Annex 7

India: Private Sector Strategy for the World Bank Group

Key Constraints and Challenges to Private Sector Growth and Competitiveness

Indian policy makers recognize that a vibrant private sector – with firms investing, creating jobs, and improving productivity – is central to promoting growth and expanding opportunities for poor people. The Government of India's (GoI) Tenth Five Year Plan sets ambitious targets for GDP growth (around 8% per year over the next decade) and employment creation (100 million new jobs) required to substantially reduce the incidence of poverty. The Plan notes that achieving these targets will require a sharp step up in investment, particularly private investment (domestic and foreign), coupled with improved productivity.

Private investment in India averaged around 15% of GDP in the 1990s (somewhat below the average for low income countries and below the level necessary to accelerate growth to a sustainable 8% a year). It was largely financed from domestic savings - foreign direct investment (FDI) inflows to India have averaged only around US$ 5 billion annually over the past few years, as compared to US$40 billion annually to China. As a share of GDP, FDI in India stood at under 1% percent in 2002/03, compared with 4% in China and between 2% and 3% in many emerging market countries.

In 2001, the manufacturing sector in India accounted for around 17% of GDP, compared with 35% in China and 25-35% in South East Asian economies.[1] India's share of non-agricultural exports in world exports increased marginally from 0.5% in 1990/91 to 0.55% in 2000/01. India's services exports have fared better, today accounting for 1.4% of global exports in services. But this growth took place on the back of a narrow set of subsectors, primarily software exports, which grew at an annual average rate of 49%

Table 1: GDP and Investment Trends Over the Past Two Decades

	1980s	1990s	1992/93-1996/97	1997/98-2001/02
GDP growth (% pa)	5.6	5.8	6.7	5.5
Agriculture, Forestry and Fisheries	3.4	3.0	4.7	1.8
Industry	7.0	5.8	7.6	4.5
Services	6.9	7.6	7.5	8.1
Investment rate (% of GDP)	22.0	23.0	23.3	22.5
Public	10.0	7.8	8.0	6.6
Private	12.1	15.2	15.3	15.9

Note: Table from the India Development Policy Review. World Bank. June 2003

[1] The organized industry and service sectors in India today together account for just about 27 million jobs, or under 7% of total employment; some 70% of organized jobs are in the public sector. Organized manufacturing provides just 7 million jobs, or under 2% of total employment.

during the second half of the 1990s. India's performance in travel and transportation services, where the underlying growth is linked to trade in goods, has been mediocre.

International comparisons indicate that India has intrinsic advantages, such as macroeconomic stability, a large and rapidly growing local market, a large and relatively low-cost labor force, a critical mass of well-educated workers, and abundant raw materials, that should allow it to attract and sustain higher levels of private investment, both domestically and foreign financed. Capitalizing on these national advantages, India's private sector has registered some important achievements in the past decade and a half – for example, the development of exports of software and back office services, the emergence of a competitive automotive sector and quantum improvements in domestic air travel – driven largely by the liberalizing reforms initiated in the early 1990s.

At the same time, the potential still to be tapped is clearly enormous. The Bank's investment climate assessments (ICAs) for India, and other recent studies,[2] show that the private sector in India continues to be constrained by a number of factors, especially: (i) product market distortions, including persistent weaknesses in the tax and tariff regimes, restrictions on foreign direct investment (FDI), regulatory restrictions on the industrial sector (particularly for small businesses),distortions in the pricing and marketing of agricultural products, and business inefficiencies arising from bureaucratic hassles; (ii) factor market distortions that impede the functioning of labor and land markets, and weaknesses in the competitive environment, including in legal framework for business operation and exit; (iii) problems in access to finance; and (iv) severe infrastructure bottlenecks.

The potential gains to growth from removing key bottlenecks to private sector growth and competitiveness have been estimated to be in the range of 2% to 4% per annum. A study by McKinsey (2001) estimated that addressing the inefficiencies generated by the multiplicity of investment regulations, distortions in the land markets, and widespread government ownership of business, would free India's economy to grow as fast as China's, at 10% a year, and create some 75 million new jobs, sufficient not only to provide employment to new entrants in the work force, but also to reabsorb the majority of workers displaced by productivity improvements. The ICA 2002 estimated that, if each Indian state could attain the best practice in India in terms of investment climate, GDP growth could increase by about 2 percentage points. The survey indicated that, if India could achieve Chinese or Thai levels in distinct investment climate areas where it lags behind those countries, its growth acceleration would be even more dramatic. While recognizing India's real achievements in promoting the private sector in the last decade and a half, the balance of this section focuses on an assessment of the key constraints that still remain.

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[2] See, for example: the *Tenth Five Year Plan,* Planning Commission (2003); *Report of the NK Singh Steering Committee on Foreign Direct Investment,* Planning Commission (2002); *Report of the Prime Minister's Economic Advisory Council (2001); Govindarajan Committee Report on Reforming Investment Approval and Implementation Procedures,* Ministry of Commerce and Industry (2002); *India: Development Policy Review: Sustaining Reform,* Reducing Poverty, World Bank (2003);
India Country Assistance Strategy, World Bank Group (2001) & *Update* (2002); *India's Growth Imperative, McKinsey* Global Institute (2001); *Learning from China to Unlock India's Growth Potential,* CII and McKinsey (2002).

Product Market Distortions

Weaknesses in the tax regime. A key barrier to competitiveness is the lack of a unified VAT regime in all the states, barring Haryana. Any raw material or intermediate inputs purchased by a manufacturer attracts state level sales taxes that vary from 2% to 3% if these are purchased from the same state; and 4% central sales tax if such inputs are bought from other states. On the final product, the 'floor' state sales tax rates have slabs of 4%, 8% and 12%, with petroleum products carrying a rate as high as 20%. The actual rates on the end products are often higher than these floor rates. None of these state sales taxes gets the benefit of VAT credit, leading to tax cascades that range between 6% and 12% of total ex-factory cost. Successive studies and surveys have demonstrated the high degree of uncompetitiveness arising out of non-VATable state level indirect taxes and levies, and the need to implement a unified VAT regime as quickly as possible. The full and uniform implementation of the new VAT across all states, so as to reduce distortions caused by the indirect tax regime, should be a key priority.

Tariff protection. in India is still substantially higher than in most other developing countries. In March 2003, including the protective effect of the Special Additional Duty (SAD), the un-weighted average protective tariff was about 32.7%, overall, 30.7% for industrial goods and 46.8% for agricultural products including processed foods. This is far lower than pre-reform tariff levels during the 1980s, but still very high by world standards (for example, China's import duties are expected to average 9% by 2005). High import tariffs drive up the prices of finished products, suppress demand and provide opportunities for inefficient firms to survive and for efficient firms to capture rents. A phased reduction in tariffs is thus a critical priority.

Restrictions on Foreign Direct Investment (FDI). While policies towards FDI have been significantly liberalized, FDI is still subject to limits, particularly on full ownership by foreign players. For example, FDI is currently not permitted in pure retailing (global retailers can participate in India's retail sector only through wholesale trade or by operating retail outlets through local franchises). In apparel, another important sector for job creation, FDI is limited to 24% of equity. In housing construction, restrictions on foreign ownership of land limit the entry of foreign builders and developers. In banking, restrictions on foreign ownership of domestic banks have held back improvements in financial sector performance by constraining competition to domestic banks and the introduction of new technologies and techniques.

Inappropriate industrial policy for small businesses and policies towards agricultural products. The growth of small business has been inhibited by investment ceilings and product reservations for small-scale industries (SSIs). At the start of the reform program of the early 1990s, some 800 items were reserved for exclusive production in the SSI sector, which meant that investment in plant and machinery in any individual SSI unit in a 'reserved product category' could not exceed the narrowly defined investment ceiling. The list of reserved items has been pruned, but some 590 items continue to remain reserved. Small firms that produce goods in the reserved sectors cannot expand, achieve economies of scale, and improve efficiency. Also, the efficiency of private investment in agriculture is constrained by minimum support prices on agricultural products, input subsidies, as well as some laws and procedures that create barriers to trade and movement of agricultural commodities and prevent corporate investment in agriculture.

Bureaucratic hassles and the Inspector Raj. While the complex web of regulations known as the "License Raj" has been substantially reduced at the Center, it survives at the state level, along with a pervasive culture of government interference known as the "Inspector Raj", imposing serious costs on doing business in India, and reducing competitiveness. Private investors require many approvals from state government to start a business. They also have to interact with state bureaucracy in day-to-day operations because of laws governing pollution, sanitation, worker welfare, etc. The World Bank's Doing Business indicators show that the median time to start a business in India 89 days, almost three times higher than in China. The ICA 2004 shows that Indian manufacturers face, on average, 8.9 visits per year from government officials. Although this has reduced from 10.8 visits in 2000, and there are significant variations across states, even the best Indian state compares poorly with a country like Malaysia, where the average number of visits is 2.8. Moreover, 15.8% of senior management time each year is spent dealing with government officials — versus 5% for Malaysia, 7.6% for Brazil, 8.5% for the Philippines and 11.2% for China. Such high levels of government interaction raise the potential for corruption, which survey respondents regard as a major problem. Reducing costs related to delays and rent seeking would require re-engineering the entire gamut of business approval and regulatory processes, especially at the state and local levels. Clear principles of transparency and strong accountability are needed on the part of the concerned officials.

Factor Market Distortions

Labor market inflexibility. Restrictions on the hiring and firing of workers by medium and large firms are one of the greatest challenges of doing business in India. India's complex labor market legislation is designed to protect the formal sector workforce, but has the effect of deterring the creation of formal jobs, which as a result account for just about 7% of the country's total workforce. Employment in India's registered firms (those with more than 100 employees) is highly protected. Any registered firm wishing to retrench labor can only do so with the permission of the state government which is rarely granted. These provisions make labor rationalization in registered firms very difficult, discourage the hiring of labor in the organized sector, and are especially onerous for labor-intensive sectors. They are obviously especially burdensome for exporters who have to compete with producers in other exporting countries. And they also explain the tendency of FDI to focus on the domestic market rather than use India as a base for exports. The ICA 2002 found that the typical Indian firm reported having 17% more workers than it desired and that the labor laws and regulations were the main reason why it could not adjust to the preferred level. Further, the use of contract labor is restricted to temporary activities by the existing Contract Labor Act.

Land markets. Problems with the use and transfer of land also affect the performance of firms. According to ICA 2002, some 90% of land parcels in India are reportedly subject to disputes over ownership, which take decades to settle in court. Restrictive tenancy and rent control laws keep a large part of urban real estate off the market. The central government has already abolished the Urban Land Ceiling Act, which previously made changes in land use very difficult. But only a few states have repealed their corresponding Land Ceiling Acts, and this is an urgent priority for state governments.

Problems in debt recovery and bankruptcy. Difficulty in recovering distressed assets and the lack of effective bankruptcy procedures have made industrial restructuring and business exit very difficult.[3] This has burdened the financial sector with high non-performing loans (NPLs) and deterred lending to the industrial sector. The recently enacted law on Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (2002), which allows banks to take over collateral more easily, is an important step that could push debtors to pay up. However, the effectiveness of the law remains a matter of concern, given loopholes that make it difficult for creditors to sell recovered assets. Similarly, the enactment of Amendments to the Companies Act (January 2003) and repeal of the Sick Industries Company Act (December 2003) provide a new framework for the liquidation of firms outside the court process, thereby helping to speed up bankruptcy proceedings. The new bankruptcy framework also prescribes the setting up of National Corporate Law Tribunals, which are to be manned by experts in corporate law and finance. However, these tribunals have not been formed, and the new bankruptcy procedures are yet to be implemented.

Problems in Access to Finance

After more than a decade of financial reforms and deregulation, initiated in 1991, India's financial sector has grown significantly in size and complexity. India's financial savings are much higher than in many other large emerging market economies. The share of financial assets in GDP in India is about 93 percent, compared to 68 percent in Mexico. Equity markets are booming. Prudential norms have been tightened and competition in the banking sector has increased. However, success with mobilization of the much-needed long-term capital to finance infrastructure remains limited, and India's financial sector has not been able to efficiently allocate resources to the private sector, to finance the higher levels of investment necessary for sustained growth, job creation and poverty reduction. The ratio of private credit (from deposit money banks and other financial institutions) to GDP in India remains low at under 40%, compared to over 100% for countries such as China, Korea and Malaysia. While the top layer of Indian corporates (which can now access both international and domestic capital markets) today have much better access to finance than in the past, critical sectors, such as small and medium enterprises (SMEs), rural households and micro enterprises face serious difficulties in accessing adequate finance on competitive terms.

A number of policies have distorted banks' risk-return signals. Banks' borrowing costs are kept high by floors on short-term deposit rates, while Government policy dictates that lending rates on small loans (up to Rs. 200,000) be capped at the prime lending rate (which banks are free to set). These restrictions make banks reluctant to lend to small clients, particularly rural households and micro-enterprises, who are perceived as high risk. Statutory pre-emption of credit through high liquidity and cash reserve ratios and directed ("priority sector") credit crowd out lending to the private sector. Government's large deficit, financed through the market, further crowds out credit to the private sector.

[3] Recent estimates show that it is entirely common for bankruptcy proceedings in India to take more than 2 years, and over 60 percent of liquidation cases before the High Courts have been in process for more than 10 years. Not surprisingly, when looking at the share of firms that go bankrupt, India has a much lower share (0.04 per cent) than other emerging markets, such as Thailand.

Financial regulations and laws have been upgraded but poor enforcement weakens market discipline and integrity. Gaps also remain in the infrastructure underpinning financial institutions and markets, for instance, the lack of credit information services, and the absence of a well-developed integrated clearing and settlement system for capital markets. Government maintains restrictions on foreign borrowing by Indian companies (including loans from IFC), which constrains the competitiveness of Indian companies by inhibiting them from accessing capital from foreign sources. Interest caps are also imposed, inhibiting foreign borrowing for riskier projects, including infrastructure projects.

An efficient and sound financial system that can mobilize resources (including longer term resources) and allocate them towards productive investment is critical to ensuring better access to finance for sectors (such as SMEs, rural households and micro enterprises, and new infrastructure projects) that are currently underserved, and to ensuring overall growth, and stability. As elaborated in the Bank's Financial Sector Strategy (May 2002), key reform priorities for the GoI include: reducing government ownership/domination of the financial sector and correcting the policies that distort credit allocation decisions; improving financial regulation and supervision (including for market risks) and better enforcement of laws and contracts; enhancing the quality and flow of credit information; developing and deepening capital markets, particularly debt markets, which are critical to the mobilization of longer-term resources and their efficient allocation for infrastructure investments; continuing pension system reforms, which can play an important role not only in resource mobilization and providing longer term income security, but also, in expanding the institutional base to support the development of long-term savings instruments and deepen the capital markets; encouraging the development and use of innovative financial products and instruments (such as insurance products, securitization, etc.) to improve access to finance for underserved segments and to better manage risks related to natural disasters.

Infrastructure Bottlenecks

In the telecom and ports sectors, the regulatory framework evolved over time and once stabilized yielded positive results in terms of an increase in private investment, both domestic and international. In other sectors such as power, transport, water and sanitation and solid waste, progress has been negligible. Severe infrastructure bottlenecks in these sectors hamper the efficiency and competitiveness of Indian business, particularly manufacturing firms.

Power. The absence of adequate, reliable power supply remains a key concern for Indian businesses. Not only does industry receive irregular and low quality power (the ICA 2004 found that, on average, manufacturers in India face 17 significant power outages per month, versus 1 in Malaysia and less than 5 in China and that approximately 9% of the total value of output of firms is lost due to power breakdowns — compared to 2.6% in Malaysia and 2% in China), but also, industry is charged tariffs much above the cost of supply. As a result, a large majority of Indian firms operate their own (captive) generators. Almost 61% of Indian manufacturing firms own generator sets, versus 20% in Malaysia and 27% in China. This switch to captive generators has further increased the cost of power faced by industry (India's blended real cost of power is 74% higher than Malaysia's and 39% higher than China's), and reduced industrial

competitiveness. Power sector reforms are now widely accepted as fundamental to improving industrial performance. An urgent priority is the need to rationalize power tariffs, depoliticize the tariff-setting process, and implement a phased reduction in cross subsidies that operate against industrial consumers. Time of day tariffs need to be introduced for industries with peak and off-peak rates.

Roads. India has one of the most extensive transport systems in the world, but there are severe capacity and quality constraints, that impose costs on firms. India currently has no inter-state expressways linking the major economic centers, and only 3,000 kms of four-lane highways (China has built 25,000 kms of four-to-six lane, access-controlled expressways in the last 10 years). Poor riding quality and congestion result in truck and bus speeds on Indian highways that average 30-40 kms an hour, about half the expected average. Notable progress has been made with the Golden Quadrilateral (GQ) project, which links Delhi, Mumbai, Chennai and Kolkata and is expected to be completed by mid-2005. The North South-East West (NS-EW) highway project is slated for completion by December 2008. However, even if the GQ and the NS-EW projects are implemented on schedule by the end of 2008, India will have reasonably well surfaced, four-lane national highways accounting for just 22% of the country's national highways and none of the State highways, which are in serious disrepair.[4]

Railways. With a network of 63,000kms, the Indian Railways is the second largest rail network in the world. However, it fails to provide an efficient means for transporting goods. A key problem is high cargo tariffs arising out of cross-subsidization of passenger fares. This has caused long haul goods traffic to move steadily away from rail to roads. Second, excessive congestion on main lines is steadily increasing long haul delivery times and making the railways even more unattractive as an efficient transport provider. Third, the rapidly deteriorating quality of rolling stock has led to declining safety standards.

Ports, airports. Although there has been limited reform and operational improvement of some of the major ports, airports and customs procedures, and increased private investment in port facilities, there is still considerable scope for further advance. For instance, according to the ICA 2004, the mean delay at customs while importing is still 6.3 days; and while exporting it is 5.1 days. This compares unfavorably with, say, Malaysia where the mean delay while importing is 3.6 days, and while exporting it is 2.5 days. The upshot of this is that exporting industries such as garments, leather goods, textiles, pharmaceuticals and automobile components — all of which import raw materials and intermediates — suffer from a total delay ranging from 13.4 days to 11.8. This raises the working capital requirement and reduces competitiveness.

World Bank Group Private Sector Development Strategy

As part of the overall Bank Group CAS, the Bank Group's private sector strategy will support India in its efforts to meet the challenge of increasing private investment and enhancing productivity, through addressing the key constraints to private sector growth and competitiveness, thereby contributing to the CAS objectives of promoting private sector led growth and

[4] Moreover, there are some 470,000 km of 'major district roads', and another 2.65 million km of 'village and other roads'.

poverty reduction. The focus of the private sector development strategy will be on:

- Facilitating greater private sector competitiveness through: (a) improvements in the investment climate; (b) improved financial intermediation to the private sector; and (c) direct support to firms to promote their growth and competitiveness;
- Improving the quantity and quality of infrastructure through greater private sector participation;
- Promoting private sector participation in the provision of health and education services;
- Promoting improved rural productivity and growth through greater private investment.

In selecting these priorities, the strategy takes into account the critical constraints that must be addressed to foster private sector development and the need to balance opportunities for intervention with the limited resources and instruments available. The choice of priorities also reflects the WBG's comparative advantages vis-à-vis other donors and financial institutions, based on such considerations as the WBG's potential leverage and ability to bring to the table cross-country experience, and takes into account the presence of reform champions within and outside government.

The strategy calls for close collaboration between the Bank and IFC, which is expected to have a strong pay off, allowing the institutions to gain from potential synergies in key sectors while drawing on their respective comparative advantages. The basic principle guiding the division of labor is for the Bank to support activities which warrant public support while IFC assistance will focus on activities that fall within the private sector's role.

The strategy will require engagement with GoI, state and local governments, the private sector and independent research institutions. Given the respective mandates of the Bank Group institutions, the Bank's engagement will be primarily with the Central or state governments, to support an enabling policy, regulatory and institutional environment for private sector development. The Bank will pursue the strategic priorities at the GoI level through sector-specific investment operations, where opportunities exist (and preferably as part of the GoI's larger, sector-wide reform programs); at state and local government levels, in order to maximize impact with limited resources, support to foster private sector development will be targeted towards states/local authorities with which the Bank Group is actively engaged. Such support will be structured, as far as possible, either as part of adjustment operations or sector-specific state-level investment operations. IFC will provide direct assistance to the private sector, focusing on supporting competitive industry and services and private investment in infrastructure. The Bank and IFC will work together closely to support higher private sector investment, including through public-private partnerships in infrastructure, health, and SME development, where a mix of public sector interventions and investment and TA to private companies are required.

The Bank Group will meet its objectives through a range of available instruments:

- Bank instruments include: (i) knowledge support: diagnostic surveys, knowledge creation and dissemination of best practice – through reports, workshops, advisory technical assistance; and (ii) lending instruments: adjustment lending programs (at the state level), investment projects (State or GoI), guarantees/risk sharing arrangements, TA loans.

- IFC instruments include: equity and long-term debt investments in specific firms, including local currency loans for sectors like infrastructure and healthcare which do not generate foreign exchange; guarantees; and technical assistance.
- MIGA instruments: guarantees to private Indian companies investing abroad..

Facilitating Greater Private Sector Competitiveness

Investment Climate Moving from diagnostics to implementation, the Bank Group will use the ICA results to support critical reforms to improve the investment climate in the States in which the Bank is actively involved (or about to be involved) through its adjustment lending. The immediate focus will be on streamlining and re-engineering business entry and operation procedures, for example, through introducing "single window" and "deemed" clearances; improving the legal framework, for example labor laws and laws governing the sale and transfer of land; and introducing VAT. The regular updating of ICAs, with the responsibility for this increasingly shifted to the Confederation of Indian Industry, is expected to yield an ongoing flow of data on the evolving investment climate across the Indian States, and this analysis will be used to identify new areas/opportunities for Bank Group assistance in support of a better investment climate.

At the level of GoI, the Bank will selectively use investment lending coupled with analytical and advisory assistance (AAA) to support private sector development, for example, in the area of SME sector development and financing. The proposed Bank operation in this sector, with support from donors, will focus on improving access to finance by SMEs but also on broader financial sector and industrial policy issues that affect SME performance and competitiveness. In areas where there is no investment lending, and where reforms need to be led by GoI, the Bank will use its program of analytical and advisory assistance to respond to GoI requests for knowledge support to build consensus for key reforms, such as trade and tariff reforms, FDI regulations, improving corporate restructuring and bankruptcy procedures, improved financial sector regulation, strengthened financial infrastructure to ensure better access of financing for underserved segments, SOE reform, and competition policy (through a recently approved IDF grant). IFC, through programs such as SEDF (in North-East India) and FIAS, could provide technical assistance for more detailed diagnostic work, and to support implementation of reforms aimed at improving the investment climate for foreign and domestic investors.

Financial Intermediation The agenda in the financial sector is large, and reforms are likely to be gradual. The strategic focus of the Bank Group will be on reforms to: i) improve the financial sector's ability to mobilize and intermediate longer term capital required for private infrastructure, and ii) enhance the efficiency of resource allocation towards productive but underserved sectors (such as SMEs, rural enterprise), while maintaining systemic stability.[5] IFC will make investments and provide technical assistance to build capacity in private financial institutions which contribute to financial deepening and expansion of financial services to underserved segments. IFC will also support pioneering transactions, such as partial guarantees of bond issues, which will help develop financial markets. In addition, IBRD and IFC may issue Indian rupee bonds, which would contribute

[5] Also refer to the India Financial Sector Development Strategy, World Bank (2002).

to the development of the long-term bond market. To this end, the Bank will aim to build partnerships to support critical reforms.

In addition to the selective use of investment lending to improve access to finance for underserved segments such as SMEs and rural households/micro enterprises (see above), the Bank could respond to GoI's requests through providing AAA to: i) support improved financial regulation, supervision and legal enforcement; ii) enhance the quality and flow of credit information; iii) help develop and deepen capital markets, particularly debt markets, which are critical to the mobilization of longer-term resources and their efficient allocation for infrastructure investments; iv) accelerate pension system reforms, which can play an important role not only in resource mobilization and providing longer term income security, but also, in expanding the institutional base to support the development of long-term savings instruments and deepen the capital markets; v) encourage the development and use of innovative financial products and instruments (such as insurance products, securitization, etc.) to improve access to finance for underserved segments and to better manage risks related to natural disasters; vi) build consensus for restructuring public sector financial institutions; and vii) keep a watch on financial system stability and potential risks.

Direct Support to Firms. IFC will continue to invest in manufacturing and service companies that are: (i) developing new products and markets; (ii) restructuring and modernizing to become internationally competitive; and (iii) expanding and moving towards establishing a regional or global presence. In doing so IFC will focus on providing firms with long-term debt and equity which may not be available from domestic financial markets, and would add value in the area of global best practices; assistance in creating global partnerships and entering new markets, where IFC's global presence has an important role to play; and advice and technical assistance to companies to improve the environmental and social sustainability of their businesses, and improve their corporate governance.

Promoting Private Sector Participation in Infrastructure

34.Based on the state of sector reforms to date, the best prospects for private participation are in telecoms, power generation, ports and airports. In telecom and ports, investors have direct access to the end consumer unlike in power, roads (except where tolled), water, sanitation, and solid waste. The interface in these sectors has been through the national or subnational government. The perceived risks are higher and it has been more difficult to mobilize private capital. The analysis of the Bank Group is that in the power distribution and transmission, road, water and sanitation and solid waste sectors, involvement of the private sector needs to be encouraged through a variety of models including public-private partnerships.

The Bank Group is well placed to promote PPPs by realizing strong synergies between the Bank and the IFC to support infrastructure development. The Bank can promote policy, regulatory, and institutional reforms in the infrastructure sectors to help create a more enabling environment for private investment. These reforms will be supported through the Bank's state-level adjustment lending and sector investment lending, and should help encourage private entry, mobilize private risk capital and facilitate competition. IFC will support pioneering private or public-private transactions by: i) providing equity and long-term debt; ii) using guarantees and the

B-loan program to mobilize financing from domestic and international lenders; iii) developing the local capital markets by introducing credit enhanced long term bonds and securitizations and iv) assisting domestic and foreign sponsors to pursue opportunities in the infrastructure sector. IFC could also provide both financing and advisory services to support the transfer of public infrastructure assets or their operations and management to the private sector, including water utilities and power distribution systems, ports and airports.

Telecoms. Telecoms was the first subsector of infrastructure where reforms reached the critical point at which large scale private investment took off, which has led to rapid expansion in services, especially in mobile telecoms (where connections grew by 250% over the last year). However, connectivity remains very low by international standards at around 77 lines per 1,000 people (around a third the teledensity of Brazil, for example.) IFC has a continuing role to help private companies mobilize the large amounts of longer term financing required to increase teledensity, especially in semi-urban and rural areas. No Bank role is envisaged in this sector.

Power. Power sector reforms will form a key part of the Bank's policy dialogue and TA in selected states, with a focus on addressing problems of cross-subsidization and sub-optimal pricing; improving the financial health of state electricity boards; reducing transmission and distribution (T&D) losses (that arise from theft and leakages) through better metering; and strengthening the state-level electricity regulatory commissions. While the ultimate aim would be to minimize public investment in power generation, and create a competitive market for power, during the transition period, some public investment may be necessary. In such cases, where needs and opportunities exist (e.g., in the hydropower sector), the Bank could provide investment lending to help create demonstration projects of good practice.

IFC will capitalize on the Bank's efforts to create a more enabling policy, regulatory and institutional environment for private investment in power, investing in generating capacity, mainly through captive power plants, especially cogeneration plants which bring environmental benefits, in IPPs with creditworthy off-takers (such as power trading entities or industrial users), and in merchant plants. IFC will also seek further investments in transmission and distribution infrastructure..

Ports and airports. The Bank Group could share case studies of global best practices regarding modern independent regulatory authorities for airports, ports and civil aviation, and help in the setting up of such authorities. Through sharing best practices, creating an enabling legal and institutional environment for encouraging private investment, and investment lending, the Bank Group could be involved in airport modernization to demonstrate the benefits of private sector investment. In the airport sector, the Bank and IFC are considering a PPP structure with public investment areas being addressed by the Bank, and investment with the winning private sector bidder being considered by IFC.

In the port sector 20 terminals in major ports have been concessioned to the private sector. The response from foreign port operators has been good and the efficiency gains in privatized terminals such as the Nhava Sheva International Container Terminal have contributed to the growth and diversion of traffic. The NSICT, which achieved a growth rate of 32% per annum over the last few years, illustrates the

efficiency gains that can be achieved with private sector participation as well as the potential that remains to be tapped. A new concept being tried out in Ennore, Tamil Nadu, is the concept of the Landlord Port. In this model, the public sector sets up the basic port infrastructure facilities and then leases it out to private operating companies. Ennore, which has been in operation for 4 years is now in the process of bidding out various terminals (cargo, petroleum products, commodities, containers) to the private sector. In addition there are minor privately developed ports such as Pipavav and Mundra where the domestic private sector developers have taken the lead and have brought in international operators as partners.

Debt financing to the privatized port terminals has been available from Indian financial institutions that have provided close to US$1 billion equivalent in funding for this sector. IFC's role in the port sector, therefore, is to consider longer term debt and new financing instruments (mezzanine debt, securitization of financial institution loans) and equity.

Roads. In its state highway development program, the Bank will help promote PPPs by: (i) sharing with the state governments best international practices as well as lessons from pitfalls on the building, maintenance and revenue collection from state highways; and (ii) creating a small, but revolving, state-level project development or initiation fund that can finance feasibility studies, provide technical expertise and help in documentation. In addition, the Bank Group will aim to identify and get involved with a few important road projects, involving PPPs, at the national/state levels. This would entail being a key partner and being involved with these projects at every level, publicizing these projects as best practice case studies, and using these projects as empirical platforms to push for policy changes.

Annuity and build, operate, transfer (BOT) schemes, accounting for 10% and 12% of the Golden Quadrilateral respectively, have attracted investments from domestic private infrastructure firms as well as from some Malaysian firms. The needs of this sector are large and the involvement of both the public and private sector critical. Domestic financial institutions have been active in financing Annuity Road projects which represent sovereign risk, and BOT projects as well. IFC has and will continue to seek opportunities to introduce new financing structures such as securitization of toll receivables or institutional loans provided to projects in the road sector. IFC will also consider financing road projects where there is appropriate risk sharing between the government and the private sector, including BOT and annuity projects that are being converted to long term operations and management contracts.

Promoting Private Sector Participation in the Provision of Health

The focus of the private sector development strategy in the social sectors will be on health. Through its state level health sector investment operations, Bank assistance could support: (i) Enhanced regulation of privately provided health care services; (ii) Designing and implementing effective social franchising or contracting model for increased private participation in primary healthcare (including public education and primary curative healthcare services) and non-clinical services; the emphasis will also be to assist public-private partnerships in contracting with output driven monitoring project design; and (iii) Developing an efficient and wide

reaching private health insurance market, and also effective community-based voluntary private insurance plans.

Complementing the Bank's work with the national and state governments, IFC could contribute to the development of the private health sector by directly supporting private providers, continuing to pursue investments with top-tier facilities. IFC will also explore opportunities with second-tier institutions—recognizing that many will require substantial technical assistance in terms of both financial and clinical practices—and begin to explore opportunities in diagnostic and ambulatory care facilities. IFC will continue to pursue investments in pharmaceutical and biotech companies, either directly or through investment funds. This may include investments in companies which are developing new products or cheaper production processes which can assist in the control of infectious diseases.

Promoting Improved Rural Productivity and Growth through Greater Private Investment

Reforms to support agricultural productivity, and particularly those that benefit small farmers, would likely have a multiplier effect on the rest of the Indian economy, by attracting greater private investment and improving productivity in agro-industry and other non-farm sectors. These objectives will be actively pursued through policy dialogue with states. At the central government level, dialogue could include focus on improved rural access to finance (including microfinance), a key ingredient of promoting rural growth and productivity, and improving livelihoods. These opportunities could be pursued by the Bank through a rural finance investment operation that capitalizes on the existing branch network of rural banks while leveraging on innovative financial delivery models and practices that have evolved in the private sector (including micro finance), building on a recently completed AAA. IFC will continue to seek opportunities to support financial institutions expanding in rural areas, including finance for small and micro-enterprises.

IFC can also support companies in agriculture, agri-processing and agricultural input supply that expand their operations. Priorities will be on projects that: (i) improve the efficiency of food supply chains; (ii) have a broader development impact by providing quality inputs and services or integrating the production of local farmers into commercial supply chains; and (iii) introduce resource-saving technologies. Such support may involve TA or mobilization of financing, as well as community development activities. This can both strengthen the competitive position of the processing firms, and help to strengthen the rural economy.