complete assessment of CAS implementation.

know-your-customer requirements; and the Prime Minister's call for effective investigation and prosecution of large-scale economic crimes. The possibility of Bank support is currently being discussed with the GoI.

17. Analytic work is underway on fiscal decentralization to the local governments, in both rural and, more recently, urban areas. In partnership with the GoI, the Bank has focused its work on states that are interested in pushing fiscal decentralization forward, such as Karnataka and Kerala. Central to this work is the identification of the basic elements of a system of fiscal transfers between state and local governments that would strengthen incentives for performance and accountability. Recent initiatives taken by states to further decentralization in all its various dimensions show that this is a dynamic agenda. Karnataka's recent comprehensive report on furthering rural decentralization is a case in point.⁸ The Bank has an important role to play in this regard, especially in sharing international experience. The Bank's analytic work complements project-level interventions, especially those to support the rural poor, which increasingly work with and through local rural governments (see paras. 47-49).

Improving Competitiveness of Industries and Services

18. A major analytic report on improving India's investment climate, jointly carried out by the Bank and the Confederation of Indian Industry (CII) (completed in March 2002), analyzed factors that have constrained India from enjoying fully the benefits of global integration, and highlighted the urgency of removing impediments such as complex procedures for entry and exit, the burden on firms imposed by government regulation, the high cost of power and inflexibilities in the markets for land, labor and capital. The AAA covered policies that required attention at the central government level, as well as state-level policy issues based on a survey of the investment climate in 10 states. Its findings have been disseminated in workshops throughout India. The Bank is currently in dialogue with two states, Andhra Pradesh (AP) and UP to undertake a second-round of surveys that would help define a more concrete agenda for reform in support of improving the investment climate in those states. Separately, Karnataka has also taken significant steps to streamline complex regulations governing the entry and operation of firms in the industries and service sectors. The Bank would be ready to support a larger number of state-level investment climate surveys as well as a follow-up investment climate survey at the all-India level.

19. Following requests from the GoI and a number of state governments, the Bank, in collaboration with the National Council of Applied Economic Research (NCAER) is reviewing Indian experiences with labor adjustment in the privatization of loss-making public enterprises. The Bank-NCAER study aims to provide policy lessons on developing a framework for implementing severance and labor redeployment to facilitate the sale of loss-making central government and state-level public enterprises, while minimizing socio-economic costs.

20. IFC has continued to invest in the restructuring of second-tier manufacturing firms to improve their competitiveness. IFC's support has been critical for these companies to obtain financing, since their credit rating does not allow them to mobilize longer-term financing, and domestic financial institutions are unable to extend sufficient additional credit due to balance sheet constraints. IFC has also invested in new growth sectors with good prospects for international competitiveness, including information technology (IT), IT-enabled services and pharmaceuticals. IFC's financing and advice on issues, such as environmental management and corporate governance, help clients move toward world-class performance standards required to attract further financing and compete internationally.

21. The GoI has sought the Bank's assistance for a long-term reform program to strengthen technical and engineering institutions at the tertiary level to produce high quality professionals. The first operation in support of this reform program is scheduled for Board discussion in November 2002. At present, the design of the project provides for competitive funding of public and private institutions in seven states,

⁸ <http://www.kar.nic.in/rdpr/decentralisation-frameset.html>

based on their willingness to undertake major governance and financing reforms. IFC has financed innovative student loan programs to help IT students.

Financial Sector Development

22. The Bank Group has stepped up its financial sector policy dialogue with the GoI. A major AAA report on a Financial Sector Strategy for India (May 2002) provided a forum for intensive consultations. A number of other significant AAA products have also been prepared in response to the GoI's requests. Through these non-lending services, the Bank has brought in international experience, which is valued by the GoI, and has helped shape the direction of policy debate in support of four pressing reform issues:

- Strengthening the regulatory and legal framework for dealing with banks' NPAs. At the GoI's request, the Bank recently prepared policy notes on improving the legal framework for debt recovery and mechanisms to deal with NPAs (early 2002). These notes provided inputs to the recent ordinance on creditors' rights and the creation of the first majority privately-owned asset reconstruction company. IFC will consider investments in future asset reconstruction companies, subject to appropriate structuring.
- Enhancing the governance and regulation of the equities market, which has experienced a number of scandals in recent years and is the main source of capital markets vulnerability. The Bank, in collaboration with the IMF, has recently completed a major AAA on improving securities markets integrity (October 2001). The GoI has expressed interest in follow-up assistance from the Bank to help design and implement key recommendations of the report. IFC is supporting the development of a long-term corporate bond market through the use of partial credit guarantees and structured finance products for pioneering transactions.
- Designing and implementing pension reforms to help savings mobilization, provide the institutional investor base necessary to support the development of longer-term debt instruments, and deepen the capital markets. Pension reforms are also important for fiscal consolidation, given a large and growing un-funded government pension liability. A major AAA on pension reforms was recently completed and submitted to the GoI (June 2001), and the Bank has been asked to step up its efforts to help build consensus for pension reform.
- Implementing reforms in rural finance which is crucial for broadening access to financial services. Recent dialogue with the GoI has led to the launching of a AAA study on improving access to financial services. Building on a micro finance report (June 2001), the new AAA work will assess the gaps between the demand for and supply of financial services by poorer segments of the population, and examine how markets and institutions can be developed to bridge these gaps. The Bank may support reforms in these areas through financial assistance in future. IFC has invested in and provided TA to micro finance and other non-bank financial institutions serving rural areas.

23. The agenda for future reform remains large and challenging, as articulated in the Bank's Financial Sector Strategy. The Strategy will underpin the Bank Group's medium-term engagement in the sector, focusing on: (i) enhancing the supervisory and regulatory framework governing financial institutions so as to bring it up to international standards, thereby improving market discipline and ensuring the smooth implementation of legal reforms to facilitate debt recovery; (ii) strengthening the PSBs through reducing government ownership and improving corporate governance; (iii) enhancing the integrity of the equity markets and deepening the debt markets; (iv) developing a contractual savings base; and (v) implementing reforms to improve poor people's access to financial services.

Improving the Quality of Infrastructure

24. Reform of the **power sector** is critical to India's fiscal adjustment and growth prospects, especially since the sector represents such a large claim on government financial resources (financial losses of the sector account for 1.5% of GDP). Despite financial problems stemming from the weakness of the state power utilities, the central power generation and transmission utilities are reasonably efficient and are continuing to increase their capacity, under the regulation of the Central Electricity Regulatory Commission. In contrast, the state power utilities are in financial crisis, stemming from an abnormally high level of theft, leakages and losses that are related to weak internal management and poor governance, and from major tariff deficiencies. Technical and commercial losses amount to between 40-50% of electricity generated across most Indian states. States have thus continued to default on their obligations to central utilities (with arrears amounting to Rs. 414 billion, or 1.8% of GDP) and to lenders, and/or to borrow off-budget. This has exacerbated fiscal deterioration in many states, as ultimately governments become liable for the losses of their utilities.

25. Power sector reforms remain a priority for the Bank. The Bank's support for power sector reforms began with Orissa, where, despite privatization of the distribution companies, the private operators were unable to reduce losses or improve the quality of supply significantly given pervasive inherited governance problems and an uncertain regulatory environment. Learning from this experience, the Bank is revising its approach to power sector reforms to focus on the corporate governance of utilities, measures to reduce theft and leakage and steps to improve the regulatory regime, as a pre-requisite for successful privatization (at least of distribution). Based on the Orissa experience as well as the reform experience of several other states (para. 26), the following elements appear to be of key importance:

- Improving the corporate governance and financial management of the transmission and distribution companies (the latter configured with privatization in mind) so that they operate as independent companies, albeit with public ownership, and ensuring satisfactory progress by utilities in achieving financial viability.
- Introducing a regulatory regime conducive to private management and ownership of utilities which replaces the government as the supervisory body of the power sector.
- Implementing measures to reduce theft, leakages and losses (even when the utility's ownership remains public)—through better internal management and discipline to prevent graft, enforcement of proper billing and collections, and curtailment of corrupt practices by employees; public governance reforms to enable the commercial operation of distribution utilities, including the ability to install and read meters, and to disconnect fraudulent or non-paying customers; and enforcement of law and order to protect the commercial interests of utilities.
- Developing alternative mechanisms to subsidize agricultural consumers. The political reality in India is that the government will provide subsidies for farmers. Unfortunately, in the past decade, the power tariff has emerged as the key instrument for subsidizing farmers, with heavy costs in terms of efficiency, equity and environmental impact. As long as this is so, privatizing distribution will remain difficult, and the issue of losses suffered by the utility as a result of low agricultural tariffs will continue to complicate reforms of the power sector. A key element of power sector reforms, therefore, is the development of mechanisms to deliver subsidies to the farmers or other target groups in a manner which is more transparent and direct, and place the financial burden of such subsidies on the government rather than the power utilities. The Bank has started to work with AP and Karnataka to explore options.
- Addressing the legacy of the heavy indebtedness and other un-funded liabilities (such as arrears to vendors and central utilities, and pensions) that the new utilities have inherited from the former state electricity boards. A financial workout would be necessary to create the base balance sheet to attract private investors to the sector.

- Subjecting the sector to increased fiscal discipline, by (i) closing the loophole that allows utilities to run up large arrears with central suppliers (the GoI has begun actions in this regard recently, to securitize states' arrears to the central utilities into long-term bonds. Under the securitization package between the GoI and a concerned state, any future defaults would be deducted by the central government from its transfers to the state concerned); and (ii) ensuring that the subsidy obligations imposed by the sector on government are consistent with the state government's financing capacity, and then ensuring that these subsidies are paid.

26. In line with the above approach, AP has taken the lead in reducing theft and addressing governance problems. Stiff penalties for non-payment have been introduced, truly independent commercial entities for transmission and distribution have been created, and a three-year track record has been established of tariff filings by the utilities and tariff notification and implementation without interference from the state government, even under very difficult political circumstances. As a result, the operating losses of AP's power sector fell in the first half of 2001/02, contributing to the stabilization of the state's consolidated fiscal deficit. However, a rapid expansion in the subsidy bill to farmers, as well as continuing subsidies to other groups, have limited the impact of these reforms on the power sector's bottom line. AP is thus looking into alternative subsidy delivery mechanisms for agriculture which, along with other measures such as universal metering, should further improve power sector performance. *Rajasthan* has also made some progress: metering has increased, electricity tariffs have been increased twice over the past three years, and collection efficiency has reached 100%. As a result, power supply conditions in the state improved and the financing gap of the sector had been reduced by about 20% in the last two fiscal years. However, the utilities still face severe financial difficulties caused mainly by the historic debt burden and tariffs that do not cover the cost of supply. *Karnataka* is also beginning to focus on measures to reduce theft and increase metering, as well as exploring alternative subsidy delivery mechanisms. And *Orissa* is making renewed efforts to streamline the regulatory environment and assist distribution companies to fight theft and clamp down on illegal connections. Progress in UP, in contrast, has been limited. The Bank is also exploring ways to further support state-level power sector reforms through partnering with the GoI in implementing its reform-based resource transfer schemes (para. 89). A power sector strategy note is being finalized to underpin this discussion.

27. A number of projects to support private investment in power generation and distribution in states have run into regulatory and other difficulties, and IFC funding has not yet been committed. Obstacles to IFC investments in the sector include an insufficient number of credible local private sector developers, lack of interest by foreign investors and the weak financial position of State Electricity Boards.

28. A major AAA report on India's **transport sector** (completed May 2002) was prepared with extensive stakeholder participation. The report concludes that the poor performance of India's transport sector relates to (i) severe financial constraints that are linked to the fiscally strapped position of the center and most states; (ii) generally low levels of cost recovery from many types of users (for example, only 45% of railway expenditure is internally generated with market borrowings and budget support making up the balance); (iii) the weak institutional capacity and accountability of transport agencies; (iv) the slow pace of policy reform and the high degree of uncertainty over policy and regulatory frameworks, the unreliability of the legal system in the enforcement of contracts, and exposure to political interference and corruption, all of which have served to deter the mobilization of private funding; (v) poor asset management, such as the preoccupation of many transport agencies with new investment at the expense of adequate attention to maintenance (more than half of national and state roads are in poor condition largely due to insufficient maintenance, backlog in rail track renewal amounts to 11,000 km, and many paved rural roads become unrecognizable just a few years after construction); and (vi) market distortions arising from subsidies, cross-subsidies, and outdated regulations and price controls. The Bank's transport sector strategy aims to help the GoI address these long-term problems, through (i) reform-based lending operations, the bulk of which focus on expanding the capacity of India's trunk road network; (ii) institutional reforms of road agencies to improve public sector accountability and performance; (iii) promoting private sector participation in transport financing, operations and management; and (iv)

continuing policy dialogue in transport sub-sectors (e.g., ports and railways) where the Bank has no ongoing lending operations.

29. Since the CAS, the Bank has committed US\$1.8 billion for transport sector operations. At the national level, the Bank, alongside the Asian Development Bank (ADB), has been supporting the first phase of the 14,000 km National Highway Development Program, which aims to link all major cities in the country through four to six lane routes by 2007. Project implementation is proceeding well, and the initial outcomes of reform-based lending at the national level are positive. The implementation and management capabilities of the National Highway Authority, the executing agency for this program, have been strengthened. Feasibility studies, engineering design and construction works, traditionally undertaken by the public sector, are now almost all out-sourced to the private sector, regardless of funding. Increasingly, India has been able to attract international firms to compete for and take up large highway construction contracts under the Bank-financed projects. In order to improve accountability and user-responsiveness, the GoI is introducing a stakeholder participation mechanism into its decision making process. Recently, the GoI has requested the Bank's assistance on its Rural Roads Program which focuses on the most poorly connected states. Initial preparation has started. The Bank is working closely with the GoI to develop a generic rural road maintenance policy that aims to address the financial and physical sustainability issues of rural road programs (para. 37).

30. Through its state highway lending program, the Bank is playing an important role in supporting ongoing reforms, including improving the regulatory environment, and modernizing road agencies in procurement, financial management, strategic planning, supervision, traffic management, information and human resource. These reforms have been initiated in some states, for example, commencement of departmental medium-term financial planning in Karnataka linking with the state-wide medium-term fiscal framework, enhanced procurement and works programming in Gujarat, introduction of a department-wide modern financial management system in Uttar Pradesh, better asset information collection and management in Andhra Pradesh, and passage of a Road Fund Act in Kerala. Reforms will begin shortly in several other states. In addition to strengthening the efficiency of the public sector, an essential element of reforms is to expand the role of the private sector. Karnataka has handed over the maintenance of its core network of state highways to the private sector through a series of multi-year contracts and AP piloted "performance-based contracts" for private road maintenance—both a first in India.

31. The World Bank Group supports India's efforts to attract private sector investment to the toll road, bridge and port sectors through concessions and Build-Operate-Transfer contracts as a means to reduce congestion and inefficiencies, which in turn reduces transport costs and product prices. To fund these projects, long term debt is typically available from local financial institutions, but equity is sometimes difficult to mobilize domestically. IFC has been actively pursuing investment opportunities and will continue to do so, particularly in the toll road and port sectors.

32. The **telecom sector** has been the most advanced in opening up to large-scale private investment, including foreign investment, through competitive new entry. But massive investment needs remain for India to increase its teledensity above today's very low level of 3 lines per 100 persons. Given the downturn in international telecom investments, private investment relies heavily on domestic sources of capital. In this context, IFC is playing an important role in mobilizing financing, through equity and loan investments, and partial credit guarantees to support bond issues.

33. Since the last CAS, the Bank has completed an **urban sector** strategy for India that identifies three areas for Bank assistance: (i) urban decentralization; (ii) urban governance and management; and (iii) improving resource mobilization and financing systems to help address investment backlogs. The Bank has recently completed a Poverty and Access to Municipal Services Policy Note for AP and begun work on an urban reform program in Karnataka. The Water and Sanitation Program (WSP) and other donors are assisting the GoI to establish a City Challenge Fund, an incentive-based grant facility that will

support the transition costs of moving towards sustainable institutional systems of municipal delivery, as well as an Urban Reform Incentive Fund (para. 89). Since the CAS, IFC has invested in a second infrastructure finance company which supports the construction of urban infrastructure.

34. In the **urban water and sanitation sector** (UWSS), the Bank's strategy since the last CAS has been to shift away from the past emphasis on strengthening specific public utilities towards support for reform to create the conditions for greater private sector participation. The reform agenda includes creating commercial water utilities, reducing price distortions and increasing tariffs, improving the service providers' creditworthiness and establishing new independent regulatory entities. The GoI is preparing guidelines for a regulatory framework for the states on private sector participation in UWSS. At the same time, several states (such as Karnataka) are engaged in redefining their urban water policy, focusing on efficiency measures and exploring ways to attract private operators in the sector. IFC is exploring opportunities to invest in the sector.

Accelerating Rural Growth

35. The Bank's support through AAA and various projects is contributing to improving the functioning of the agricultural research and extension, irrigation and rural road systems in India. The ongoing National Agricultural Technology Project (NATP), the largest agricultural research project in the Bank focuses on rationalizing the agricultural research system towards demand-driven, farmer-centered technology development, as well as piloting effective delivery of agricultural extension services in 7 states and 28 districts. These pilots have decentralized decision making to the district level and encouraged greater farmer participation in planning and resource allocation. The GoI plans to mainstream this successful approach under the Tenth Plan. IFC is considering an investment in private farm service centers.

36. Sustainable and more equitable use of increasingly scarce water resources is a major and growing challenge. Building on policy dialogue, state-level policy notes, and experience of water-user participation in the management of surface irrigation systems in AP (the first in India and supported by the Bank), the Bank's new water sector restructuring projects incorporate support for establishing a regulatory and policy framework for the water sector to deal with inter-sectoral water allocation and management; restructuring water departments to reduce costs and improve skill mix; reallocating expenditures from supply-driven asset creation to demand-driven investment and O&M; rationalizing water charges to ensure long-term financial sustainability; devoting more importance to agricultural productivity per unit of water used; shifting planning and management from the single sector approach to an integrated multi-sectoral and river basin approach; and strengthening support services for irrigated agriculture. These principles are integral in Bank supported water projects in UP and Rajasthan (2002), MP (under preparation) and in ongoing dialogue in AP, Karnataka, Tamil Nadu and Maharashtra.

37. The Bank's dialogue and support for the rural roads program in India has emphasized the importance of road maintenance to promote the sustainability of rural roads. Based on the positive experience of the Bank's support to strengthen rural roads with focus on maintenance, the Bank is assisting the GoI in formulating a national policy on rural road maintenance. The positive experience gained in several Bank projects with rural roads components is being integrated into the GoI's Rural Roads Program (para. 29). AP's pilot in road maintenance contracts, supported by the Bank, is being scaled-up to the entire state.

38. A major challenge in accelerating rural growth is to reform food grain policy. Since the last CAS, the steady increase in government procurement prices, coupled with good monsoons, have resulted in burgeoning buffer stocks, expected to exceed 70 million tons in 2002/03, more than three times the standard level. This has led to rising fiscal costs (estimated at 0.84% of GDP in 2002/03). Food procurement schemes are largely skewed in favor of a few states and have not addressed the question of disparity among states in accessing food stocks. Meanwhile, food insecurity still affects a large share of

the population. The Bank has continued its dialogue with the government on food policy reform, building on the AAA on “Improving Household Food and Nutrition Security in India” (June 2001), but reform has not materialized.

39. Rural growth will also be influenced by improved employment and income-generating activities in the rural non-farm sector. Jointly with the GoI and DFID, the Bank organized a national workshop on “Rural Transformation in India: The Role of the Non-farm Sector” (September 2001), which has helped to broaden the understanding of factors affecting the performance of the rural non-farm sector and identify policies and practices that will promote broad-based and more rapid growth of the sector. The workshop findings served as input to the preparation of the Tenth Plan. Policy notes, which identify state-specific policy constraints to more rapid agricultural and rural growth and poverty reduction and analyze the impact of the GoI agricultural policies on State agricultural performance, have been completed for Karnataka, AP and Maharashtra. An agricultural policy note for UP is under preparation.

III B. SUPPORTING CRITICAL PRO-POOR INTERVENTIONS

40. India’s poverty reduction strategy recognizes the importance of government intervention to ensure that opportunities for improved livelihood are widely available across the whole spectrum of society. Accordingly, the CAS focuses on promoting education and health for all, and supporting pro-poor rural development, reflecting their critical importance (especially for achieving the MDGs), and the Bank’s comparative advantage. This sub-section summarizes progress on pro-poor interventions.

Promoting Education and Health for All

41. The Bank’s main instrument for supporting primary **education** has been the GoI’s District Primary Education Program (DPEP) initiated in 1995 and supported by several donors, which has targeted districts with low levels of female literacy. The DPEP is entering its concluding stage and an evaluation of its impact is being undertaken by the GOI and the Bank. To scale up the successful DPEP, the Cabinet approved a broad scheme, the Sarva Shiksha Abhiyan (SSA—Education for All). The objectives of SSA, even more ambitious than the MDGs, are to achieve Universal Primary Education by 2007 and Universal Elementary Education by 2010, eliminate all gender and disadvantaged social group gaps, and ensure all children complete eight years of quality education. SSA largely builds upon DPEP, but differs in a few significant ways: it encompasses the whole elementary cycle, will cover every district in the country that develops an agreed District Elementary Education Plan (DEEP), encourages public-private partnerships, and will also serve as the umbrella for all Centrally-Sponsored Schemes from grades 1 through 8. The states and districts have begun developing the district plans. Key challenges for SSA are to: (i) continue and expand quality improvements; (ii) attract and retain the hardest-to-reach children (for example, those in isolated areas, working children, and children with disabilities) to schools by addressing economic, social and cultural issues; (iii) find modalities to encourage public/private partnerships; and (iv) scale up and sustain governance reforms (for example, by strengthening performance incentives and accountability, and decentralizing management). A critical role in establishing the DPEP has been played by the Bank and other external donors, and the GoI has recently indicated potential interest in SSA being funded by the Bank and the Education for All Fast Track Fund. IFC has invested in companies using IT and the Internet to deliver educational services.

42. In focus states, the Bank is shifting from a project-based to a sector-wide approach linked with public expenditure and governance reforms. The Bank has undertaken analyses of education financing and secondary education-labor market linkages in Karnataka. Using these analyses, the results of other sub-sectoral studies, and the report by the Government of Karnataka (GoK)’s Task Force on Education, the GoK has prepared a draft strategy paper for education, developed action plans for governance reforms, and prepared a departmental medium-term fiscal framework (MTFP) linked with the state-wide MTFP (para. 60). In Andhra Pradesh, the Bank is undertaking studies to suggest ways to operationalize the education and health goals of the AP Government’s strategy document *AP Vision 2020* that

encompasses, but goes beyond, the MDGs. In both cases, the work could help serve as a basis for strengthening the sectoral content of future adjustment lending (para. 88).

43. The Bank recently completed a comprehensive study on the **health sector** (June 2001). This major analytic piece, widely discussed in India, benefited from household surveys that provided detailed information on the use of health services by income groups, a comprehensive review of the role of the private sector in the provision of health services, and the use of public facilities. The report documents that for 80% of Indians, rich and poor alike, the private sector is the main and, in some cases, only provider of health services. The report also documents in detail the generally poor quality of services delivered by both the public and private sectors. The challenge is to operationalize the report's recommendations to integrate the private sector in the provision of health services, improve the quality of service delivery in both the public and private sectors, and explore the viability of providing the poor with some insurance against catastrophic health events. The new health systems projects at the state level will build upon the report and the lessons learned from the implementation of on-going projects. New areas of health sector reform to be addressed by these projects will include more extensive collaboration between public and the private health sectors; development of ideas and strategies for including traditional healers within the health system; piloting of risk pooling mechanisms, including experimentation with community health insurance schemes; and more explicit targeting of the poorest sections of society. AP and Karnataka have already sought independent evaluations of health service delivery, with AP linking financial incentives with performance. A health project under preparation for Rajasthan is exploring community-based health insurance, and networking with informal health providers to enhance access by the poor; networking is also being explored in the ongoing UP project. Building on the above, and the ongoing GoI initiatives, the Bank is working with the GoI to develop strategies to maximize the contribution of the non-public sector to meeting the Tenth Plan's goals. IFC is considering investments in private providers of health services.

44. Furthermore, the Bank's strategy has been to support the decentralization of the management of the Centrally-Sponsored Schemes in the health sector to the states. The results have been more positive in some programs (for example, Tuberculosis and Reproductive and Child Health) than in others. Personnel changes and slow clearances in the Central Ministry of Health and the Department of Women and Child Development have slowed down implementation of some critical centrally-sponsored Bank-financed projects, particularly the Integrated Child Development Services and the Malaria Control projects. If the deterioration in performance of the affected central projects is not quickly reversed, their future will be in question. A key Centrally-Sponsored Scheme is the National AIDS Control Program, which the Bank is supporting through the largest AIDS control project that it has financed (the second one for India). These projects have played a major role in shaping a response to the AIDS epidemic, which appears to have had some impact, although the epidemic remains a serious development challenge for India. An analytic study is ongoing to better understand the course of the epidemic and the role of drugs in prevention and treatment.

45. The goals of the GoI as expressed in the recent National Population Policy and the draft National Health Policy are consistent with the MDGs. However, while India is likely to achieve the MDGs for HIV/AIDS and tuberculosis, it is much less likely to do so for maternal mortality, infant mortality and malaria. In all these areas effective Centrally-Sponsored Schemes are critical. Improved implementation of a number of Centrally-Sponsored Schemes (such as disease control, women's health, child health and nutrition) at the state level is needed, including, where appropriate, involvement of the private sector. This will require closer coordination between the Centrally-Sponsored Schemes and implementation of state health programs.

46. The Bank has started to integrate its support for health, nutrition and education programs into a variety of poverty reduction projects. For example, the AP Rural Poverty Reduction Project will be aimed at ensuring the convergence of these critical services for the poorest through introducing mechanisms for joint planning and resource pooling. At the same time the proposed project will target adolescent girls and

working children in remote areas through bridge courses, and providing hostels to attract children, especially girls, from remote villages to attend schools. A Chile Development study is underway to examine the integration of health, education and nutrition in early childhood development. Another will address the health of the urban poor. A study of Household Energy: Indoor Air Pollution and Health, recently completed, shows that indoor air pollution leads to hundreds of thousands of lives lost per year. This and other environmental health issues—such as poor water quality, lack of sanitation, and urban air pollution—are increasingly evident as important aspects of achieving the MDGs.

Accelerating Pro-Poor Rural Development

47. The GoI and state governments have strongly supported community-driven development (CDD) approaches to reducing poverty in rural areas, as well as ensuring more sustainable use of natural resources. Accordingly, the Bank has moved toward mainstreaming CDD approaches in its recent projects covering watershed management, forestry, tank irrigation, rural water supply and sanitation, and District Poverty Initiative Projects (DPIP). These projects, building on earlier Bank project experience, have emphasized cross-cutting principles such as beneficiary involvement and empowerment, partnership between the public and non-public sectors (for example, the use of non-governmental organizations and other alternative service delivery providers), institutional reforms to strengthen rural local governments, cost recovery and pro-poor targeting.

48. The Bank's involvement in rural water supply and sanitation (RWSS) illustrates the mainstreaming of CDD approaches. The Bank has assisted the GoI in developing a sector reform strategy in RWSS through policy dialogue and reform-based investment lending. The basic principles of the sector strategy are: adoption of community-driven approach to service delivery; shifting the role of government from direct service delivery to facilitation; partial capital cost financing and full O&M user responsibility; and participation of communities and local governments in the management of water resources. These principles have been adopted by the GoI's national program—the Rajiv Gandhi National Drinking Water Mission's Sector Reform Pilots covering 64 districts in 22 states. The two recent RWSS operations (Kerala and Karnataka) support decentralizing decisions and responsibilities to beneficiaries and rural communities to strengthen accountability, efficiency and sustainability. The two projects will directly benefit 1.5 and 4 million people, a large proportion of which will be rural poor and socially disadvantaged people. The Bank is currently reviewing its strategy in this sector to better foster mainstreaming of pro-poor CDD initiatives within the context of needed sector-specific policy and institutional reforms.

49. The Bank has also supported targeted community-based District Poverty Initiatives Projects (DPIP) in AP, MP and Rajasthan. Preparations for the DPIP for Chattisgarh are under way. Integral to these operations is active participation by vulnerable groups. These projects have begun to yield positive outcomes in improved livelihood opportunities and reduced poverty and distress migration. Preparation of the AP rural poverty project involves scaling up the AP DPIP to the entire state based on a comprehensive approach including integration of health and education.

50. The trade-offs between rural poverty alleviation and natural resources management have become particularly acute as population growth increases the pressure on forests and marginal lands. Over the last ten years, the Bank has financed first-generation forestry projects and supported to a large extent better mechanisms to enhance participation of forest-dependent people in forest regeneration. The Bank is currently reviewing its strategic framework for further involvement in the forestry sector by providing renewed emphasis on livelihood issues for poor people living in and around the forest and seeking win-win approaches to the sustainable protection of natural resources. It also seeks to foster more effective institutional arrangements and project design, while providing adequate consideration to the reputational risk involved.

Mainstreaming Social and Environmental Concerns

51. In addition to ensuring due diligence at the project level, the Bank has been collaborating with the GoI on policy issues related to resettlement and indigenous people. The Bank undertook countrywide consultations in November 2001 on its proposed revised Operational Policy on Indigenous Peoples. But there has been relatively little progress on developing a more comprehensive national policy on involuntary resettlement, with the exception of Bank support to training and capacity building. The Bank is increasingly working with selected states to integrate analysis of poverty and social development issues and to better understand the social dimension of economic reforms. At the project level, increased emphasis is being given to a good understanding of the social prerequisites to ensure poverty reduction outcomes, especially in projects dealing with natural resources.

52. To address vulnerability to natural disasters, which can have serious negative consequences by pushing large segments of the population into poverty, the Bank's strategy places emphasis on disaster response and management. Following the Gujarat Earthquake, the Bank was able to respond quickly to restructure existing projects and provide a new Credit for relief and reconstruction, together amounting to US\$700 million (IDA). Recognizing the importance of disaster mitigation, the projects also had a long-term disaster management component, including developing a modern pre-disaster preparedness and post-disaster response system, piloting risk transfer and insurance, and developing a community-based disaster management system. A regional AAA initiative to develop a catastrophic risk insurance facility covering India is near completion. Disaster assistance is also being provided following cyclones in Andhra Pradesh and Orissa.

53. The status and roles of women continue to be a development challenge for India (box 1). Various initiatives, such as the Country Gender Assessment and the inclusion of gender analysis in project social assessments, are being planned to mainstream gender issues in the Bank's work. These proposals are outlined in the June 2001 Bank report "Operationalizing Gender in the India Program." The Bank supports the Rural Women's Development and Empowerment Project (RWDEP) in nine states, and the DPEP directly addresses lower female literacy (para. 41). Gender issues are also being addressed through AAA work ranging from support to a national discussion held in December 2001 coordinated by the UN Inter-Agency Working Group leading to better attention to gender issues in India's Tenth Plan, to an international conference (December 2001) organized by the Bank on social inclusion focusing on indigenous peoples and gender issues. A three-day workshop on addressing gender issues in Bank project preparation was held in May 2002. The systematic poverty monitoring systems in focus states have specifically focused on building gender-disaggregated data bases (para. 63).

54. The cost of environment degradation remains high (6-8% of GDP), but a new planning effort is underway at the national and state levels to mainstream environmental concerns. The draft Tenth Plan explicitly incorporates environmental objectives and requires state environmental submissions, a first in India. AP, Karnataka, Gujarat and UP are taking a lead among Indian states to strengthen environment management, by sharpening the strategic focus of environment-related work in line with health and livelihood-related MDGs. This is embodied in the strategic environmental analyses (SEA) being or proposed to be carried out by them. These are also improving monitoring and compliance by industrial entities (through information disclosure and clear accountability). AP and UP are pilot testing economic instruments for pollution control, and Karnataka has begun to streamline the environment-related regulatory process. While it is too early to gauge results, these initiatives aim at mainstreaming environmental concerns into overall policy making. Several Bank-supported environmental projects (approved prior to the CAS) are active on many fronts and have successfully addressed serious implementation problems raised over the last two years. The Bank-supported program of strategic studies and technical assistance is also large and expanding, and is replacing to some extent the emphasis given in the previous decade to environmental investment projects.

III C. SUPPORTING COMPREHENSIVE STATE REFORMS

55. India's poverty reduction strategy, as articulated by its Ninth Plan, emphasizes the importance of state-level reforms to achieve the twin goals articulated above of strengthening the enabling environment and supporting pro-poor interventions. Unlike the reforms of the early 1990s, many of the reforms needed today, such as in the physical and social infrastructure sectors, are in the domain of the states. The states also make up half of the consolidated fiscal deficit—fiscal reform at the state level is of increasing importance. The logic of selectivity also pushes the Bank and donors, such as DFID and ADB, in the direction of focusing its efforts geographically in a large country such as India.

56. The Bank's assistance strategy has been reoriented over the last two CAS periods to include an emphasis on states that: (i) have chosen to embark on a comprehensive program of reforms, including fiscal and governance reforms, and reforms of key sectors such as power; (ii) have expressed interest in entering into a partnership with the Bank; and (iii) have relatively high levels of poverty. This approach of focusing on a relatively small number of states has enabled the Bank to take a holistic approach in these states using a mix of instruments (adjustment lending, investment lending and analytic work).

57. The three main states in which the Bank is most active are AP (since 1997), UP (since 1998) and Karnataka (since 2000). With a combined population of about 300 million, these three states account for 30% of the poor and 29% of out-of-school children in India. Further, the Bank also has significant dialogue and/or lending roles in a number of other states interested in comprehensive reforms, such as Orissa, Rajasthan and Maharashtra. There has been strong collaboration between DFID and the Bank in AP and Orissa, two of DFID's partner states (para. 86)⁹. This subsection focuses mainly on progress in supporting comprehensive state reforms in the Bank's three focus states.

Key Reforms and their Outcomes

58. The thrust of the Bank's assistance to the focus states is to support a comprehensive program of fiscal and governance reforms, combined with programs in sectors that are critical to growth and poverty reduction, such as power, irrigation, forestry, health, education and selected anti-poverty interventions. As the sectoral initiatives have already been discussed in sections III A and III B, the emphasis here will be on fiscal and governance reforms and the impact of the overall program on growth, poverty and other developmental outcomes, including the MDGs.

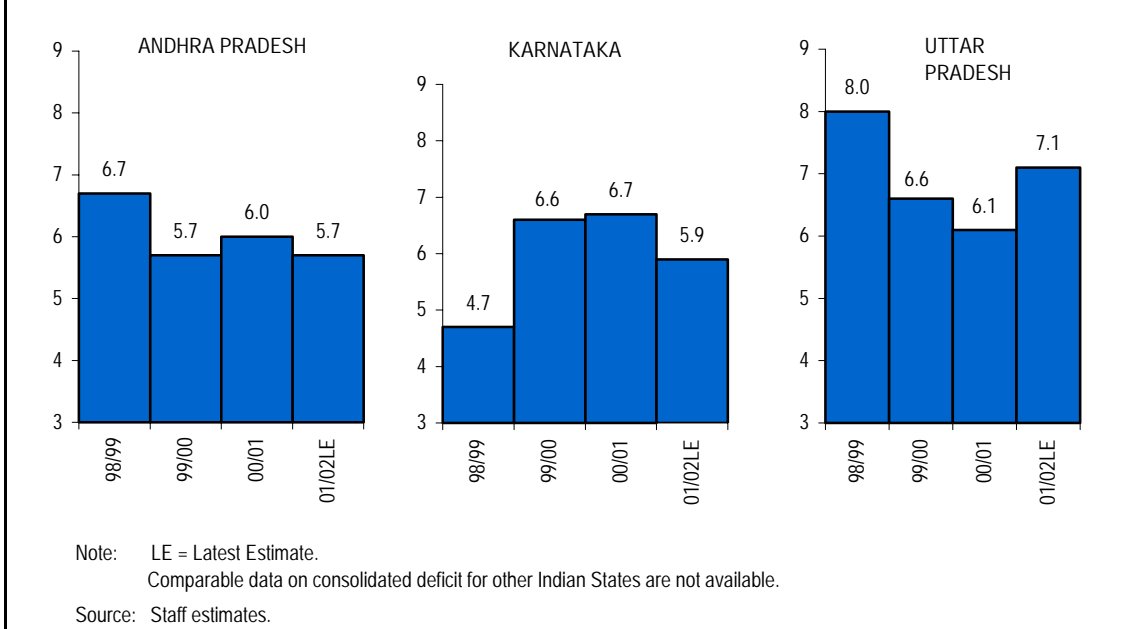
59. The poor fiscal performance of the Indian states is the result of a number of structural factors which will take several years to correct. Given the wide socio-economic and political diversity in India, the nature of the problems confronting the focus states has differed considerably across states, as have the solutions and pace of implementation of the reform programs. Understandably, the results on the ground have been slow to materialize and have varied significantly across states. Nevertheless, some results are beginning to appear.

60. **Fiscal Reforms.** The goals of fiscal reforms are to reduce fiscal imbalance, improve the composition of expenditures and enhance public service delivery, thereby increasing the developmental impact of government spending. The following are examples of fiscal and public expenditure reforms being supported by the Bank and their impact.

- A medium-term fiscal framework (MTFP) has been developed by AP, Karnataka and UP. Karnataka has also prepared departmental MTFPs for five key sectors (water, power, roads, education and health) and enacted a Fiscal Responsibility Act—a first in India. Off-budget liabilities, particularly those of the power sector, have been brought on to the budget and steps are being taken to reduce state guarantees. These reforms have shown encouraging initial results, though their sustainability is yet to be established. The consolidated fiscal deficit to GSDP ratio

⁹ ADB's partner states are Gujarat, Madhya Pradesh, Kerala, Assam and Sikkim.

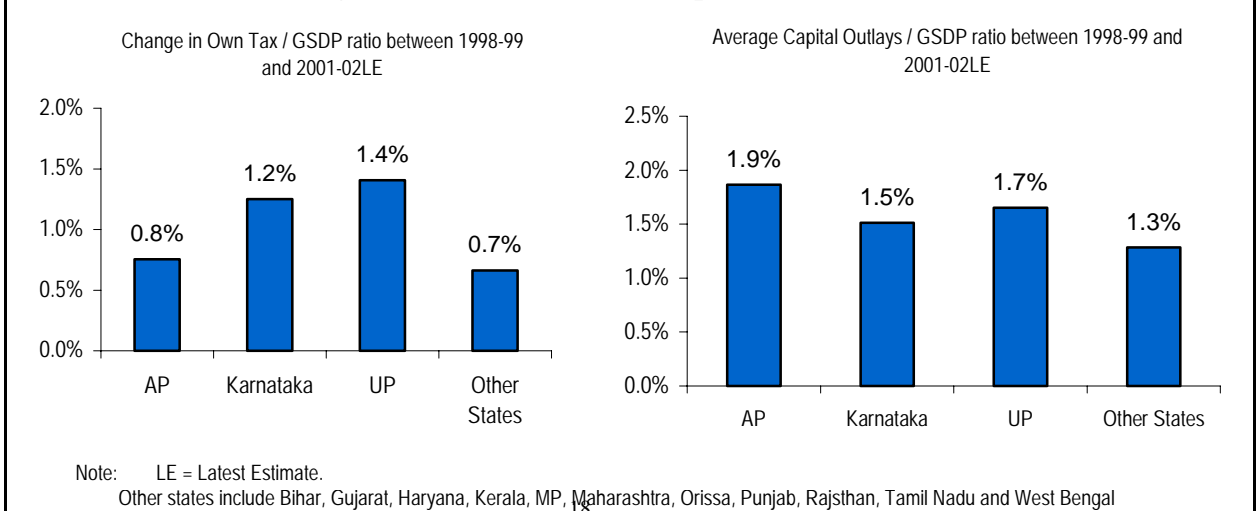
Figure 2: Consolidated Fiscal Deficit as a percentage of GSDP



has declined in AP and Karnataka, and after falling for two consecutive years in UP it increased in 2001/02 largely because of the state's inability to pursue power sector reforms (figure 2). Fiscal correction will need to be sustained for several more years to stabilize the debt/GSDP ratio.

- Major tax and expenditure reforms have been launched. The states have embarked on reforming the complex indirect tax system to rationalize rates, broaden the base and simplify and computerize tax administration. AP and Karnataka are in an advanced stage of preparation for the introduction of the Value Added Tax. Expenditures have been controlled and rationalized to increase O&M and priority spending, and reduce and better target subsidies. Cost recovery has been increased for power, water and other services. AP has strengthened public expenditure management, leading to greater clarity in budget formulation and execution. These reforms have begun to yield impressive results. As figure 3 shows, the three states of AP, UP and Karnataka have shown considerable improvement in own tax revenue to GSDP ratio in recent years compared to the other major Indian states. Their Plan capital outlays to GSDP ratio have also risen in recent years, while it has remained unchanged or even fallen modestly in the other major states.

Figure 3: Selected Tax and Expenditure Indicators



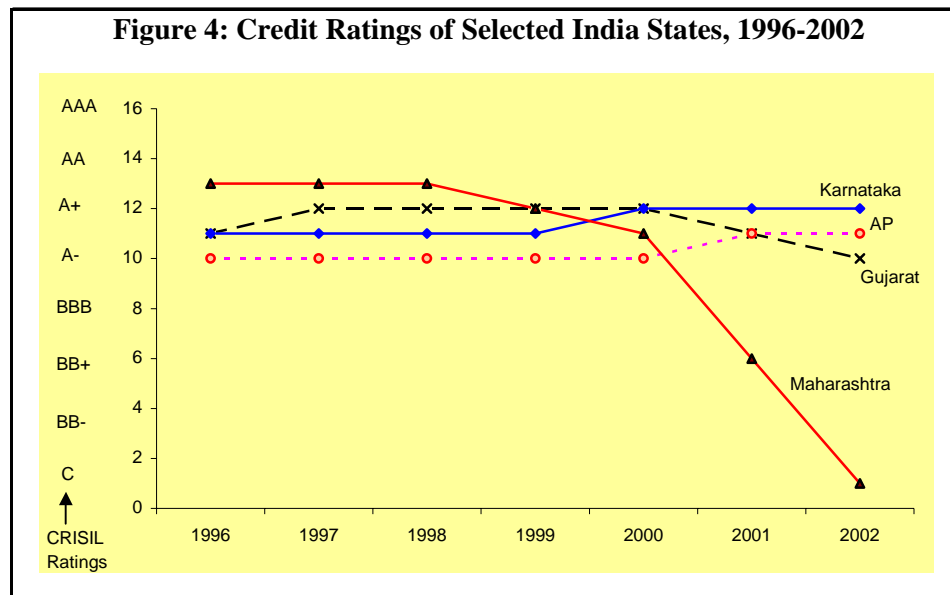
- A number of procurement and financial management reforms are ongoing. Karnataka became the first Indian state to enact the Transparency in Public Procurement Act. Information technology is being used extensively to enhance transparency in the procurement process, including placing of tenders on the Internet in the three states. UP has computerized its treasury operations, and substantially enhanced the timeliness and quality of financial information, and is now posting financial information on the Internet on a monthly basis. UP has also made significant progress in developing its computerized payroll system. Karnataka has established institutional foundations for modernizing the public financial accountability function by establishing a full-time Controller's (Accounts Management) Office to lead these efforts. It is also making progress in computerizing and networking its treasury and sub-treasury offices. Karnataka is also regularly posting its monthly accounts on the Internet, substantially enhancing fiscal transparency and monitoring. Karnataka and AP have taken steps to reduce the backlog of accounts and audits in various government entities. To develop a medium-term strategy for improving public financial accountability and management, State Financial Accountability and Management Assessments/Studies are being carried out in Karnataka and AP, and a similar study is planned for UP.

61. **Governance and institutional reforms.** The Bank's collaboration with reforming states has been useful in providing a platform to support cross-sectoral governance and institutional reforms. A number of reforms are in various stages of implementation across the three states, aimed at making governments smaller, more effective and more responsive to the needs and demands of citizens. These reforms are helping lay the foundation for sustained improvements in the fiscal position of the states.

- Civil service reforms have been launched to tackle the problems of fragmented bureaucratic structures, cumbersome business processes, lack of flexibility in staff deployment, political interference in staff transfers, and low productivity and accountability. States such as Karnataka are implementing a variety of measures to address these problems. Due to an administrative ban there, premature transfers declined drastically from 50,000 in 2000/01 to less than 17,000 in 2001/02. Karnataka has further commissioned an independent evaluation of 13 major departments to suggest ways of eliminating duplication, and is piloting mergers and streamlining of a few departments with the objective of extending the exercise to other departments. AP has recently established a Center for Good Governance with support from DFID, designed to provide analytic support for a far-reaching civil service reform agenda. It has also set up a central unit to oversee improvements in human resource management throughout the civil service. In UP, while there have been promising steps to create a computerized human resource database that will both facilitate rationalization and redeployment and help to curb unauthorized recruitment, problems of administrative fragmentation and premature transfers remain.
- Combating corruption and enhancing accountability and transparency has been a priority. AP has adopted a strategy for fundamentally restructuring and expanding its anti-corruption effort and enhancing its independence. AP has also taken vigorous measures to reduce power theft. Karnataka has been active in passing legislation to promote transparency and reduce corruption, including the Transparency in Public Procurement Act, the Right to Information Act, and the Industries (Facilitation) Act. UP has increased the staffing and funding for anti-corruption agencies. The number of sanctions for corruption has increased, albeit from a low base.
- Improving the delivery of public services through the streamlining of government transactions has shown initial results. AP has pioneered the use of information technology for re-engineering business processes. Its Computer Aided Registration Department, for example, has reduced the waiting time for stamp registration for deeds and titles from months to less than 30 minutes. It has set up "one-stop shops" for multiple public services and is computerizing information flows within the Secretariat. In both AP and Karnataka, the computerization of millions of farm land records has drastically reduced access time to minutes, thereby reducing harassment and corruption. In UP, there have been visible gains in public access to information through the

Internet. In Karnataka, citizens charters initiatives cover many key services (for example, transport and land-related services). Users are invited to participate in setting standards for service delivery and simplifying procedures. Corruption in the re-engineered transport department has been substantially reduced. The time needed to secure urban land has been reduced from five years to one.

62. In response to improved fiscal management and outcomes, the credit rating profiles of AP and Karnataka have improved. These two states now enjoy more favorable ratings than Gujarat and Maharashtra, which are traditionally considered to be the best managed states in India (figure 4).¹⁰



63. **Poverty monitoring, impact evaluation and statistical strengthening.** Efforts are well-advanced in UP and Karnataka to improve the information base for better poverty monitoring and analysis, and similar work has recently been initiated in AP. In UP, a poverty and social monitoring system (PSMS) has been established in the Planning Department: the baseline survey has been completed and a follow-up monitoring survey is in the field; GoUP is finalizing its baseline report and will disseminate the findings widely. In addition, training is being carried out to upgrade field skills and enhance the analytic capacity of UP's Directorate of Economics and Statistics. The Bank's recent UP poverty assessment has contributed to the policy debate and ongoing dialogue with key stakeholders. Karnataka established a Poverty and Human Development Division (PHDMS) under the Department of Planning, and major activities have included preparation of regionally disaggregated poverty estimates for the state for 1999/00, publication of a chapter on poverty and human development in the Government's annual Economic Survey, as well as efforts to improve state-output estimation and data processing systems. Another major activity has been to renew efforts to prepare the Karnataka Human Development Report, which in the past two years has been used to reallocate government expenditures towards poorer districts. In addition, a number of evaluation studies have been launched by various line departments under the government's independent evaluation initiative, which earmarks 1% of plan outlays for evaluations of major schemes. A number of these evaluations have been followed up by actions taken by the departments to improve the effectiveness of their schemes. GoAP is setting up a Poverty and Social Analysis Monitoring Unit (PSAMU) under the State Poverty Eradication Mission, with the mandate to develop a more integrated strategy for poverty reduction in the state, identify concrete actions and actors

¹⁰ Data are from Credit Rating and Information Services of India Limited (CRISIL). CRISIL ratings are available for 6 Indian States: the 4 states shown in the figure and Orissa and Tamil Nadu. But since ratings for all the years (1996-2002) for the latter two states are not available, these two states were not included in the figure.

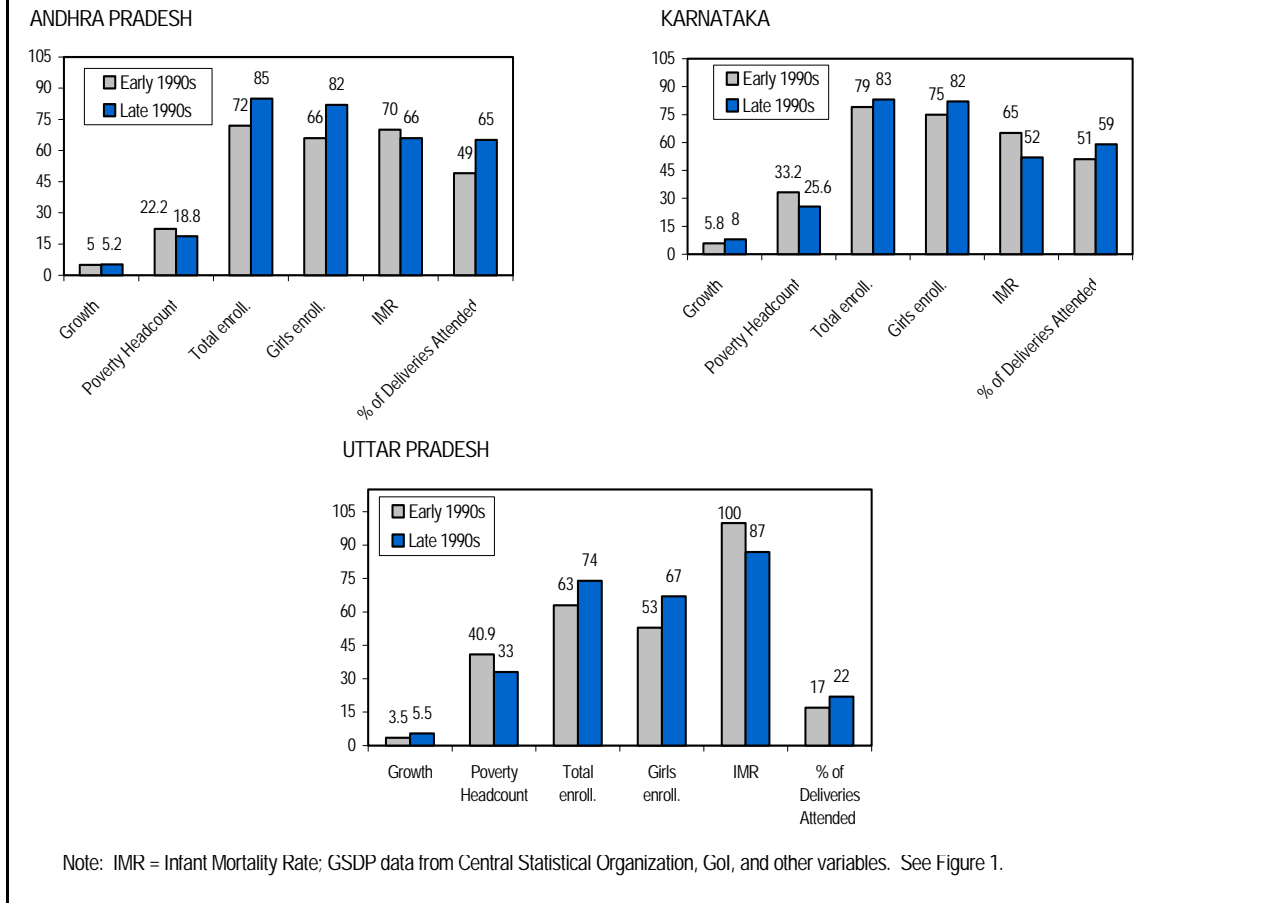
to implement the strategy, and develop a system for monitoring poverty and broader development outcomes (including MDG indicators). The Bank, in coordination with DFID, is providing training and capacity building in support of this effort and is undertaking joint work with staff in the PSAMU.

Overall Impact on Growth, Poverty and MDGs

64. It is too early to evaluate the overall impact of the Bank's assistance in the focus states on final outcomes, such as growth, poverty and other MDGs. It would also be presumptuous to assume that the Bank's program could have a determinant impact on these variables, given that Bank lending has constituted on average less than 1% of the output in these states. But encouraging results from fiscal and governance reforms in the initial stage indicate that the sustainability of these reforms holds the key to accelerate economic growth and reduce poverty in these states.

65. The recent performance of the focus states in terms of various economic and social indicators is encouraging. Growth prospects have improved, poverty levels have declined, and key social indicators critical to India's attainment of the MDGs have either improved or their deterioration has been arrested in all three states (figure 5). Karnataka has become one of the fastest growing Indian states, and school enrollments and health and mortality indicators have improved steadily in the 1990s. Poverty declined moderately in AP, due largely to slow growth in agriculture. Enrollment rates for boys and girls, however, have improved dramatically in the state. While UP has more poverty and higher levels of deprivation in other dimensions of welfare than most states in India, substantial improvements in school enrollments, IMRs and safe motherhood were recorded in the 1990s. Indeed, UP and AP stand out among the Indian states in terms of recent progress in improving literacy—especially for women—and raising primary school enrollment rates. But it is worth noting that 87 out of every 1000 children born in UP still die before reaching their first birthday and only 67% of girls are enrolled in primary school. India's ability to achieve the MDGs will be predicated on its success in addressing the challenges in UP and other poor states.

Figure 5: Trends in Selected Economic and Social Indicators



Expanding State Reforms

66. The momentum for state reform continues to grow, and several other states have expressed interest in entering into a reform-based partnership with the Bank. *Orissa* is one state that the Bank has been in dialogue with for several years. Orissa is India's poorest state, and also perhaps the most fiscally-stressed state. It was also the first state to privatize the electricity sector (para 25). Although this experiment has not so far yielded positive results, the state has not reversed the privatization policy and is now taking corrective measures to put the reforms back on track. An adjustment operation for Orissa is currently under preparation, pending the Government of Orissa's ability to implement difficult fiscal reforms. *Rajasthan* is another poor state in which the Bank has completed extensive analytic work. The current engagement is focused on important sectors, namely power, irrigation, education, health and rural development. *Maharashtra* has the largest industrial base of all Indian states, but wealth is concentrated in Mumbai, and the state has surprisingly high (above-average) levels of rural poverty. At the request of the state government, the Bank completed in October 2002 a comprehensive fiscal report that suggests a set of reforms to correct the state's deteriorating finances. Future involvement of the Bank with the state will be determined with the GoI and depend on the Government of Maharashtra's commitment to initiate critical reforms.

67. The Bank has continued to support important sectoral reforms in many states in India through reform-based lending, focusing on projects of high development impact or demonstration effects, as well as support for social sector projects in India's poorest states including Bihar, provided that corruption and governance issues are addressed (see III A and III B). Bank's lending to the three focus states accounts

for 34% of new lending, while lending to all other states accounts for 31%, with the remainder of 35% going to the center (para. 77).

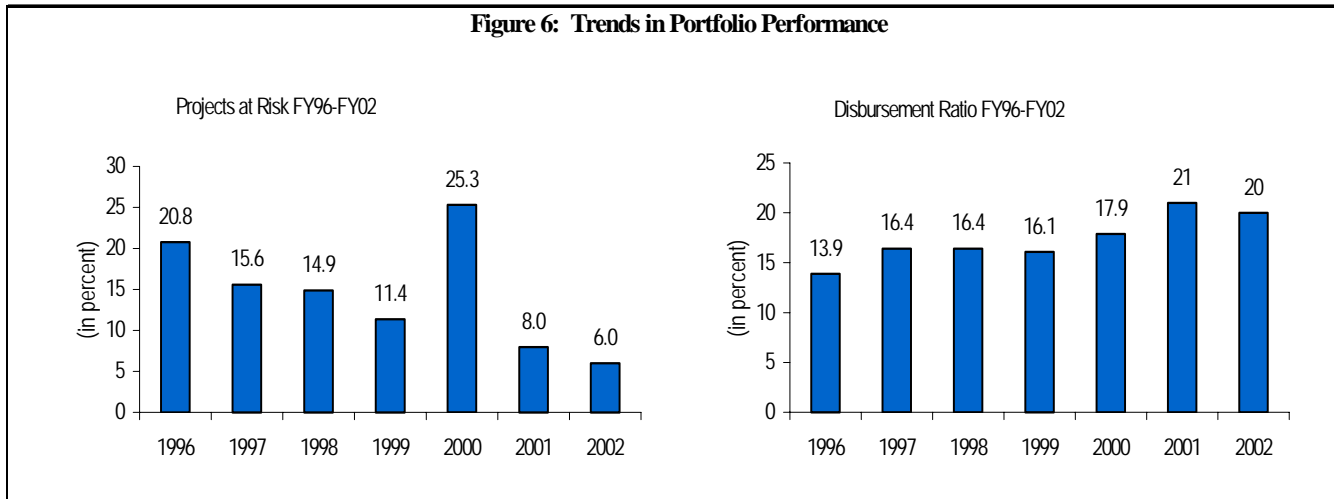
68. As discussed above (para. 3), all 15 major states (accounting for 90% of India's population) showed progress in reducing poverty and by and large improving social indicators. However, as better-performing states have made faster progress, poverty and illiteracy have become more concentrated in India's large and poorer states. UP, Bihar and MP now account for nearly 50% of India's poor. The MDGs will not be achieved without widening economic opportunities and overcoming barriers to more rapid poverty reduction and better human outcomes in these poorer states. UP, the largest Indian state with a population of 166 million, is the state with the largest share of India's poor (21%). UP has been a focus state of the Bank since 1998 (its reform progress is summarized in paras. 60-64). Bihar, with a population of 83 million, is the state with the second largest share of India's poor (16.9%). Bihar represents a particular challenge—a state of extreme poverty, collapse of civil services and near absence of law and order. The Bank is preparing an analytic study on Bihar in order to arrive at a deeper understanding of development challenges facing the state. MP, with a population of 60 million population, represents the third largest share of India's poor (11.8%). MP is a focus state of ADB and DFID.

IV. BANK GROUP PORTFOLIO

IBRD/IDA Lending

69. **Portfolio performance.** The active India portfolio is the second largest in the Bank, comprising, at the end of September 2002, 69 projects with a net commitment of US\$12.9 billion, and with an undisbursed balance of US\$3.8 billion IDA and US\$4.1 billion IBRD. Portfolio performance has seen a consistent and marked improvement, as shown in figure 6. The improvement was achieved through increased management attention by both the Bank and the GoI to project performance monitoring. Performance indicators are being used more rigorously in assessing project outcomes and implementation. Ratings are being shared with the GoI on a monthly basis, and highlighted in mission reports. The annual Country Portfolio Performance Review has paid particular attention to systemic portfolio issues, such as funds flow, audits and continuity of staffing. New projects are reviewed for implementation readiness, and additional training is provided in procurement, financial management, and environment and social requirements. Improved systems are being developed for financial management and disbursement monitoring, and these show that timely release of project funds has improved. Decentralization of the Bank's procurement, disbursement and portfolio management activities to the New Delhi Office has helped reduce response times and improve sharing of information with the GoI. Action plans for project restructuring or for problem projects are setting shorter targets and their implementation is being monitored more frequently.

Figure 6: Trends in Portfolio Performance



70. **Major diagnostic work.** Building on a series of core diagnostic AAA that had been completed prior to the CAS, additional work has been completed or launched. These include:

- The completion of poverty note/reports for Karnataka and UP respectively, and the commencement of work to assist the AP government to operationalize its Vision 2020 policy document that contains and goes beyond key MDGs (para. 42). A national-level poverty assessment is being planned, and a major AAA study has been initiated on MDGs (para. 92).
- The commencement of the Development Policy Review to be completed in FY03.
- The completion of a Financial Sector Strategy and various policy documents on key reforms outlined by the FY01 Financial Sector Assessment Program (paras. 22-23).
- The completion of additional two state-level PERs, the initiation of two more (para. 15), and analysis of debt sustainability and contingent liabilities as priority elements of public expenditure analysis at the national level (para. 96).
- The completion of the first, second and third phases of the Country Procurement Assessment Report (CPAR), with the first phase covering the central government, the second phase covering three states (UP, Karnataka and Tamil Nadu) and the third phase covering central public enterprises. The Ministry of Finance (MoF) is considering constituting a working group including several ministries to agree on an implementation plan at the central government level. At the state level, findings are being translated into action (for example in Karnataka) and have been disseminated in several other states leading to more state-level procurement studies (Maharashtra and AP).
- Preparation of State-level Financial Accountability Assessments (SFAAs) for Karnataka and AP and planned SFAAs for UP and Orissa. While the CAS proposed a Country Financial Accountability Assessment (CFAA) in FY02, it was decided to start with a few SFAAs which could help better define issues and frame the focus for the CFAA in FY04. Progress in procurement and financial management reforms in the focus states is summarized in para. 60.

71. **Fiduciary aspects of the portfolio.** Timeliness in receipt of audit reports has improved; suspension of SOE disbursements due to audit delays was reduced from 12 projects in FY01 to 5 projects in FY02. Discussions have begun with the C&AG on terms of reference for audits, and the quality of audits prepared by private chartered accountants has shown improvement in FY02. In addition, discussions have started with the GoI about improving the funds flow and cash management on Bank-financed projects to support and strengthen GoI's overall funds flow systems while ensuring that projects

have adequate resources. By working closely with the MoF, the C&AG, state and project officials, the quality of financial reporting, especially on new projects, has improved.

72. **FY02 lending and future IBRD/IDA lending scenarios.** The FY01 CAS set out two lending scenarios for FY02-04: (i) a base case of about US\$3 billion per year (US\$2.15 billion IBRD, US\$850 million IDA); and (ii) a low case of about US\$1.5-2.0 billion per year (US\$1.0-1.5 billion IBRD, and a core IDA program of US\$400-500 million). The Bank's proposed response to the Gujarat earthquake would be additional. Movement between the low-case and base-case lending scenarios was to be regulated by two sets of triggers: self-activating triggers, linked to fiscal and structural reforms at the state level; and global triggers linked to overall macroeconomic performance.

73. The self-activating triggers, which the CAS foresaw would automatically lower the lending program if states are unable to sustain basic structural reforms, have indeed caused a substantial reduction in lending volumes. For example, in the case of UP, a planned adjustment operation (US\$125 million IBRD, US\$125 million IDA) and a power sector investment loan (US\$150 million IBRD) were postponed due to slow progress in reforms, particularly in the power sector. More generally, slower than expected reform movement in the power and urban sectors have caused a substantial reduction in IBRD lending volumes, while IDA funding remained in strong demand, notably to support rural poverty reduction initiatives (e.g., Karnataka) and crucial water resources management reforms (e.g., Rajasthan and UP). As a result, commitments in FY02 (not including the Gujarat Earthquake Project for US\$443 million IDA), totaled US\$1.75 billion (US\$893 million IBRD, US\$854 million IDA).

74. Three global triggers were identified in the CAS, to be monitored in deciding overall lending volumes. Performance under these global triggers has been as follows:

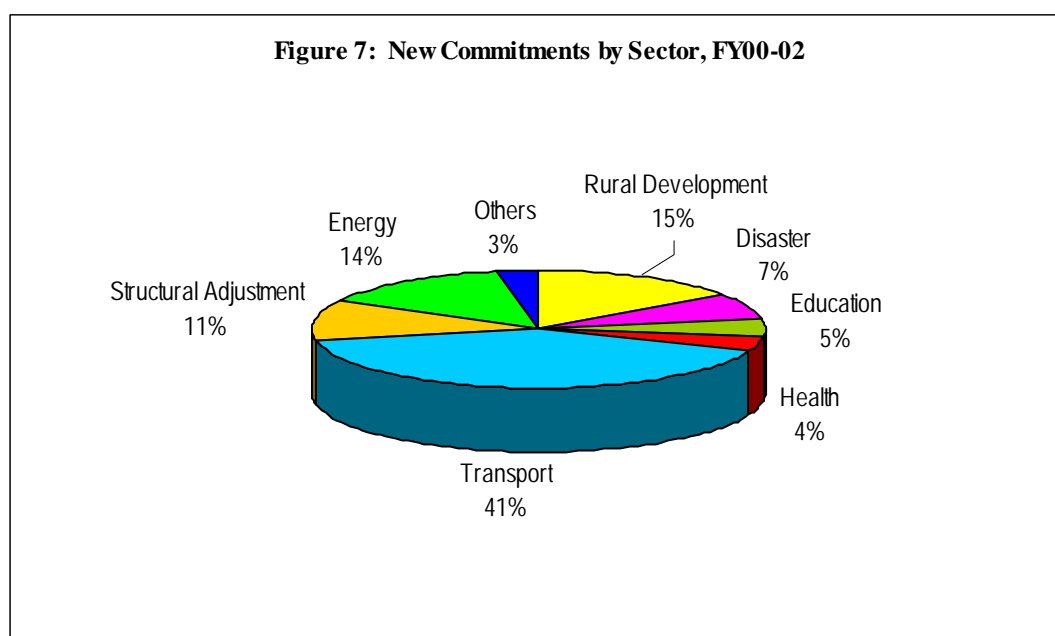
- *Fiscal and external balances.* The CAS stipulated the triggers for macroeconomic performance as: (i) improvement in the fiscal balance indicated by a decline in the General Government Deficit; (ii) consolidated public debt falling below 85% of GDP; and (iii) external stability indicated by net international reserves above 50% of the money base. The outturn has been as follows: (i) India's General Government Deficit increased to 10.4% of GDP in 2000/01, and to 10.3% of GDP in 2001/02, compared to the 1999/00 baseline of 9.7% of GDP in the CAS¹¹. The current forecast for 2002/03 is 10.2% of GDP; (ii) the consolidated public debt rose to 86.4% of GDP at the end of 2000/01, 91% of GDP at the end of 2001/02 and is projected to increase to 94.6% at the end of 2002/03; and (iii) the ratio of net international reserves to the money base reached 86% as of September 2002. In summary, external performance has been very strong, but the fiscal targets have not been met.
- *National structural reforms.* The CAS identified four key areas of reforms—external trade liberalization, banking, deregulation and privatization of public enterprises. There has been progress in each of these areas, although in some cases, the pace of reforms has been slow. Details are set out in para. 10.
- *Portfolio performance.* For this trigger, the CAS set the following targets: problem projects not to rise above 15% of projects under implementation, and the disbursement ratio not to fall below 17%. The share of problem projects declined from 13% in FY00 to 4% and the disbursement ratio increased from 18% in FY00 and has been maintained at 20% (see para. 69). Thus, portfolio performance has been good.

75. India's fiscal deterioration is a source of serious concern (discussed further in the risks section, para. 95). Overall, the mixed performance under the global triggers suggests that India is currently at the low end of the base case. Consistent with this and combined with the effect of the self-activating triggers, new commitments are currently estimated at US\$1.6 billion (US\$0.8 billion IBRD, US\$0.8 billion IDA)

¹¹ Revised actuals for 1999/00 show a General Government Deficit of 9.9% of GDP.

for FY03 and US\$1.9 billion (US\$1.1 billion IBRD, US\$0.8 billion IDA) for FY04 (for the latter year, assuming no significant improvements in performance). Continued demand for financial assistance in the social sectors and for poverty-focused rural development programs underpins the planned level of IDA lending, which will still remain well below India's needs, particularly given the country's efforts to move faster towards achieving the MDGs (para. 92).

76. **Distribution of the portfolio.** The sectoral distribution of new lending to India for the three fiscal years FY00 to FY02 is shown in figure 7. Transport constituted 41% of new lending, or US\$2.7 billion, followed by rural development and energy. Structural adjustment loans/credits represented 11% of the total. New lending for health and education was 9%, considerably less than their combined 26% share of the portfolio.



77. The state-wise distribution of new lending for FY98-02 is shown in table 1. In this period, 34% of new loans/credits went to the states of AP, Karnataka and UP that collectively represent 28% of India's total population and 30% of India's poor. 31% of new lending went to other states and 35% to the GoI.

Year	AP, UP & Karnataka		Other States		Center		Total US\$ M
	US\$ M	%	US\$ M	%	US\$ M	%	
FY98	785.4	23	327.4	11	1,028.8	30	2,141.6
FY99	404.1	12	324.7	11	326.0	10	1,054.8
FY00	804.7	24	100.5	3	895.6	26	1,800.8
FY01	610.4	18	811.0	27	1,133.9	34	2,555.3
FY02	749.7	22	1,439.8	48	0.0	1/ 0	2,189.5
Total	3,354.3	100	3,003.4	100	3,384.3	2/ 100	9,742.0

1/ The Grand Trunk Road Project (US \$589 million IBRD), originally planned for FY02, was advanced to FY01.

2/ Lending to the Center includes projects that cover multi-states.

78. **IDA/IBRD Exposure.** India is IDA's largest exposure, with IDA debt outstanding of US\$20.4 billion (21.2% of the IDA portfolio) at the end of FY02. As concerns IBRD, India is the seventh largest exposure. IBRD exposure indicators for India are favorable (see annex B5). Total IBRD exposure has been declining, and at end-FY02 amounted to US\$7.02 billion (5.7% of the IBRD portfolio), well below the peak level of US\$11.2 billion in FY95. With the current lending plans for FY03 and FY04 (para. 75), IBRD exposure is expected to remain at the current level through end-FY04, significantly lower than the US\$9.0 billion projected in the CAS, and well below the current single-borrower limit of US\$13.5 billion. (Indeed, these levels of exposure reflect a joint approach by the GoI and the Bank to manage IBRD exposure proactively in the context of a long-term active GoI/IBRD relationship—see CAS para. 131; they compare with a sustained level of IBRD lending at around US\$1.4 billion a year that could increase exposure to close to the concentration limit in the longer term, depending on the pace of actual disbursements, future cancellations and prepayments, as well as exchange valuation effects.) IBRD debt service is a small and declining share of exports (less than 2% in FY02), and the share is projected to decline further (see annex B5). While preferred creditor debt service is projected to be about one third of total public external debt service, total external debt service is projected to amount to only about 15% of exports. With continued strengthening of India's external position, total external debt outstanding is projected to continue to decline as a percentage of both GDP and exports.

IFC Portfolio and Program

79. India is IFC's third largest exposure. As of end-FY02, IFC's portfolio in India consisted of investments in 84 companies, with total exposure of US\$661 million for IFC's own account and US\$67 million for B-loan participants. Of IFC's FY02 commitments, 43% have been concentrated in mid-sized industrial companies, with 32% in infrastructure and 25% in the financial sector. Portfolio performance has been unsatisfactory, largely due to the poor performance of four old investments in the steel and textiles industries. Non-accruing loans are equivalent to 32% of disbursed principal; total arrears are US\$87 million. Equity loss reserves represent 31% of the disbursed equity portfolio. IFC realized US\$12.3 million in capital gains in FY01 and US\$7.93 million in FY02.

80. To improve the quality of its India portfolio, IFC has intensified project supervision, with the establishment of a portfolio unit in New Delhi, which supervises about 40 general manufacturing and financial markets investments. Being closer to the client and market, IFC is in a better position to monitor its portfolio and work proactively with clients. Increased attention has been given to resolving portfolio problems and exiting inactive equity positions. In the past twelve months, IFC has managed to exit from four inactive equities through negotiations with potential buyers. In three cases, IFC managed to sell its position above its cost. In addition, IFC is giving greater attention to credit quality in new investments and to structuring projects in ways that provide a return commensurate with the risks. This is particularly challenging in India, where the regulatory framework is not conducive to standard structures such as equity put options and quasi-equity and restricts the maximum interest that can be charged on external borrowings and thereby limits the return IFC can obtain.

81. IFC has continued to increase its investments, with commitments of US\$233 million in FY01 and US\$139 million in FY02, up from about a total of about US\$300 million for FY98-FY00. IFC made its first Indian rupee loan in FY02. In addition, a pull-back from project lending by Indian financial institutions and the downturn in international and domestic capital markets has created a new role for IFC in supporting larger Indian corporations that have lost access to financing from other sources. In the current market environment, IFC has a counter-cyclical role in helping these companies raise financing for restructuring and expansion. While alternative sources of financing remain inadequate, IFC will continue to work with these companies, and will seek to leverage the capacity of these large corporations to finance innovative products and services.

82. However, as discussed above, progress in implementing sector reforms necessary to attract private investment in infrastructure, with the exception of telecoms, has been disappointing, and a

significant reform agenda remains. Meanwhile, the pullback of international infrastructure developers from emerging markets has reduced the availability of foreign sponsors. Recession in the industrial sector and high real interest rates have led to a decline in new private investment beyond infrastructure. Total commitments over FY01-FY03 are likely to fall well short of the level indicated in the CAS (US\$1.0-1.5 billion).

83. IFC has played an active role in knowledge-sharing in the region, including seminars on insurance and on small and medium-size enterprise (SME) financing, and in technical assistance to microenterprise institutions. A new regional TA facility in Dhaka, co-financed with bilateral donors, will support the development of SMEs in the northeast states of India and neighboring countries.

MIGA Program

84. MIGA has intensified its marketing efforts in India (setting up a mobile office in three cities, for example) to promote Indian SMEs and Indian investment in other developing countries. Foreign investors have expressed interest in MIGA's coverage of investments in India, largely in the power, telecommunications and medical sectors. MIGA has no outstanding guarantees for projects in India. It has insured two projects undertaken by Indian companies in Tanzania and Zambia, facilitating FDI of US\$203 million. Currently, MIGA has one active contract with US\$1 million outstanding from Indian investors. Indian investors have continued to express interest in MIGA coverage for their investments in other developing countries and emerging markets, and MIGA anticipates underwriting a project in FY03.

Partnerships

85. Progress has been made in building partnerships with key players—from the GoI and reforming state governments to the private sector, civil society, external donors and investors. In particular, the dialogue with the GoI has broadened—with Bank advice being sought in new areas such as in financial sector reforms, privatization and voluntary retirement schemes (para. 22). The Bank worked with the National Institute of Public Finance and Policy, MoF and DFID on the Fiscal Policies to Accelerate Economic Growth Conference (para. 15), and with the Planning Commission on the Monitoring and Evaluation Poverty Workshop (para. 2). Consultations outside of government circles on Bank policy have grown in importance: national and regional-level consultations were held recently on the revision of the policy on indigenous peoples. The Bank is also actively engaging civil society in preparation and implementation of a broad spectrum of projects—one of the more interesting cases being the partnership with the Society for Promotion of Area Resource Centres (SPARC) in ensuring the rights of railway slum dwellers within the Mumbai Urban Transport Project. NGOs and civil society organizations have been closely integrated into the implementation of the Gujarat Earthquake Recovery Program leading to the effective community participation and monitoring of the reconstruction program. In addition, over the past year or so, the Bank has collaborated with CII to analyze and disseminate information on improving the investment climate (para. 18), with NCAER to examine labor adjustment issues in the context of privatization (para. 19), and with the Indian Council for Research on International Economic Relations (ICRIER) and the National Institute of Bank Management to organize a high-level seminar on financial sector reforms in India.

86. Partnerships with other donors have expanded. The Bank has developed strong partnerships with USAID in UP, and with DFID in AP and Orissa to provide technical assistance and to collaborate on co-financing operations to support comprehensive state reforms. In addition, DFID is providing considerable trust fund support to the Bank's overall program, enabling a greater focus on the reforms necessary to achieve lasting poverty reduction. At the sectoral level, partnering with other donors—including the USAID, EU, the Netherlands, DFID, CIDA, UNICEF and WHO—has been particularly important in education and HIV/AIDS programs. The Bank is also in dialogue with the Government of Japan to ensure exchange of information and appropriate coordination of our activities. As in other countries, Japan PHRD grants are an important source of support to project preparation for eventual Bank financing.

In June 2001, ADB and the Bank completed a Coordinated Assistance Strategy for the Road Sub-sector in India, that has since been updated by ADB and the Bank. The Bank also participated in an ADB-sponsored high-level donor forum in January 2002 to increase collaboration for supporting the newly-created states and northeastern states. The Water and Sanitation Program (WSP) is an international donor partnership supported and managed by the Bank. In India, in the context of the WSP, the Bank collaborates with DFID, SIDA, the Netherlands and other donors in a range of activities including rural and urban water supply with a formal partnership with the Rajiv Gandhi Drinking Water Mission (para. 48) and decentralization activities such as the City Challenge Fund (para. 33). With the support of the Swiss Government, the Bank and the GoI are about to initiate a National Strategy Study on Clean Development. The Bank and the GoI have continued to partner with the GEF and Montreal Protocol, including the world's second largest program to eliminate the production and use of ozone-depleting substances. The Bank is also working with KfW to facilitate new GEF support for solar thermal power generation. The Bank has worked closely with the UN Inter-Agency Working Group on gender and development, through setting annual agendas, participating in shared events and carrying out joint learning exercises.

V. EMERGING ISSUES AND RISKS

Supporting State Reforms and Development

87. While a full assessment is not yet possible, it appears that the shift in the Bank's strategy in recent years—working with the GoI to support major structural reforms at the state level—is well-founded. The number of reforming states is growing, as is the breadth and depth of reforms in individual states, though it should be emphasized that even the leading reforming states are still grappling with very difficult reform issues and fiscal challenges. To build on the achievements to date, and to carry forward the states-based strategy, a number of emerging issues will need to be addressed, in close partnership with the GoI. The spread of reform among states raises the issue of whether, given administrative budget and staff constraints, more can be done to maximize the impact of the Bank's involvement, for example, through greater coordination between the Bank and other external partners supporting reform at the state level. A related question concerns the mechanisms for determining whether new reforming states should be considered for Bank lending, as well as for the exit of states that might be lagging in reform efforts.

88. While adjustment lending at the state level has been a very useful instrument for supporting state reforms, its use has not been as widespread as anticipated in the CAS, partly because reforms have not moved as fast as expected, and partly because of a desire on the part of the GoI to review experience with adjustment lending at the state level. Accordingly, in February 2002, the GoI requested the Bank to conduct a review of its sub-national adjustment lending in India. This review noted that adjustment lending was still a relatively small component of the overall lending program: 14% in FY00, 6% in FY01 and 16% in FY02. The review also made a strong case, based on available evidence, that sub-national adjustment lending was starting to show results, with visible progress from participating states in terms of fiscal adjustment and governance improvements. (See also section III C above). The future of sub-national adjustment lending in India is currently under discussion between the Bank and the GoI. Meanwhile, efforts are ongoing to strengthen the reforms supported by such operations, for example, to focus increasingly on reforms which are difficult to reverse, such as legislative changes, and deep institutional reforms, to promote sustainability.

89. The increased use by the GoI of reform-based transfers—a very welcome development—raises the question of the relationship of Bank lending to these new schemes (for example, the Fiscal Reform Facility aimed at restoring the health of states' finances, the newly created Urban Reform Incentive Fund and City Challenge Fund, and the Accelerated Power Reform Development Program (APRDP), which provides soft financing for power sector investments based on reform progress). Preliminary discussions are underway as to how the Bank can best support these reform-based transfers. In particular, the GoI has

asked the Bank to bring international experience to bear in the design of these facilities. Beyond technical assistance, there may also be financing opportunities, including: technical assistance; arrangements whereby states can access Bank financing (“upper tranches”) when they have achieved a stipulated higher hurdle of reform over and above the “first” level of reform stipulated by, and funded through, the GoI window; and focusing Bank financing on a subset of states within an agreed and common policy framework.

90. **Support for north-eastern and newly-created states.** The GoI has requested the Bank and other external agencies to provide concentrated support for the three new states of Jharkhand, Chhattisgarh and Uttarranchal,¹² and for the eight, isolated northeastern states and for Jammu and Kashmir. The donor community recognizes the special development challenges facing these states and is increasingly active in them. The Bank is preparing projects in all three of the new states, and plans to undertake a fiscal assessment of Jharkhand in the upcoming forestry project in that state. With respect to the northeastern states, the Bank is expanding its portfolio, and is considering extending its financial assistance to the state of Tripura for road and integrated rural development. However, at the same time, the Bank is constrained by security concerns and availability of resources. IFC is also expanding its support to SMEs in the northeast (para. 83).

91. These major issues will be an important focus for discussion between the GoI and the Bank over the coming year, so that agreed steps to evolve the states strategy can be incorporated in the next full CAS.

Achieving the MDGs

92. This CAS progress report documents the advances made by India in the 1990s towards the MDGs and makes clear the scale of the challenge ahead (para. 3). As stated earlier (paras. 2-3), the key goals of poverty reduction and human development are at the core of India’s development plans and in turn, constitute an essential thread of the Bank’s assistance strategy in India. Over the coming year, to enhance its effectiveness in pursuing this important agenda, especially given the renewed prominence of the MDGs in the global development dialogue, the Bank will focus on improving its analytical base. Work has thus been initiated to: (i) obtain a better assessment of MDG achievements at the sub-national and sub-state level and document the considerable heterogeneity that exists in the prospects of individual states and districts in attaining the MDGs; and (ii) understand the socio-economic and policy determinants for achievement of the Millennium Development indicators better. The results of this work will help to formulate, jointly with the GoI, further Bank support for the policies and programs that will need to be undertaken to move faster towards achieving the MDGs and to articulate the coordinated interventions across sectors which the next full CAS would support.

Key Risks

93. The FY01 CAS identified a number of risks facing the Bank and its work in India. On the political and programme risk side, the chief issues identified included: (i) the risk of reform derailment; (ii) the possible implications of growing disparities between states; (iii) portfolio risks, including the impact of fiscal deterioration, the effectiveness of community-based interventions and social and environmental risks; and (iv) a risk of the Bank becoming less relevant. Credit and exposure risks were considered fairly small, with the main issue being the possible failure to progressively reduce the fiscal deficit.

94. Thus far, there has been no indication of derailment of reform; the issue has rather been the pace of reform, as indicated in para. 10 above. So far, the automatic correction to the level of Bank lending in the face of slow reform at the state level seems to have worked well. States are paying increased attention

¹² These new states were created from existing states in November 2000.

to communication strategies to build consensus for reform, an area which the Bank is increasingly emphasizing through the work of its external affairs unit.

95. As noted in para. 78, India's external creditworthiness indicators are strong. Nevertheless, the fiscal situation is of significant concern. In addition to the high and growing burden of consolidated public sector debt, now over 90% of GDP, contingent liabilities are also on the rise, mainly in the form of guarantees (largely due to projects in irrigation and power). There are also large unfunded pension obligations and recapitalization requirements of weak public-sector banks. These fiscal trends have implications for the long-term sustainability of the national debt and the related risks have led the major international credit rating agencies to lower their credit ratings of Indian local currency debt.¹³ Without tough measures to consolidate the fiscal situation and accelerate structural reforms (for example, by cutting untargeted subsidies), the fiscal position is unlikely to improve. Clearly, the longer the fiscal deficit goes uncorrected, the greater the risk that interest rates are driven to crippling levels and/or an upsurge of inflation is generated—in either case leading to a slowdown or even interruption of growth and poverty reduction. Over time, such a scenario could pose potentially serious risks to the financial system by undermining the public's confidence in government support for financial institutions—which is a major factor in the financial system's current stability. In such circumstances, a spillover into the balance of payments could not be ruled out, particularly if combined with adverse developments in the global economy such as high oil prices and/or slow growth.

96. The CAS triggers have already mitigated the risks to the Bank in this emerging situation (paras. 73-75), and, as mentioned, IBRD exposure at the end of the CAS period is likely to be significantly below the level forecasted in the CAS (para. 78). However, the progressively increasing risks posed by the fiscal situation require close monitoring, and an even greater focus of the Bank program of assistance on fiscal and related structural reforms. Analytic work on debt sustainability and on contingent liabilities will also be given priority.

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¹³ Moody's revised its rating from BA2 (stable) to BA2 (negative), while Standard & Poor lowered its rating of Indian local currency debt from BBB- to BB+ in September 2002.