

GOOD PRACTICE NOTE FOR DEVELOPMENT POLICY LENDING

SUBNATIONAL DEVELOPMENT POLICY LENDING

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THE WORLD BANK



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ABBREVIATIONS AND ACRONYMS

APL	Adaptable Program Loan
CAS	Country Assistance Strategy
CAS PR	Country Assistance Strategy Progress Report
CEM	Country Economic Memorandum
CFAA	Country Financial Accountability Assessment
CPAR	Country Procurement Assessment Report
DPR	Development Policy Review
GPN	Good Practice Note
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
MDG	Millennium Development Goal
OP/BP	Operational Policy/Bank Procedure statement
OPCS	Operations Policy and Country Services
PER	Public Expenditure Review
SNAC	Subnational Adjustment Credit
SNAL	Subnational Adjustment Lending
SWAP	Sectorwide Approach

FOREWORD

This Good Practice Note is being issued in conjunction with Operational Policy/Bank Procedure 8.60, *Development Policy Lending*. The authors of this note are Egbert Gerken and Adriana Weisman, with inputs from Marina Wes (SASPR), David Rosenblatt (DECVP), Shekhar Shah (SARVP), William Dillinger (ECSPE), and Stefan Koeberle (OPCCE). Henry Chase (OPCCS) and Gero Verheyen (OPCCE) provided editorial support. This note is intended to provide recommended guidance to staff in the preparation of development policy operations and is not mandatory operational policy. The contents will be updated periodically to reflect emerging lessons of experience. For further updates and other Good Practice Notes, access the Operations Policy and Country Services (OPCS) website under development policy lending or contact the Country Economics Unit in the OPCS Vice Presidency.

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Contents

I.	Introduction	1
II.	Policy Framework	3
III.	Link to the CAS	4
IV.	Lending Criteria	5
	A. When to Lend to Subnationals?	5
	B. Lending to Whom?.....	12
	C. Choice of Lending Instruments	14
V.	Design of Subnational Development Policy Operations	15
	A. Direct vs. Indirect Lending	15
	B. Structure of the Operation	16
	C. Conditionality	17
	D. Risk Management	17
	E. Financial Management Issues.....	19
	F. Results Orientation and Program Matrix.....	20
	G. Documentation	20
	Annex A. List of Subnational Operations Cited	21

SUBNATIONAL DEVELOPMENT POLICY LENDING

I. INTRODUCTION

1. A number of World Bank borrowers have a federal or quasi-federal structure of government, where states or provinces have legislative and administrative autonomy in various areas and independent budgetary authority, including the right to raise revenues and issue debt.¹ Given their share in overall public expenditure and the reach of their policy domain, the performance of state or provincial governments can matter greatly for the country's macroeconomic stability, growth, and poverty reduction.² The objectives of Bank support to federal countries therefore often include the strengthening of subnational finances—to underpin economy-wide fiscal stability and sustainability of subnational public spending—and the improvement of state-level policies, institutions, and public and quasi-public services. Ongoing political and economic decentralization in Indonesia and other countries is likely to increase the importance of these objectives.

2. ***Subnational lending.*** The Bank supports efforts to improve subnational finances and state-level policies, institutions, and public services with analytic work, technical assistance, financial support through investment lending and development policy lending, and, in the case of IBRD-eligible countries, financial products such as currency and interest rate hedges. Except for development policy operations, this support is not limited to the states or provinces of federal countries, but is also provided to local authorities and agencies of both federal and centralized countries if they are the actual providers of public services and respond to local demands. The Bank normally provides subnational development policy loans or credits only to jurisdictions immediately below the level of the national government that have significant legislative and budgetary authority, that is, the states or provinces of federal or quasi-federal countries (including jurisdictions of similar status such as the republics and regions of the Russian Federation and the federal districts of various Latin American countries). In the following, the term state is used for all such jurisdictions.

3. ***Investment Lending.*** Two types of investment lending operations³ commonly support development efforts on the state and local level:

- Individual investment operations (including adjustable program loan operations) help finance state or local public sector projects and also support subnational institutional development and capacity building. The loans are provided directly to the state or local government or agency, with a sovereign

¹ This includes most of the Bank's large borrowers, such as Argentina, Brazil, India, Mexico, Pakistan, Russia, and Ukraine.

² In India, for example, state-level deficits account for almost half of the consolidated fiscal deficit. Improvements in the composition of country-wide public expenditures, the investment climate (through the removal of bottlenecks in product and factor markets), and the delivery of infrastructure, health, education, and safety-net services all require significant policy and institutional reforms on the state level.

³ See Annex A for references to lending operations cited in this Good Practice Note.

guarantee,⁴ or to the country with proceeds on-lent to the subnational unit,⁵ though IDA credits are always extended to the member country which onlends the proceeds.

- **SWAP operations** support central governments' sectorwide approaches (SWAPs) that involve both sector policy reforms and expenditure programs. In federal countries, SWAPs tend to include state-level sector policy reforms and spending on public services. Bank lending to the central government in support of SWAPs typically contributes to a pool of financing along with government and donor funds.⁶

4. **Development policy lending.** Lending support for efforts to improve subnational finances, policies, and institutions takes different forms depending on the roles of the central and the state-level authorities:

- **Fiscal federalism operations** help the central government improve the incentive structure of "fiscal federalism" (e.g., the assignment of expenditure and tax responsibilities between the levels of government, the design of intergovernmental transfers, and the rules for subnational borrowing).⁷ Such loans may also help the central government provide financial incentives to state governments for state-level programs of policy and institutional actions aimed at adjusting to the fiscal federalism framework.⁸ The borrower is the central government and there typically is no onlending, though the central government may provide grants or other incentives to reforming states.
- **Multistate development policy operations** support policy and institutional actions designed by the center and implemented by states. Here, the sovereign borrows from the Bank and onlends to any state that implements the defined set of measures.⁹ Such "wholesale" operations in practice are limited to cases where state-level reforms are sufficiently uniform to be easily quantified and made into eligibility criteria for the central program.
- **Individual state development policy operations** support state-level programs of fiscal and sector policy and institutional actions designed by the state

⁴ Direct investment lending to states has been a long-established practice in Brazil. More recent examples in other countries include two secondary education loans and one infrastructure loan to the Province of Buenos Aires and the power sector adjustable program loans (APLs) to Haryana, Andhra Pradesh, and other Indian states.

⁵ Examples include several infrastructure loans and one health loan to Argentina, and the Brazil state pension reform technical assistance (TA) loan.

⁶ The *Mexico Decentralized Infrastructure Reform and Development Project* loan provides an example. Also, a recently negotiated loan to the State of Ceara, in Brazil, will support state actions through a sector-wide approach.

⁷ Examples include the Mexico decentralization adjustment loan, the Bolivia programmatic SAC for decentralization, the Russia SAL3, and the Ukraine PAL.

⁸ Examples include the fiscal federalism and regional fiscal reform loan to Russia and four fiscal reform loans to Brazil (including also administrative and social security reforms).

⁹ This includes the "first" provincial reform loans to Argentina.

government and discussed with the Bank and the central government.¹⁰ These are “retail” operations, where the borrower can be the state, with a sovereign guarantee, but usually is the country which onlends the loan proceeds. Historically, retail loans were first constructed as investment loans that were policy-based in substance with funds disbursed against policy actions specified as conditions for tranche release.¹¹ The need for this awkward construction¹² was obviated by the introduction of subnational adjustment loans or credits (SNALs/SNACs) in 1998.¹³ Like all policy-based lending instruments, SNALs/SNACs were superseded by development policy loans (DPLs) when OP/BP 8.60 was issued in 2004.

5. **Purpose.** This Good Practice Note (GPN) provides advice to Bank staff and to government counterparts on development policy operations in support of state-level programs of fiscal and sector policy and institutional actions, with a focus on individual state development policy operations. The note complements the OPCS series of GPNs for development policy operations, particularly *Good Practice Note 1—Designing Development Policy Operations*,¹⁴ and it also draws on earlier staff guidelines issued by the Poverty Reduction and Economic Management (PREM) Network.¹⁵ It concentrates on issues that are specific to subnational development policy lending. This GPN provides no advice on development policy operations supporting fiscal federalism reforms and on subnational investment operations (except when discussing the choice of lending instruments).

6. **Organization.** Following this introduction, Section II discusses the relevant policy framework for state development policy operations. Section III discusses the link between these operations and the Country Assistance Strategy (CAS). Section IV sets out criteria for their use, while Section V provides advice on the design of state development policy operations.

II. POLICY FRAMEWORK

7. The Bank’s policy framework for development policy lending applies to subnational development policy operations; specifically, they must meet the “special

¹⁰ Examples include the “second” provincial reform loans to 4 Argentine provinces, the economic reform loans to four Indian states, and three SNACs to Pakistani provinces. The borrower under all of these loans was the country, which onlent to the states or provinces.

¹¹ The state reform loans to four Brazilian states were technically investment loans. (The loan to the State of Minas Gerais was approved by the Board, but not signed.)

¹² Preparation of the Brazil state reform loans required considerable effort for the identification of state expenditures that would match the time frame of an adjustment loan and would be eligible for financing. A review of these operations, requested by the Board, led to the introduction of SNALs/SNACs.

¹³ See *Adjustment Lending to Subnational Units* (SecM98-96), May 14, 1998.

¹⁴ See *Good Practice Notes for Development Policy Lending*, October 2004. See also other GPNs issued by OPCS on the use of poverty and social impact analysis, financial management issues, environmental and natural resource aspect, participation, results orientation in development policy lending, and on lending to fragile states.

¹⁵ See *Adjustment Lending to Sub-National Units*, May 1998.

circumstances” provision of the Bank’s Articles of Agreement¹⁶ and comply with the Board-approved operational policy on development policy lending (OP 8.60.) The following provisions are specific to subnational lending.

8. **Articles of Agreement.** The Bank’s Articles of Agreement allow direct lending to political subdivisions of a member country¹⁷ and require that in such cases the national government guarantee the payment of the principal and interest and other charges on the loan.¹⁸ But the Bank’s policy on the choice of borrower (OP 7.00) limits direct lending to IBRD.

- IDA normally makes credits only to national governments, which may then onlend, to ensure that the full benefit of the concessionality of IDA resources is accorded to the member.
- IBRD generally prefers to lend directly to the entity responsible for implementing the project or program for which the loan is made, to better monitor implementation and suggest corrective steps if appropriate. But it will lend to the central government when direct lending is not possible or practical.

9. **Development Policy Lending.** Two provisions of OP 8.60 are specific to subnational DPLs:

- OP 8.60 defines eligible subnational units as states or provinces. This would include also differently named jurisdictions with comparable legislative autonomy and budgetary authority such as the federal districts of Buenos Aires and Mexico and the republics and regions of the Russian Federation, but normally not municipalities and counties subject to state or provincial legislation and oversight.
- For any development policy operation to go forward, the Bank must have determined that the country’s macroeconomic policy framework is appropriate. For a subnational operation the Bank also must find the fiscal framework of the specific state or province appropriate, including its expenditure program and its fiscal relations with the central government (OP 8.60, paragraph 5).

III. LINK TO THE CAS

10. In federal or quasi-federal countries, the central government’s economic policy program often includes the promotion of state-level programs of fiscal and/or sector policy and institutional actions. Guaranteeing or onlending Bank loans, which are low-cost relative to other sources of financing, can be among the incentives the central government offers.

¹⁶ *IBRD Articles, Article III, Section 4 (vii) and IDA Articles, Article V, Section 1 (b).*

¹⁷ *IBRD Articles, Article III, Section 4 and IDA Articles, Article V, Section 2.*

¹⁸ *IBRD Articles, Article V, Section 4 (i) and IDA Articles, Article V, Section 2 (d).*

11. ***Selectivity.*** Whether to lend to states should always be determined in the context of the country assistance strategy (CAS), the document in which the Bank sets out its lending and nonlending support to the country’s overall development program. The choice of interventions is linked to the CAS results framework and reflects a number of considerations, including relevance to the overall strategy and results framework, magnitude of expected developmental benefits to the country, quality of analytic underpinnings, and the Bank’s comparative advantage.¹⁹ The CAS should be specific about the contribution of expected state-level results of Bank support to the development objectives of the country.

12. ***Selection of States and Lending Instruments.*** Subsequent to the determination to lend to states, the selection of states to lend to and the choice of lending instruments normally also should be determined in the CAS or CAS Progress Report. In some cases, information about possible recipients’ interest in, and suitability for lending support, and about important details of their reform programs may not suffice for making these determinations. In such cases, the CAS or CAS Progress Report should establish the relevant criteria.

13. ***Adjusting the Strategy.*** CAS decisions to lend to states and to use particular lending instruments are not, however, cast in stone. When conceptualizing a subnational development policy lending operation, staff should review whether the arguments underpinning the CAS decisions continue to hold. Also, new opportunities to lend in support of state-level policy programs may arise during the CAS period. In that case, the arguments for a state development policy operation can be put to the Board in the Program Document, provided the CAS has sufficient flexibility for shifting between slow- and quick-disbursing operations. However, if the CAS contains no discussion of subnational issues, it would be difficult to present the operation as a change of instruments within the established strategy. A CAS Progress Report would then be appropriate.

IV. LENDING CRITERIA

14. This section discusses the necessary assessments and criteria for determining when to lend to states or provinces, to whom to lend, and what lending instrument to use.

A. When to Lend to Subnationals?

15. The CAS determination to lend (or not to lend) to states or provinces in support of their reform programs needs to be supported by the Bank’s assessment—based on adequate analytic work—of the country’s federal policy and institutional framework and the central government’s policy toward subnational issues. The strength and sustainability of the state-level program to be supported, and the ownership of the program (including the central government’s support, and political support within the state or province) and the subnational government’s ability to implement also should be assessed.

¹⁹ See *Good Practice Note 1—Designing Development Policy Operations*.

16. **Analytic Underpinnings.** In federal countries and in countries engaging in significant political and economic decentralization, the Bank’s diagnostic work underpinning the CAS, including broad-based country economic analysis—Country Economic Memorandum/Development Policy Review (CEM/DPR) and Poverty Assessment—and fiduciary assessment—Public Expenditure Review (PER), Country Procurement Assessment Report (CPAR), and Country Financial Accountability Assessment (CFAA)—should systematically include the analysis of issues arising from the division of responsibilities between central and state-level governments.

- Good practice also would include an updated study on federalism in the country that deals not only with the system of fiscal federalism but also with the main issues of state-level fiscal and sector policies and institutions, and complement this with diagnostic work on the state(s) the Bank intends to lend to, such as a state PER or state CFAA.
- At a minimum, the CAS should assess the adequacy of available analytic work—by the Bank, the country, and/or third parties—and indicate how the gaps would be filled ahead of or during the preparation of subnational development policy lending operations.

17. **Federal Framework.** The assessment of a federal country’s policy and institutional framework should include an analysis of the distribution of public expenditures and policy responsibilities between the federal, state, and local levels. A significant subnational share in expenditures and responsibilities can justify state development policy lending only if the assessment also identifies serious state-level distortions that affect the country’s growth and poverty reduction, and which the policy and institutional programs to be supported would address. Possible problem areas to be explored include the following:

- **Threat to macroeconomic stability.** Subnational finances can come to threaten overall macroeconomic stability, as exemplified by events in Argentina and Brazil during the 1990s. The basic problem is that lower-level governments often face weak budget constraints that enable them to overspend, under-tax, and over-borrow in the knowledge that the federal government ultimately cannot refuse to bail them out. The fiscally most reckless province may win at the expense of the nation and the other provinces.²⁰
- **Unsustainable debt dynamics.** Even with adequate intergovernmental fiscal arrangements, state fiscal policies can result in unsustainable debt accumulation and thus threaten future spending on infrastructure and social services. Poor governance, weak expenditure management, inefficient tax structure or tax administration, underpricing of utility services, and poor debt

²⁰ For a discussion of examples and the underlying problem see *Subnational Fiscal Sustainability: Are World Bank Assistance Programs Yielding Results?* (Preliminary DEC paper).

management can be among the distortions at the root of the problem. Some states in India have historically counted among the examples in this category.

- ***Obstacles to pro-poor growth.*** Adequate intergovernmental arrangements and sustainable state fiscal policies are necessary but not sufficient for growth and poverty reduction in the state. State sector policies and institutions can hold up growth and poverty reduction, e.g., by overstaffing the provincial administration and/or utilities, undersupplying critical public investments or inputs into infrastructure and social services, or creating a nontransparent regulatory environment for private investors. Other shortcomings include the lack of targeting in state social expenditures and failure to ensure poor peoples' access to water, sanitation, and other basic services.
- ***Need for further devolution.*** The supply of public and quasi-public goods and services can be inefficient due to a suboptimal distribution of responsibilities among different levels of government. Even with adequate intergovernmental fiscal relations and adequate state policies and institutions, there may be a case for the further devolution of responsibilities from federal to state governments and from state to local governments.

In principle, distortions in any of these areas can justify subnational development policy lending to support a strong state-level program addressing them, provided it has central government backing, is sustainable, enjoys the necessary political support within the state or province, and can be implemented by the state authorities.

18. ***Central Government Policy and Support.*** A subnational development policy loan supports the central government's policy toward subnational issues as well as the reform program of the particular state receiving the funds the sovereign guarantees or onlends. The central government, furthermore, plays a key role in the success or failure of state-level reforms by shaping the structure of fiscal federalism and by providing political support, advice, and financial incentives. For both reasons, a sound central government policy toward subnational issues and strong support for state-level reforms based on that policy are indispensable for subnational development policy lending.

19. Key questions for **determining the quality of central government policy and support** include the following:

- Has the central government articulated its policy toward subnational issues in a public document? Does the policy enjoy political support on the national level?
- Have the objectives and instruments of the central government's policy been spelled out? Does the central government provide support beyond guaranteeing or onlending Bank loans to a few states, and does it have a strategy for spreading reforms to all states? (If Bank loans to a few states are the only instrument, the strength of the central government's commitment may be in doubt).

- What is the overall set of central government financial incentives for state-level reforms? Are the incentives fiscally sound and are subsidy elements justified by expected developmental benefits for the country, including subsidies implicit in the terms of onlending or guaranteeing the Bank's development policy loan?
- Is the central government taking the necessary measures in its own policy domain (i.e., fiscal federalism) to render state-level reforms sustainable? (For example, continuation of an existing weak budget constraint would undermine state-level fiscal reforms.)
- Are the central government's priorities for state-level reforms consistent with the Bank's assessment of the key distortions on that level? (For example, promotion of further devolution of responsibilities would likely not be beneficial in an environment of unsustainable state fiscal deficits.)
- Is the central government's selectiveness with respect to recipient states based on a strategy to maximize the impact on growth, poverty reduction, and/or macroeconomic stability (e.g., by focusing on the largest, poorest, or most reform-minded states, and/or the states with the worst debt sustainability)? Or is selectiveness driven by political considerations?

20. **Program Strength.** As with all development policy lending, Bank staff considering lending to subnationals should establish that the program to be supported addresses major distortions identified in the CAS as important obstacles to more rapid and sustained growth and poverty reduction, and is sufficiently strong to overcome them. Programs addressing only noncore issues would not merit support through a development policy operation; nor would piecemeal actions (for example, changes in some tax rates without expanding a narrow tax base, reforming a corrupt tax administration, and improving poor expenditure management would do little for restoring the state's financial health). Analytic work underpinning policy dialogue on the need for a more comprehensive approach would be a more appropriate mode of support in such cases, as would be technical assistance and investment lending to build support and implementation capacity for strong actions that could become suitable for DPL support at a later stage. By contrast, deliberate steps toward medium-term objectives can be appropriate subjects for programmatic lending support as long as they are part of a comprehensive multiyear program.

21. **Sustainability.** To merit DPL support, the subnational program of policy and institutional actions must be judged sustainable. Again, other support instruments should be considered if sustainability is in doubt. In the preparation of the CAS or CAS PR and during appraisal of a subnational development policy operation, judgments must be made whether the macroeconomic policy framework, intergovernmental fiscal relations, and the medium-term fiscal balances of the recipient state or province allow the operation to achieve its objectives. Additional challenges arise for operations that focus on sector policy and institutional reforms and operations supporting devolution.

- **Macroeconomic policy framework.** Development policy lending—whether to the center or to a political subdivision—cannot hope to contribute to a sustainable increase in growth and poverty reduction if the country’s macroeconomic policies are unsustainable; a satisfactory macroeconomic policy framework is therefore required for all development policy operations, including those to states or provinces. The assessment of the framework is always conducted by Bank staff during the preparation of the CAS or CAS PR, and is updated during the appraisal of any development policy operation not presented at the same time as the CAS or CAS PR, and when an operation or tranche is disbursed. The presence of an on-track IMF program is usually a positive input into this determination.²¹ For the operation to go ahead, the assessment must show that the macroeconomic policy framework is adequate. Detailed advice on how to conduct this assessment is provided in GPN 1—*Designing Development Policy Operations*.
- **Intergovernmental fiscal relations.** In the continued presence of a weak budget constraint in intergovernmental fiscal relations, a program to reform subnational fiscal policies is unlikely to be fully implemented or its outcome maintained over the medium term. State governments tightening their fiscal policies, rather than exploiting their ability to make the federal government pay, could well be seen by the public as acting against their interests. If major tightening of the budget constraint is necessary to make fiscal reform worthwhile to the states, this should precede the reform of state fiscal policies or be conducted at the same time.²² However, since federalism reform affects all states, it would not be advisable to make it a condition for a loan in support of reforms in one particular state. Instead, lending for fiscal federalism reform—possibly including support for central government incentives to states for adjusting their fiscal policies, as in the Brazil fiscal reform loans—would be a better approach in such cases.

OP 8.60 requires “satisfactory fiscal relations with the central government” for subnational DPL operations to go ahead. The **standard for “satisfactory”** is not a textbook model of fiscal federalism—state responsibilities matching own revenues and rule-based transfers and binding constraints on borrowing—but a practice of fiscal relations that does not undermine the incentive for state fiscal policy reform. A review of the track record—for example, the frequency of bail-outs or discretionary transfers by the central government—can help make that assessment. Good practice also involves exploring whether disincentives inherent in flawed fiscal federalism arrangements are balanced by other sources of discipline, for instance, financial market practices, control by a political party that dominates on both

²¹ If there is no IMF program, Bank staff ascertain that IMF staff have no major outstanding concerns before making their own assessment. See *Strengthening IMF-World Bank Collaboration on Country Programs and Conditionality—Progress Report* (SecM2004-0070), World Bank and International Monetary Fund, February 27, 2004.

²² Given their importance for macroeconomic stability, actions to tighten subnational budget constraints could also be among the corrective policy measures associated with a formal IMF program.

the national and the state level, or the threat of severe political penalties, such as a temporary loss of autonomy to direct central government rule (as in India.)

- ***Fiscal balances.*** Satisfactory intergovernmental fiscal relations are not sufficient to ensure that the individual state's fiscal accounts will balance over the medium term. Unsustainable debt dynamics would put many fiscal and sector policy reforms at the risk of being reversed. Staff should assess upfront whether the state's fiscal policies are likely to achieve sustainable fiscal balance over the medium term, and identify necessary corrective fiscal policy measures.²³ In that assessment, staff will normally not have the input of an IMF assessment. Also, state-specific fiscal targets are normally not included in Fund-supported programs. On the state level, therefore, the Bank must be prepared to include fiscal targets and conditionality on corrective fiscal actions in subnational development policy operations. It is important, however, that the choice between options for corrective actions be guided by an assessment of their impact on the provision of public services, particularly the delivery of basic services to poor people.

Good practice is to construct public sector accounts using a broad definition that includes not only the state administration and its agencies but also state-owned banks, utilities, and enterprises. The fiscal outlook should be projected for different paths of revenues (from taxes, fees, transfers, and divestiture proceeds), expenditures, and interest rates (affecting debt servicing costs). Projections for a reform scenario should include the use of Bank loan proceeds (e.g., for retiring high-cost, short-maturity debt in an environment of declining fiscal deficits). The assessment should also consider possible threats to debt sustainability arising from contingent liabilities (particularly uncovered pension liabilities), short debt maturities and floating interest rates, debt denominated in foreign currencies, economic shocks that may force the province to provide financial assistance to public or private corporations and banks, and political instability. A good example is provided in the Program Document for the loan to India for the Orissa socioeconomic development program.²⁴ The Program Matrix includes a set of fiscal targets reflecting targets set in the state's medium-term fiscal plan. The Annexes include the medium-term fiscal plan presented to the state legislative assembly and the Bank's explanatory note containing the analysis of the fiscal accounts.

- ***Sustainability of sector policy and institutional reforms.*** Most subnational development policy operations to date have supported both fiscal and sector policy and institutional reforms for the sound reason that corrective fiscal policy measures were required to bring the fiscal accounts into medium-term balance and to underpin the sustainability of sector reform measures. In

²³ For a discussion of the subnational "macro framework" see *Subnational Fiscal Sustainability: Are World Bank Assistance Programs Yielding Results?* (Preliminary DEC paper)

²⁴ See *India: Orissa Socio-economic Development Program* (PR 26550-IN), September 28, 2004.

future, there could be more cases in which DPL support for a program limited to sector policy and institutional reforms would be justified, particularly in states or provinces that have already undertaken successful fiscal reforms. It would be entirely appropriate to focus lending support on policy and institutional actions in the social and infrastructure sectors and other areas in the state's domain that are crucial for pro-poor growth, if the judgment can be made that fiscal relations with the central government and medium-term fiscal balances would not undermine these actions.

Sector policy and institutional reforms are supported for their **efficiency enhancing and poverty reducing effects**, but some tend to have **adverse short-term fiscal impacts**. For example, civil service reforms and public enterprise divestitures usually require significant up-front severance payments; and permanent increases in spending on social services often cannot be balanced immediately by reductions in other components of public spending. Absent simultaneous fiscal measures, such reforms would temporarily increase the fiscal deficit. But this is not an argument against supporting reforms aimed at higher growth and more rapid poverty reduction as long as the medium-term fiscal balances remain sustainable. It would be good, though, in such cases to demonstrate that the fiscal balance and/or ability to carry debt are likely to improve over the medium term as the full set of reforms supported by the operation takes hold, increased growth enhances state revenues and creditworthiness, and loan proceeds are used to retire high-cost, short-maturity debt.

- ***Sustainability of devolution.*** A number of countries pursue devolution—from the center to the states and from states to local units—for the purpose of improving the efficiency of public service delivery. Given its experience in federal countries, the Bank is in a unique position to provide advice and technical assistance to hitherto centralized countries embarking on a program of devolution. In existing federal countries, further devolution of responsibilities to the states is unlikely to achieve increased efficiency of public service delivery in an environment of poor intergovernmental fiscal relations, unsustainable state fiscal balances, or inefficient state sector policies and institutions. Development policy lending should help resolve these issues before supporting the transfer of additional responsibilities. However, devolution from state to local governments can be among the solutions for inefficient state public service delivery, for example, in the very large states of India. Whether to support a state's decentralization program with Bank lending would depend on the Bank's assessment of the merits of the program in terms of increased efficiency and impact on the state's medium-term fiscal balances.

22. ***Country Ownership.*** The often complex policy and institutional reforms for which a country seeks DPL support can only be adopted and implemented if they have sufficient political support within the country, including support within the relevant parts of the central government and among nongovernmental stakeholders. GPN 1 provides

advice on assessing country ownership and on helping the government build ownership for a good program.

23. ***State Ownership.*** For subnational DPL operations, ownership also needs to be assessed at the state level. Usually, there is little or no track record of implementing Bank-supported reforms—the most important indicator of government commitment and ability to implement an agreed set of actions at the national level. Bank staff also tend to be less familiar with key stakeholders within and outside the government and must make extra efforts to gain insight into the state’s politics and political economy (e.g., by working with local universities and think-tanks). Useful indicators for gauging ownership include:

- That the state government has articulated the objectives of the program and key measures in a document widely discussed in the state; already taken initial actions; and drafted the program matrix for discussion with the Bank and agreed that the Bank will eventually disclose the program document.
- That political leaders and widely recognized speakers for key stakeholders have come out in public in support of the program.
- That discussions have been held with key constituents and the concerns of groups likely to suffer losses been taken into account.

B. Lending to Whom?

24. This section discusses the eligibility of states for development policy lending and the choice between eligible units.

25. ***Eligibility.*** Jurisdictions with legislative autonomy and independent budgetary authority immediately below the national government are eligible for development policy lending, including states, provinces, and other entities with similar status such as the republics and regions of the Russian Federation and the federal districts (capital cities) of federal countries in Latin America. At a minimum, such entities units must have the requisite legal autonomy to undertake the proposed reforms to be supported by the loan. In the case of direct lending (with a sovereign guarantee), they also must have the authority for external borrowing and debt management, and the country needs to be IBRD-eligible.²⁵ Municipalities, counties, and other political entities subject to state legislation and oversight are not normally eligible for development policy lending.²⁶ The recent Kazan Municipal Development loan is an exception that reflects the circumstance that the substate devolution program is being implemented directly by the Russian

²⁵ To date, only the Brazil state debt loans have been provided directly to the respective states. A development policy loan to be made directly to the Brazilian state of Minas Gerais is under preparation.

²⁶ This does not exclude the possibility that the Bank lends in support of a state’s devolution program and the state uses the proceeds to provide financial support to substate units.

Federation, not by the state (the Republic of Tatarstan) to which the municipality belongs.²⁷

26. ***Selection of States.*** The Bank typically lends to only a selected narrow subset of a country's states or provinces. A choice therefore must be made with the ultimate objective of maximizing the impact of the Bank's scarce resources on the country's development results. Ideally, the Bank would lend to the states that have, at the same time:

- the strongest reform program and commitment to implement (i.e., where reforms are most likely to succeed and serve as a demonstration to other states);
- the highest poverty level or the greatest number of poor (i.e., where—other things equal—the direct impact on poverty reduction is likely to be strongest);
- the greatest significance to the national economy (i.e., where the impact on the country's growth—and indirectly on poverty reduction—is likely to be greatest); and
- the worst debt sustainability issues (i.e., where reforms are most needed to underpin macroeconomic stability and future public expenditures).

27. In reality, rankings of states along these criteria rarely, if ever, coincide. A **two-step approach** to the selection of states is useful.

- First, articulate minimum criteria values below which it would not be appropriate for the Bank to lend scarce resources, and remove from consideration all states that do not meet them. In particular, the level of state government commitment needs to be sufficient for reforms to have a reasonable chance to succeed, and the number of the poor in the state should be such that Bank lending can have a significant impact on the achievement of MDGs. The judgment of state government commitment should be based on a careful assessment (as described in paragraph 23 above) and should only be concluded after the state government has been given an opportunity to improve the level of its commitment.
- In the second step, apply a weighted ranking to the remaining states, where the weights reflect the Bank's judgment of the trade-offs among the criteria in the country. (While such judgments are country-specific, experience suggests that government commitment always merits a high weight.) In the policy dialogue with the central government, staff always should seek to establish a common set of criteria (i.e., strength of commitment, poverty level, significance to the overall economy, and relevance to debt sustainability) and

²⁷ The borrower in this case is the Russian Federation, which uses the loan proceeds for a grant to the City of Kazan. See *Russia: Kazan Municipal Development Loan* (PR 31414-RU), January 27, 2005.

arrive at shared judgments of the trade-offs. If the government also has political considerations, staff needs to assess whether they can be accommodated without undermining the development effectiveness of the operation; states not meeting the Bank's minimum requirements established in step 1 should not be accepted. Also, the commitment of the central government to the overall program of subnational development would be indoubt if its selection of states is primarily driven by political considerations (as discussed in paragraphs 18 and 19 above). This would raise questions about sustainability and development effectiveness. In practice, the exclusion of states not meeting the requirements of both the Bank and the central government may well reduce the remaining eligible states to a number that obviates the need for a weighted ranking.

C. Choice of Lending Instruments

28. Following the decision to lend in support of state-level reforms, the CAS usually indicates the appropriate lending instrument(s). However, circumstances may change during the CAS period (e.g., reforms may turn out weaker than initially envisaged or the central government may adopt a different approach to subnational issues, such as a SWAP to reform and development). The task team preparing an operation therefore should review the continued case for using a development policy loan and, if appropriate, consider investment lending alternatives.

- ***Individual investment loans.*** These instruments finance specific expenditures with a focus on long-term investment, institutional development, and sectoral or local capacity building. They are not suitable for supporting major policy reforms.²⁸ However, if the reform program to be supported turns out to be weak, unsustainable, lacking political support, or it cannot be implemented with the existing capacity, an investment loan that helps build capacity and facilitates policy dialogue and analytic work for a stronger reform program at a later date should be considered. Also, if the development outcome of the reforms depends on time-consuming institutional developments that would benefit from hands-on Bank support over the duration (e.g., the establishment of a functioning regulatory system prior to the actual divestiture of a public utility), it would make sense to precede a development policy lending operation with an investment lending operation. Obviously, individual investment loans are also appropriate in cases where the policy and institutional framework is adequate and pro-poor growth is furthered by financing specific investments.
- ***Investment loans in support of SWAPs.*** Countries' sectorwide or program-based approaches involve both expenditure programs and sector policy actions. In federal countries, this includes policy changes on the state level

²⁸ The OPCS Guidance Note *Disciplined Use of Conditionality in Lending Operations* states that individual investment operations should not normally carry sector conditionality. The conducive policy frameworks needed for longer-term results should be promoted through analytic work, regular engagement in policy dialogue, SWAPs, and policy-based lending.

and possibly the municipal level. Bank investment lending in support of SWAPs typically contributes to a financing pool (with government and donor resources) and disburses against a percentage of expenditures for a subprogram.²⁹ Such lending is conditioned on agreement with the government on the sector policy and expenditure frameworks. If the country adopts a sectorwide approach, the choice of a subnational development policy operation in support of state-level sector policy reforms would be difficult to justify.

V. DESIGN OF SUBNATIONAL DEVELOPMENT POLICY OPERATIONS

29. This section complements good practice advice on the design of development policy operations with a discussion of design issues arising in operations supporting state-level reforms. These concern the choice between direct and indirect lending, the structure of the operation (one-time vs. programmatic approach), conditionality, risk management, financial management issues, results orientation and Program Matrix, and documentation.

A. Direct vs. Indirect Lending

30. The option of lending directly to states (with a central government guarantee)—rather than indirectly through the central government’s onlending of Bank loan proceeds—exists only in IBRD-eligible countries. Lending directly to the entity responsible for implementing the reform program for which the loan is made would be in line with the general preference stated in the Bank’s policy on the choice of borrower (OP 7.00.) The advantage is that it places the Bank in a better position to monitor implementation and suggest corrective steps if appropriate. However, the central governments of IBRD-eligible countries have in the past chosen to act as borrowers and onlend to the states rather than to guarantee direct loans to the states.

31. **Government Considerations.** Central governments of IBRD-eligible countries have preferred indirect lending for various reasons that differ between countries. A central government may: (a) want to limit the issuance of guarantees, which usually are off-balance sheet activities, in an effort to control its contingent liabilities; (b) consider the states incapable of carrying foreign exchange risk, judge that the financial market is unwilling to assume the risk, and conclude that it should accept the risk by acting as the borrower; (c) consider indirect lending a convenient vehicle for providing financial incentives to states for conducting reforms (e.g., by not charging states for the assumption of foreign exchange risk and by onlending to them on concessional terms); or (d) prefer indirect lending for political reasons such maintaining the federal-state power balance. Also (e) in some countries states lack legal authority to borrow from foreign sources and/or in foreign currency

32. **Financial Products.** IBRD can help borrowers transfer the foreign exchange risk to financial markets, which would address one important concern underlying country

²⁹ For instance, the *Mexico Decentralized Infrastructure Reform and Development Project* loan finances the infrastructure programs implemented in the state of Guanajuato under Mexico’s comprehensive infrastructure reform and development strategy program.

preference for indirect lending. For example, the *Mexico Decentralization Infrastructure Reform and Development Project* loan has been structured as a Mexican Peso loan with 18 years maturity. IBRD also provides borrowers the choice of several instruments to manage interest rate volatility and liquidity risks.³⁰ With a direct loan, the state could benefit from these additional services.

33. **Implications.** It is good practice to discuss with the government the choice between direct and indirect lending, explain the rationale for the Bank's general preference for direct lending, and seek ways to address government concerns. That discussion should start early during loan preparation. Particularly, if the concerns relate to currency denomination and foreign exchange risk, staff should draw on advice from the Treasury's Banking, Capital Markets, and Financial Engineering Department. If indirect lending remains the choice, task teams should make extra effort to engage continuously with the recipient state governments to ensure their ability to monitor implementation and to suggest necessary corrective steps.

B. Structure of the Operation

34. The purpose of subnational development policy lending is to support well-specified medium-term programs of policy and institutional actions at the state level, not to support actions in a crisis situation. The choice of structure, therefore, is between multitranche operations and a programmatic approach (i.e., a series of single-tranche operations); free-standing single-tranche operations normally would not be appropriate. To guide the choice, it is good practice to ask three questions:

- ***Are the specific medium-term steps in the implementation of the program already well understood?*** If not, a programmatic approach with triggers for subsequent single-tranche operations is more suitable than a multitranche structure that requires up-front agreement on loan conditions regarding steps in the medium term.
- ***Which risks should be managed through the structure of the operation?*** Staff will want to consider both the relative importance of risks that may be managed through the structure of the operation and the availability of alternative means of dealing with those risks. A programmatic approach helps manage risks regarding the state's implementation capacity and/or political support for the medium-term reform steps. A multitranche operation is more useful for helping the state government counter the potential public doubts that the medium-term reform steps will be taken, by using loan conditions to signal its commitment. Also, multitranche operations can use floating tranches to address risks that affect the timing of key reform measures.
- ***What is the overall strategy toward support for state-level reforms laid out in the CAS?*** Specifically, is supporting a few set of reforms in a multitude of

³⁰ Borrowers can choose between a variable and a fixed spread loan and can cap or collar the interest rate in a way that would fit their risk profile. They also can choose between repayment schedules, which would help them reduce the risks of debt refinancing by avoiding peak years in overall debt service.

states considered more effective for the country's development than supporting a comprehensive set of reforms in a few states? A small set of reforms would tend to favor a multitranche operation: fewer steps need to be understood in advance, the government can more clearly signal its commitment to implementing them, and implementation capacity and political risks can be of less concern. But in countries that need a broad, comprehensive approach to subnational issues, programmatic operations are likely to be the better choice. The Government of India, for example, has requested that all state economic reform loans be designed as programmatic operations that support a series of reforms over a number of years.

C. Conditionality

35. The detailed advice on designing conditions, triggers and milestones in development policy lending operations provided in *GPN 1—Designing Development Policy Operations* also applies to operations in support of state-level reforms. Notably, this includes advice to:

- Select few and meaningful actions as legally binding loan conditions
- Use nonbinding milestones or benchmarks flexibly to help track progress in implementing the program
- Be clear about what actions are to be done, by whom, and when
- Include as legally binding conditions actions the government considers useful for signaling commitment to the public
- Avoid specifying outcomes as conditions unless they are in the control of the government; show the link between actions and outcomes in the Program Matrix
- Ensure monitorability.

36. ***Central Government Actions.*** A specific issue for subnational development policy lending concerns actions the central government should take to allow the state's program to succeed (e.g., actions to tighten the budget constraint for states). Such actions are neither in the control of the state government nor limited to the state that receives the loan proceeds: consequently they should be part of the prior actions to be taken before Board presentation of the loan.

D. Risk Management

37. Like all development policy operations, those supporting state-level reforms should identify and assess risks, present a strategy for mitigating (to the extent possible) risks rated medium, substantial, or high, and explain why the remaining (post-mitigation) risks are worth taking in view of the operations' expected developmental benefits. *GPN 1—Designing Development Policy Operations* includes a risk assessment template with a

checklist of potential risk factors and a process for risk assessment. Using this template—amended by risk factors that are specific to subnational operations—constitutes best practice. The note also offers detailed advice on how to mitigate important risks—including through the design of the reform program, through the structure of the operation, the use of a communication strategy, and the preparation of contingency plans for the most important risks—and on how to present the risk assessment and mitigation strategy in the Program Document.

38. ***Specific Risk Factors.*** Several important potential risk factors are specific to subnational development policy operations (and are not included in the template’s checklist of potential risk factors).

- ***The state’s fiscal policy framework*** constitutes a major risk factor. Fiscal policy conditions and state-level fiscal targets for loan presentation or effectiveness and for tranche releases are appropriate for mitigating the risk of disbursing into a weakening fiscal environment.
- ***Disputes between the federal and state authorities***—for example, over the division of responsibilities, contributions to joint activities, or specific political actions by either government—can put the federal government’s support for state-level reforms at risk. This is mitigated by the federal government’s approval of the state’s reform program, which should always be reported in the Program Document. To manage the risk, it is important to ensure that the federal government is involved in the monitoring of the program, is consulted prior to Bank decisions on tranche releases or waivers, and generally has no cause to doubt the benefits of its support.
- ***Inter-state disputes*** can pose a serious risk, particularly disputes between states about their share in federal government transfers, which affect the states’ fiscal frameworks. Staff should assess the risk from unresolved disputes and be clear in the Program Document about any assurances (or the lack of assurances) from the federal government.
- ***Political support*** at the federal and the state level may not be sustained over successive political cycles on both levels, particularly if different political parties gain power on the federal and the state level. To counter that risk, it is important to ensure during loan preparation that ownership of reforms at the state level and of national policy toward subnational issues at the federal level are both broad-based, reaching across much of the political spectrum and the main stakeholders.
- ***Market risk.*** Risks related to the refinancing of the state’s debt and to interest rate volatility could have an adverse effect on state finances and be detrimental to the development objectives of the operation. Since the state in an IBRD-eligible country could use an adequate mix of IBRD financial products to mitigate such risks, it is important to discuss these issues with the state government.

39. **Credit Risk.** The credit risk of subnational development policy operations does not substantially differ from the credit risk of other development policy operations. Since the sovereign is either the borrower or the guarantor of the loan, the Bank evaluates country, not state, credit risk.

E. Financial Management Issues

40. Development policy lending provides both balance of payments and budget support. To ensure these purposes, the Bank requires satisfactory flow of funds arrangements and appropriate management of the country's or state's budget resources. *GPN—Financial Management Issues in Development Policy Lending* sets out the issues and provides advice. The following summarizes the advice for subnational operations.

- Loan proceeds are disbursed into an account that forms part of the country's foreign exchange reserves and is normally held by the Central Bank. The foreign exchange should be promptly converted into local currency and an equivalent amount credited into an account of the borrowing government that is available to finance budgeted expenditures.
- If the federal government is the borrower, onlending terms and arrangements for the flow of funds into an account of the state government available for its budgetary expenditures should be agreed between the Bank, the federal government, and the state government, and should be described in the Program Document. Establishment of the onlending arrangements should be a condition of effectiveness of the Loan Agreement.
- A subnational development policy operation should draw on analyses of the state's public financial management system, including analyses of the budget's comprehensiveness and transparency, budget implementation and monitoring, and financial accountability for the use of public resources. Good practice is to conduct a State Financial Accountability Assessment and a State Public Expenditure Review, in addition to using relevant analyses by the country or third parties.
- In case the analyses identify serious weaknesses, action plans for strengthening public financial management and accountability should be agreed and key actions included among the prior actions of the loan. If concerns about fiduciary arrangements remain—because analyses are incomplete or key actions cannot be taken in a timely manner—additional steps may be considered in close consultation with the Bank's financial management specialists. Notably, this includes disbursement into a dedicated account that can be audited on the Bank's request, and agreement on specified purposes for which payments from the dedicated account may or may not be used.

F. Results Orientation and Program Matrix

41. All development policy lending operations require the specification of a results framework as well as agreement on a Program Matrix that summarizes for each program component the issue being addressed, policy and institutional actions (and triggers, if applicable), and the end-of-program outcomes expected to result from the operation. The Good Practice Note on *Results in Development Policy Operations* issued by OPCS provides advice on how to establish a detailed results framework and reflect it in the Program Matrix, select progress indicators, focus loan supervision on the achievement of results, and evaluate program results.

42. ***Subnational Aspect.*** Specifically for subnational development policy lending operations, it is important that expected results be formulated for both the state and the country, and that they be linked to the objectives of both the state and the national governments' economic programs as well as the CAS objectives. Good practice is to make this distinction clear in the Program Matrix by using separate columns for state and national outcomes.

G. Documentation

43. The Bank's Program Document should complement the Program Matrix, providing background material (particularly on federal-state relations) and a comprehensive explanation of the matrix, in addition to discussing the link with the CAS results framework, updating (if necessary) the Bank's macroeconomic and credit risk assessment and describing the arrangements for monitoring and evaluation of the reform program supported by the operation. (See *GPN 1—Designing Development Policy Operations* for detailed advice.)

44. ***Program Document Annex.*** The annex to the Program Document should include the state government's Letter of Development Policy. This should be accompanied by a statement from the national government that approves and expresses support for the state-level reforms to be supported by the loan. The national government's overall policy toward subnational issues and the strength of its backing for the state-level policy and institutional actions supported by the loan should be evaluated in the main body of the Program Document.

LIST OF SUBNATIONAL OPERATIONS CITED

ARGENTINA

- Argentina – Provincial Development Project (P-5394), November 21, 1990*
Argentina – Provincial Development Project II (P-6513) April 5, 1995
Argentina – Provincial Bank Privatization Loan (P-6570), April 20, 1995
Argentina – Provincial Health Sector Development Project (P-6607), July 5, 1995
Argentina – Provincial Pension Reform Adjustment Loan (P-6967), November 6, 1996
Argentina – Four Second Provincial Reform Adjustment Loan Projects – Rio Negro, Salta, San Juan, and Tucuman (P-7136), July 30, 1997
Argentina – Provincial Reform Loan Project, (P-6414), December 30, 1997
Argentina – Catamarca Provincial Reform Adjustment Loan (P-7831), August 21, 2000
Argentina – Second Buenos Aires Secondary Education Project (21010), November 7 2000
Argentina – Cordoba Provincial Reform Loan Project, (P-7401), November 23, 2000
Argentina – Santa Fe Second Provincial Reform Loan Project (P-7462), June 21, 2001

BOLIVIA

- Bolivia – Programmatic Structural Adjustment Credit for Decentralization Project (P-7439), April 16, 2001*
Bolivia – Second Programmatic Structural Adjustment Credit for Decentralization, (25089), May 19, 2003

BRAZIL

- Brazil – Rio Grande do Sul State Reform Loan Project (15943), January 24, 1997*
Brazil – Mato Grosso State Privatization Project (16515), May 22, 1997
Brazil – Rio de Janeiro State Reform Privatization Project (15869), June 6, 1997
Brazil – Minas Gerais State Privatization Project (16466), April 9, 1998
Brazil – State Pension System Reform Loan Project (17965), June 3, 1998
Brazil – Social Security Special Sector Adjustment Loan Project (P-7277), December 10, 1998
Brazil – Fiscal and Administrative Reform Special Sector Adjustment Loan Project (P-7275), March 7, 2000
Brazil – Programmatic Fiscal Reform Structural Adjustment Loan Project (P-7427), December 26, 2000
Brazil – Second Programmatic Fiscal Reform Structural Adjustment Loan Project (P-25880), May 14, 2003

INDIA

- India – Haryana Power Sector Restructuring Project, (17234), December 16, 1997*
India – Andhra Pradesh Power Sector Restructuring Project (18849), January 25, 1999
India – Uttar Pradesh Fiscal Reform and Public Sector Restructuring Project (P-7365), March 29, 2000

India – Rajasthan Power Sector Restructuring Project (20768), December 18, 2000
India – Karnataka Economic Restructuring Loan/Credit Project (P-7453), May 25, 2001
India – Second Karnataka Economic Restructuring Project (P-7511), February 15, 2002
India – Andhra Pradesh Economic Reform Loan Project (P-7508), February 15, 2002
India – Second Andhra Pradesh Economic Reform Loan Project (26534), January 9, 2004
India – Orissa Socio-Economic Development Program Project (26550), December 28, 2004

MEXICO

Mexico – Decentralization Structural Adjustment Loan (P-7343), November 30, 1999.
Mexico – Structural Adjustment Loan to the Estado do Mexico Project (P-7400), November 16, 2000
Mexico – Decentralized Infrastructure Reform and Development Project (28599), April 23, 2004

PAKISTAN

Pakistan – NWFP Structural Adjustment Credit (24118), May 31, 2002
Pakistan – Sindh Structural Adjustment Credit Project (24193), May 28, 2002
Pakistan – Education Sector Adjustment Credit Project (27528), January 8, 2004

RUSSIA

Russian Federation – Third Structural Adjustment Loan Project (P-7256), July 26, 1998
Russian Federation – Regional Fiscal Technical Assistance Project (P7345), November 30, 1999
Russian Federation – Fiscal Federalism and Regional Fiscal Reform Loan Project (P-7504), December 20, 2001
Russian Federation – St. Petersburg Economic Development Project (25550), April 15, 2003
Russian Federation – Kazan Municipal Development Loan Project (31414), January 27, 2005

UKRAINE

Ukraine – Programmatic Adjustment Loan Project (P-7473), August 23, 2001