



INDIA: Evaluating Bank Assistance for Public Sector Management

A Country Assistance Evaluation

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Acronyms

ADB	Asian Development Bank
BIFR	Board for Industrial and Financial Reconstruction
CAS	Country Assistance Strategy
CEM	Country Economic Memorandum
CPIA	Country Policy and Institutional Assessment
ERP	Economic Restructuring Project
ESW	Economic and Sector Work
GDP	Gross Domestic Product
ID	Institutional Development
IMF	International Monetary Fund
NGO	Nongovernmental Organization
OED	Operations Evaluation Department
PAR	Performance Audit Report
PES	Public Enterprise Sector
PIF	Project Information Form
PSE	Public Sector Enterprise
QAG	Quality Assurance Group
SAL	Structural Adjustment Lending

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Preface

This paper is one of the background papers prepared as an input to the India Country Assistance Evaluation (Task Manager: Mr. Gianni Zanini) by the Operations Evaluation Department (OED) of the World Bank. Findings are based on a review of project appraisal and completion reports, sector reports, and a number of other documents produced by the Borrower, the Bank, OED, and research papers. An OED mission visited India in April/May 1999. The mission interviewed current and retired government officials and Indian experts. Bank staff were interviewed at both headquarters and in the field office. Their valuable assistance is gratefully acknowledged.

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Executive Summary

1. This paper reviews and evaluates the Bank's involvement and performance in the area of public sector management. It also takes a close look at the state-level policy-based lending in India which has gained major importance in recent years. Under public sector management issues, fiscal adjustment, public enterprise reform, governance and institutional development are covered.
2. There is a growing consensus inside and outside of India that the problems faced in public sector management seriously constrain the economy to fully realize its potential. However, despite the government's recognition of the need and the Bank's efforts to assist the government, most would agree that public sector reform remains illusive. Clearly the challenge for the Bank is not only to identify the issues and to provide the analytical underpinnings, but it is also to better understand and adapt to the complexities of India's rapidly changing political economy and the pace of change in public sector management.
3. Therefore, the Bank needs to cover a number of public sector management issues. Further analytical work may be needed in some areas. In others, the Bank can play an important catalytic role in helping to identify promising reforms in certain states and sectors, and in helping to gather and disseminate information regarding public sector performance. These actions could help strengthen the Bank's dialogue with the authorities, stimulate debate, and encourage change in vitally important areas within public sector management. Areas where such action would be beneficial are identified in the paper.
4. The Bank has considered fiscal adjustment an integral part of public sector reform, since persistent fiscal deficits in the public sector has been the major macroeconomic weakness of the Indian economy. Fiscal adjustment was a component of the 1991 SAL operation but. The outcome was only moderately satisfactory. After an initial decline in the first half of the decade, the consolidated fiscal deficit has once again reached the pre-1991 level. Since the 1991 operation, no lending instrument addressed the fiscal deficit issue at the center. CEMs have made reference to the problems associated with the deficit, but they did not make lasting impact on the government. In the second half of the 1990's, the Bank shifted its attention to the finances of the states, where the need for fiscal adjustment is also great in view of worsening state finances. Also, it is in the states that the Bank decided its impact would be greater. While this is an appropriate strategy, the Bank should also explore ways to help the authorities address fiscal problems at the center.
5. The pace of public enterprise reform has been very slow. The government and the Bank have agreed that reforming the public enterprise sector essential because of the large impact of this sector on the economy, and of its negative contribution to overall fiscal deficit. Public enterprise reform was part of the 1991 adjustment operation, the outcome of which was only moderately satisfactory. Since then, the Bank was devoid of any lending instrument to address the problems of central public enterprises. References to public enterprise reform in various ESW were also inconsequential. However, the

authorities are finally taking a more active stance and are selling the majority shares in a number of enterprises. In fact, privatization is now an acceptable term. Currently, the Bank has shifted its focus to public enterprise reform from the center to the states through state-level lending. Given the prominence of the central public enterprises in the economy, however, the Bank should not drop them from the agenda for reform altogether.

6. Governance issues have been attracting more attention recently in the Bank. In India, economy-wide corruption is a major issue. The legal system falls short of fully supporting the economic transformation the country is going through. There is room for improvement in the fiscal system to strengthen transparency and accountability. The Bank is looking into these areas mostly in the context of ESW. Also, with the shift of focus to state-level lending, governance issues have gained even more importance where it is a much bigger issue. Without major improvements in states' governance, the Bank's impact through policy-based lending in the states can not be very beneficial. The Bank demonstrates full awareness of this point, and governance issues are increasingly dealt with in ESW and policy-based lending in various states. However, the Bank should explore other entry points to contribute to the dialogue in economy-wide governance issues. The Bank may also consider lending in specific areas, such as legal system reform.

7. Institutional development issues are being dealt with in the context of individual sector projects, some of which have a formal ID component. The impact of these projects, which on average is modest, is more relevant from the "agency" perspective than from the "national." The adjustment operation of 1991 was supportive of institutional changes in areas such as the financial sector, trade and foreign exchange regimes, and taxation. However, there are certain areas that require much closer attention both from the government and the Bank. Reforming the civil service and rationalizing of public expenditures are two such areas. The Bank needs to put more emphasis on these issues, and to strengthening the linkage between reforming core systems of government and sector institutions. Recently, it has begun moving proactively in this direction. These efforts need to be strengthened and encouraged.

8. The shift to state-level policy-based lending in the second half of the 1990s is clearly in tune with the change in political environment and the needs of the country. States have the responsibility for the provision of basic services and poverty alleviation. To cope with such responsibilities, states need to initiate penetrating reforms and reverse the trend in fiscal deterioration. Therefore, public sector management issues, including governance, have gained in importance in the states, and the Bank's response to this need has been timely. Also, state-level public sector management issues are increasingly the focus of recent ESW.

9. The current Bank strategy favors the reforming states. This strategy is appropriate since the impact of Bank lending is the highest in a reform environment. Also, this creates an incentive for the non-reforming states. Moreover, state-level policy-based lending provides a framework to link various elements of public sector management, tying fiscal adjustment and reform to governance issues, and to institutional

development. Meanwhile, the first project on broad-based state lending is being implemented in Andhra Pradesh. Even though the project is going well, it cannot easily be replicated elsewhere because of its complex nature. A recently approved second project, which is structured differently, addresses the fiscal reform and public sector restructuring in Uttar Pradesh.

10. Certain issues emerge from the limited experience with state-level policy-based lending. The Bank should make additional efforts to let the new criteria for lending be better understood by all. There is additional concern that the need for assistance in social sectors may even be larger in some poorer states who are not in the reform mode. While such needs should not totally be ignored, it is important for the Bank to continue to focus on reforming states to demonstrate the benefits of fiscal adjustment, better governance, and institution building.

1. Fiscal Adjustment

Background

1.1 The Bank has long considered the persistent deficits in the public sector finances as the single most important macroeconomic weakness of the Indian economy. The concern has been that high-level public sector deficits crowded out private sector borrowing, resulted in high interest rates, and raised macroeconomic risks, thus preventing the country from realizing its growth potential. The same view has also been shared by most independent observers of the Indian economy.

1.2 India started the present decade with a consolidated public sector deficit of about 11 percent, and ending with a deficit at about the same level. In between, the fiscal deficit came down to about 8 percent in 1995-96, but could not be sustained. This interim decline did not result from an increase in tax revenue. In fact, the tax measures taken after 1991 were intended to be revenue-neutral. The actual outcome was worse than anticipated, with revenue from excise and customs duties coming down more than anticipated, and the income tax revenue not increasing as much as hoped for. The interim drop in fiscal deficit was achieved through expenditure cuts such as transfers made to the states, capital spending, and to a smaller extent in subsidies. Also, the government used the proceeds from the sale of government shares in public enterprises to cover the deficit. However, mainly because of the increase in the wage bill in the latter part of the decade, the fiscal deficit rose once again.

1.3 India is not alone in her failed effort to achieve sustainable fiscal adjustment. There are many examples of fiscal reform with the deficit coming down for a short period and reappearing soon after. In retrospect, it is clear that no structural measures were taken for sustainable adjustment in India and, to a certain extent short-lived improvements were achieved through lowered asset accumulation (resulting from asset sale and lower investment). To the extent that this has happened, fiscal adjustment was not real.

1.4 The problem of fiscal deficit is not only a central government phenomenon. The states' finances are also deteriorating due to excessive expenditures and reluctance to raise additional revenue. Data indicate that the burden of explicit and implicit subsidies on the states' budgets is growing. The states are also feeling the weight on the wage bill of the recommendations of the Fifth Pay Commission. Some states have already raised wages and salaries; and others are under pressure to follow suit. However, most states are not in any position to afford such increases. As the states are finding themselves more and more financially strained, resource flows from the center are declining. It is clear that the fiscal situation of most states is unsustainable.

Bank's Involvement

1.5 **Adjustment lending.** Strong warnings about the unsustainability of the fiscal deficits were included in both Bank CEMs and IMF reports even prior to 1991. The successive India Country Assistance Strategy (CAS) documents also acknowledged the urgency of fiscal adjustment. Nonetheless, fiscal issues had never found their way to the lending operations. The economic crisis of 1991 opened the door for the first adjustment lending. With the balance of payments problems looming large, India needed additional resources to overcome the pending crisis. Concurrently, the government launched a far-reaching economic program opening up the economy to competition, reducing the role of the public sector, and achieving fiscal adjustment. This paved the way for the Structural Adjustment Loan and Credit in FY91, in the amount of 500 million USD.

1.6 According to the Performance Audit Report (PAR) (1996), the project on the whole was “well founded in good analytical work and well grounded in a long-standing relationship and dialogue between Bank staff and India.” However, the fiscal issues proved to be the most intractable, and adjustment both at the central and state level never materialized beyond the initial stage. According to the assessment made in the PAR, fiscal deficits have continued to “pose a major threat” to the sustainability of the government’s reform program. The subsequent CAS documents echo this.

1.7 The 1991 SAL was followed by a second adjustment operation in FY92. The Social Safety Net Adjustment Program Credit, also in the amount of US\$500 million was prepared in haste in response to the government’s urgent need for additional funds. The project was to support the ongoing structural adjustment process by helping to mitigate potentially negative consequences on the poor. In 1993, a third adjustment operation followed, the External Sector and Investment Regime Liberalization, which was a loan for US\$300 million. Neither of the latter two adjustment operations had a fiscal adjustment component. In that sense an opportunity was missed.

1.8 Even though the Bank had envisaged up to three adjustment lending projects per year for a period of three to four years, after these three loans the Indian Government’s need for balance of payments support disappeared, and no new quick-disbursing adjustment operation has since been initiated. In retrospect, the Bank identified the fiscal problem correctly in 1991, but it overestimated the government’s capacity to carry through the necessary adjustments. After an encouraging start, the momentum of fiscal adjustment slowed down considerably, once the crisis situation disappeared and the government switched to an expansionary policy to stimulate the slowing down economy.

1.9 The 1996 PAR rated the outcome of SAL satisfactory, on the strength of the reforms in areas other than fiscal adjustment and public enterprise restructuring. However, because of the “incompleteness of fiscal consolidation and the risks it poses” the rating given for sustainability was uncertain. Project ratings for institutional development was substantial, while both the Bank and Borrower performances were satisfactory. The 1998 PAR on the second adjustment operation found that the policy conditions of the project were met, but it had little impact, if any, on the adjustment process. The audit rated the project outcome as moderately satisfactory. The 1996 PAR

report rated the outcome of the third SAL operation very satisfactory. As indicated, however, neither of these two latter projects had a component for fiscal adjustment. The present review focussed only on the fiscal component of the first SAL, the 1991 Structural Adjustment Loan and Credit, and found that the outcome was moderately satisfactory. The present review also found that the fiscal component of the project was substantially relevant, but its efficacy was modest.

1.10 In the second half of the 1990s, the Bank's fiscal deficit focus has shifted to the states. The Bank saw that the states' finances weighed heavily on macroeconomic stability and are important for the delivery of public services assigned to them. Such a shift in focus is appropriate so long as it does not result in total neglect of the fiscal deficit at the center. In line with this new strategy, the Bank prepared a multi-sector lending project for the state of Andhra Pradesh with a fiscal reform component. It is too early to measure the impact of this operation on fiscal deficit. Also, the need was recognized in the 1998 CAS-Progress Report for untied budgetary support for the financially distressed states. Such a credit has recently been approved by the Board for the state of Uttar Pradesh.

1.11 **Non-lending activities.** In the area of fiscal deficit, which is basically covered by the IMF, the Bank has not made detailed independent analysis. However, because of the importance attached to it in the Bank, all CEMs have made reference to fiscal deficit and the importance of fiscal adjustment. These periodic reviews were useful updates of the fiscal situation, and often reiterated the main weaknesses in both the expenditure and revenue performances. In addition to these formal ESW, the Region has communicated with the authorities through informal notes on a wide range of topics, including fiscal issues. These informal communications seem to be better appreciated by the Indian authorities. While the various formal studies were relevant and to the point in their emphasis on the need for fiscal adjustment, their impact was modest.

1.12 With the shift of emphasis to the states' finances, the Bank has prepared a number of ESW products, with a relatively strong focus on the fiscal situation in Orissa (1996), Rajasthan (1997), Andhra Pradesh (1997), Karnataka (1998), and Uttar Pradesh (1998). The Andhra Pradesh study provided a basis to the ongoing ERP project. The Uttar Pradesh study, which QAG found highly satisfactory and proposed it for "best practice," provided the background for the "Uttar Pradesh Fiscal Reform and Public Sector Restructuring" project. Also, the Region contracted additional studies with a local institute on the fiscal situation in six states, which are already completed.

1.13 Beyond ESW, given the limitations of the existing instruments, the Bank's response to the fiscal deficit problem has taken new dimensions. In the 1997 CAS, reducing the central government fiscal deficit to a certain percentage of GDP was made one of the "trigger points" for moving between the "base" and "low" lending cases for India. The January 1999 CAS progress report observed that these trigger points were not satisfied.

1.14 **Unfinished agenda.** There are a number of areas that require attention if sustainable fiscal adjustment is to be achieved in India. These are also the issues that are politically sensitive, particularly so long as they relate to the center. Some of these issues may be difficult to approach outright, even in the context of ESW, let alone be subject to a lending operation. However, this should not preclude exploring different ways to encourage the government address them.

1.15 One such area is subsidies. Aggregate government subsidies of both the center and the states constitute about 14 percent of GDP, two thirds of which originate from the activities of the states. Another revealing statistic is that the recovery rate of the cost of social and economic services is only about 7 percent, indicating that about 93 percent of the costs remained uncovered. The biggest subsidies are in food, fertilizers, power, irrigation, and to a certain extent in health and education. The size of these subsidies are so large that even relatively modest increases in cost recovery could make a substantial dent in the fiscal deficit. It is also true that increased user charges would reduce the demand for relevant goods and services, and thus the cost of them to the government.

1.16 Another area that has a strong bearing on what happens to fiscal deficit is public sector employment. The public sector wage bill has grown in recent years, due to both increases in numbers and pay increases. Many believe that there is considerable room for reducing the public sector payroll. In fact, the Fifth Pay Commission has recommended a 30 percent staff reduction in ten years, mostly through natural attrition, with a view to minimizing the impact of the large wage increases it recommended. So far, the Government has been unable to restrain the increase in the size of the wage bill.

2. Public Enterprise Reform

Background

2.1 The public enterprise sector dominates the Indian economy, with well over one thousand enterprises operating in almost all sectors. The sector's share in GDP has displayed a growing trend, reaching about 25 percent in recent years. The public sector enterprises (PSEs) operate under the jurisdiction of either the central or the state governments. Despite recent efforts for divestiture, central PSEs dominate in utilities, the petroleum industry, rail transport, electricity supply, and telecommunications. However, the largest number of central PSEs are operating in the manufacturing sector. The state-owned PSEs, with few exceptions, are engaged in the supply of power, irrigation, and transport services. Traditionally, the overall performance of the central PSEs has been poor, while some improvement in performance has taken place in the 1990s, mainly thanks to developments in petroleum and telecoms. However, the situation is worse with the state public enterprises. They incur large losses every year, mainly because of their extremely poor cost recovery practices.

2.2 Public enterprise reform has been on the agenda of Indian governments for a long time without any major consequence. With the 1991 reforms, however, the government was committing itself to major changes in this sector: to phase out the budgetary support for the central PSEs, to divest government equity in them, and to develop a viable exit policy for the loss-making enterprises. Despite these commitments, however, public enterprise reform never gained much momentum. However, central government loans to public enterprises have declined sharply in recent years, on account of the enterprises financing their needs through the market. From the outset it was clear that “privatization” was not the way the government wanted to go. Instead, partial disinvestment was the chosen strategy, with the government retaining the majority control in enterprises.

2.3 Even the disinvestment process was slow. A Disinvestment Commission was set up in 1996 as an advisory body with supervisory and monitoring responsibilities. However, the actual impact of the Commission was limited. Out of 45 cases reported to the government, action was initiated on only 24 of them, while a decision is awaiting in the remaining 21 cases. More recently, a separate Department of Disinvestment has been constituted to expedite the disinvestment process. Also, a voluntary retirement scheme was introduced. Much less has been done with the treatment of chronically loss making enterprises. No action has been taken on any of the units recommended for closure by the Board for Industrial and Financial Reconstruction (BIFR).

2.4 However, some positive developments that have taken place included cutting down the number of industries originally reserved for the public sector from eighteen to three. To further encourage competition, measures were introduced to ease restrictions on private entry. Also, a number of subsidized prices were raised, including fertilizer, and steps were taken to limit the transfers to public enterprises, thus hardening the budget constraint for them. In another positive step, the government announced that in the “generality of cases” the public share in enterprises would be reduced to 26 percent, and foreign shareholders would be encouraged to participate. Meanwhile, most recently, privatization has become an acceptable term to use.

Bank’s Involvement

2.5 Over the years the Bank has treated public enterprise sector restructuring as a priority issue in ESW and CAS documents. The Bank’s view has been that, given the dominance of the public sector in the economy, what happened in this sector had a strong bearing on efficiency and growth, as well as on the size of the fiscal deficit, both in the center and the states. In the past, large resource transfers from the budget, reduced the funds that could be spent on social sectors and infrastructure. Also, financing of public enterprise losses, has crowded out the savings available for the private sector. Moreover, firms operating in both private and public sectors were forced to purchase PSE’s expensive, and sometimes sub-standard products which, in turn, negatively affected their productivity and competitiveness. However, with the liberalization process, competition both from domestic production and imports has increased.

2.6 **Adjustment lending.** PSE issues found their way to a lending operation for the first time with the Structural Adjustment Loan/Credit in 1991. Public enterprise reform was at the center of the new government policies, and thus the adjustment operation of the Bank. The Letter of Development Policy included encouraging statements to the effect that “the scope of the public sector would be rationalized,” “the budgetary support for central public enterprises would be phased out,” “the government equity in them would be disinvested” and “a viable exit policy would be developed.”

2.7 However, the pace of public enterprise sector reform was very slow; in fact, much slower than the other components of the 1991 reform initiatives. The PAR prepared by OED on the Structural Adjustment Loan/Credit (1996) points out a lack of progress in different aspects of the PSE reform and observes that public enterprises losses continue to be a major constraint on fiscal correction. According to the PAR, lack of action on closing down sick industries was particularly troublesome. It is more evident now that there has not been sufficient political support to carry out penetrating public enterprise reform. There has been opposition to reform, some emanating from labor legislation and the strong labor unions. Also, public opinion has been conditioned to government interference in the economy and to be suspicious of the motives of the private sector.

2.8 The Bank’s decision to include the public enterprise reform in the adjustment operation was appropriate. However, with hindsight, it is evident that the signals given by the government were misread, and the capacity of the government to carry out reforms in a relatively short period of time was overestimated. The present review found the public enterprise reform component of the 1991 SAL project substantially relevant, its efficacy negligible and the outcome moderately unsatisfactory.

2.9 With the shift to state lending, once again public enterprise issues are finding their way into the Bank projects. Public enterprise restructuring with a technical assistance component is already, in the Andhra Pradesh Economic Recovery Program. It is still too early to judge the impact of the operation on public enterprise restructuring in that state. The recently approved Uttar Pradesh project on public sector restructuring also has a public enterprise reform component.

2.10 **Non-lending activities.** Most CEMs make reference to public enterprise sector (PES) issues, but they do not go into detail. The only comprehensive review of the sector was made in 1988. (*India: Review of Public Enterprises*, 1988, Bank report no. 7294-IN) The Report diagnosed that the disappointing performance of the public enterprises could be traced largely to their relationship with the government. These enterprises were often asked to pursue a complex set of conflicting objectives. A large number of public enterprises relied heavily on budgetary funds not only for their investments but also for operations. The 1988 Review of Public Enterprises report did not make a lasting impact on the government. The authorities were not prepared to embrace such a report, let alone to acknowledge its recommendations. The PAR of 1996 on the Structural Adjustment Loan and Credit observed that the Bank’s ESW work on PES was considered by the authorities not very useful. The present review found ESW on public enterprises substantially relevant, but the impact was negligible.

2.11 The 1991 CAS pointed to the structural reforms in the public enterprise sector as a necessary element of a comprehensive adjustment scenario. Echoing the main conclusions of the 1988 aforementioned study, the strategy stated that “closing of chronically sick units, providing for greater autonomy and accountability of public unit managers, and permitting private participation in more profitable entities” were essential. However, in recent years, the Bank seems to have dropped the central government public enterprise issues from its list of priorities. For example, in the 1988 CAS, PSE restructuring is not included in the five priority areas. The most recent 1999 CAS Progress Report makes only a passing reference to PSE related issues.

2.12 In recent ESW on states, the review of the public enterprise sector is usually included, in the context of fiscal adjustment and reform. Understandably, these are not detailed analyses of the public enterprise sector, and generally are cursory reviews of the issues. To the extent they influence the design of lending operations they are serving a useful purpose. The present approach nonetheless leaves out the important issues related to central public enterprises. It is clear that the Bank does not have an operational leverage to make an impact in this area. Nonetheless, the Bank should encourage dialogue in this vital area through carefully crafted initiatives, preferably in cooperation with local institutions.

3. Governance Issues

Background

3.1 In recent years, there has been a deliberate effort in the Bank to address governance issues directly in project lending and ESW. This is true for India also. At this relatively early stage, however, the focus is more to identify the relevant issues and to develop strategies. Information on governance is rather scattered in the Bank. In the Bank’s “1998 Country Policy and Institutional Assessment (CPIA) Ratings,” India received slightly above average grades for governance indicators. The grades for the categories “quality of budget and public investment process,” “efficiency and equity of revenue mobilization and public expenditures,” “macroeconomic management capacity,” and “sustainability of structural reforms” were better than average. However, in the category “accountability of the public service” which covers a wide range of criteria including the general public having a voice or participation in public activities, transparency in public affairs, and the incidence of widespread corruption, India has received only an average grade.

3.2 A composite index of governance indicators assembled in the Region reveals that India’s scores are slightly worse than the developing countries average in the category of government effectiveness, the same in rule of law and business environment, and above average in general public administration and public finance. These averages, however,

should not be taken as definitive, since there continues to be considerable uncertainty about what these governance indicators actually mean.

3.3 A more qualitative overview of governance issues reveals the following. In the area of public finance, the budget and other related documents of both central and state government operations provide a relatively comprehensive overview, allowing some degree of fiscal transparency. However, there is still room for improvement both on the revenue and expenditure sides. Tax laws with frequently changing regulations resulted in a complex system, which leaves considerable discretion to officials, which in turn, gives rise to petty corruption. Large scale tax evasion in India is a well known phenomenon. Less than 15 percent of about 75 million potential taxpayers is in the tax net. Despite the fact that a number of amnesties were offered in the past, the black economy continues to exist. There is a uniform belief that there is much room to improve tax compliance through proper implementation and enforcement strategies, and that a comprehensive overhaul of the tax administration is overdue. Weaknesses exist in expenditure monitoring enlarging the scope for misuse. The existing system of management and control, (relying on traditional control mechanisms), is considered to be rather ineffective.

3.4 The existence of a credible legal system ensuring property rights and facilitating the proper functioning of a market-based economy is one of the essentials of good governance. While India traditionally has had a relatively sophisticated legal system, certain problems remain. Delays in the resolution of cases is probably the most serious issue. Currently an estimated 25 million cases are pending in various courts. Under the existing regulations, liquidation of companies and resolution of labor conflicts may take up to 20 years. Reforms are necessary in the legal system to facilitate the transformation taking place in the economy. Some legislation is pending parliamentary approval, but not in states where the need is more pronounced.

3.5 According to public opinion polls, corruption in India is regarded as a major problem leading to erosion of credibility and effectiveness of public institutions. The problem appears to be even more prevalent in the states than the center. World Bank Surveys of 1996 and 1999 indicate corruption seriously affects business confidence. The Transparency International's annual Perception of Corruption Index ranks India ninth on a list of 54 countries in descending order of perceived corruption. The problem is now a matter of public debate and the Prime Minister, on the occasion of the 50 th anniversary of independence, spoke on television at length on its gravity.

3.6 The regulatory framework that governs private sector activities has flaws. Investors, both domestic and foreign, continue to face hurdles in project approval and implementation. This is mainly because regulations governing entry, evaluation of bids and tenders, and pricing under monopolistic conditions are not always sufficiently transparent. The inflexibility of the labor markets is another factor standing in the way of rapid adjustment, and may limit India's ability to attract sizeable foreign direct investment. Some 50 major pieces of legislation on labor welfare and dispute settlement govern industrial relations. The restructuring of ailing public and private sector firms is hampered by the rules governing the termination of employment and closing of industrial

establishments. Restrictions affecting hiring and firing raise business costs. Also, fractious industrial relations help increase the inflexibility of the system.

Bank Response

3.7 Even though earlier Bank documents made a passing reference to governance in India, the issue was formally introduced in the FY98 CAS for the first time. In reference to corruption as a major problem, the 1988 CAS stated that the “commentators generally agree that contributory factors include excessive discretionary powers in the hands of public officials, cumbersome official procedures, and lack of transparency in the rules of governance.” Since then more attention has been paid to governance issues in lending and particularly in non-lending activities. Policy and institutional reforms introduced in a number of various projects did make a point to reduce opportunities for discretion. Independent regulation promoted in the power sector is an example. Also, in Bank financed rural projects, the formation of user groups is expected to strengthen accountability in the delivery of public services. In addition, greater transparency is promoted in Bank-financed projects through increased use of external monitoring.

3.8 Reforms supported by the Bank through the adjustment operations of the early 1990s were expected to have an impact on corruption since they encouraged greater reliance on markets. Industrial licensing and import restrictions were the two areas where discretionary control was pervasive in the old regime, something economic reforms have sought to abolish. However, these reforms have obviously not eliminated all areas of interface between government and business. Moreover, with the opening of the various sectors to private business, more individuals will face situations involving corruption.

3.9 To help combat corruption, the Bank continues to support economic liberalization, while enhancing client capacity to assess the financial management of projects, assisting grass roots organizations serving the poor to become more accountable by promoting the NGOs and other groups that provide rural financial services. Also, more attention is now paid to governance issues in the context of non-lending activities of the Bank. The recent economic report on Uttar Pradesh, *From Fiscal Crisis to Renewed Growth*, has a section on governance, covering issues such as deregulation and divestment, civil service renewal, and decentralization and local government reform.

3.10 In the past, issues involving the legal system have not been part of the Bank’s dialogue with the Indian authorities. However, in view of the growing concern regarding poor enforcement and inefficiency involved in the functioning of the legal system, the Bank should explore ways to help the government in its efforts to improve the capacity of the judicial institutions.

3.11 The importance of governance issues in the states will continue to grow. More Bank resources will be transferred to the states in the coming years. Issues such as corruption, poor service delivery, and weak expenditure management capacity are much more prominent in the states than in the center. Unless the relatively weak conditions of governance is alleviated, there is always the danger of the so-called reforming states being incapable of delivering the type of institutional changes necessary for a more

effective use of resources made available to them. Therefore, it is essential that the Bank satisfy itself that the client states can tackle difficult problems such as sustainable fiscal adjustment and institutional changes in view of the existing state of weak governance.

3.12 It is entirely appropriate for the Bank to focus on governance issues in states where the need is greatest; provided that there is adequate political will and administrative capacity for tackling reforms. More penetrating ESW would be helpful. It is also appropriate that some of the governance issues are addressed in the context of projects. The Bank should encourage public debate on the subject. The Bank should also consider supporting reforms in the judicial system and the labor market through project lending.

Institutional Development

3.13 Most Bank projects have had a direct or indirect impact on institutional development, defined as the ability of the relevant agency and/or the country to use human and financial resources effectively. There has not been a free-standing Bank project on institutional development during the period under consideration. However, in a number of Bank projects institutional development has been a formal component. Institutional development issues are also addressed in the context of ESW, and frequent reference is made to it in CAS documents.

3.14 **ID impact of projects.** Periodically, OED reviews the institutional development impact of projects. Data are available for India in the so-called Project Information Form (PIF) surveys for 1994 and 1997, in which OED looked into 100 projects with respect to their impact on institutional development. Sixteen of these projects had a primary focus on institutional development, while 68 projects had only a secondary focus. The efficacy (impact) of institutional development for all 100 projects were classified under the categories of high, substantial, modest, and negligible.

3.15 Around 60 percent of these projects had a modest or negligible overall efficacy level, with the number of projects with modest efficacy being about twice as many as those with negligible efficacy. About 30 percent of the projects evaluated had substantial efficacy. Only 5 percent of projects had a high efficacy rating. As to the overall estimated impact, the percentages are not substantially different. A little over 65 percent of the projects had modest or negligible institutional development impact, again the number of those with modest impact being twice the number of projects with negligible impact. The percentage of projects with a substantial impact rating was slightly below 30 percent, while only two projects had high ranking. These figures indicate that from the point of view of institutional development the overall efficacy and impact of the Bank projects in India were relatively modest. The details of these findings can be seen in the Annex table.

3.16 The breakdown of the institutional development impact of the Bank projects on “national capacity” and “agency capacity” is also tabulated. Under the national capacity heading, relevance and efficacy of projects are evaluated according to “economic management,” “civil service reform,” and “legal/regulatory system.” More than 70

percent of the 100 projects have no relevance to national capacity building. Of the remaining 30 percent, nearly half of them have had negligible institutional development impact both in terms of relevance and efficacy. Only in the case of the legal/regulatory system have more projects had substantial relevance, but their efficacy was also relatively low.

3.17 More Bank projects were relevant to the development of agency capacity. Data are broken down for “planning/policy analysis,” “management,” “skills upgrading,” and “management information systems.” Bank projects have had more high or substantial relevance with respect to management. This was followed by skills upgrading, planning/policy analysis, and management information systems, in that order. In terms of efficacy, the majority of projects had substantial and modest ranking, particularly in skill upgrading and management. However, compared to relevance, the number of projects with high and substantial grades are fewer.

3.18 **ID in adjustment assistance.** The main vehicle for the Bank to support the Government’s efforts for institutional development at the national level was the adjustment operations of the early 1990s. The reform efforts of the Government were also supported by the Bank’s ESW and policy dialogue. The Government’s program covered fiscal adjustment, deregulation of domestic industry and promotion of foreign direct investment, liberalization of the trade regime, reform of domestic interest rates coupled with measures to strengthen capital markets and institutions, and public enterprise reform. The reforms also tried to improve efficiency in the public sector, avoid wasteful spending, and improve resource mobilization and allocation.

3.19 The outcome of the Bank-supported program implementation was mixed from the point of view of institutional development. Towards liberalization, sectors previously reserved for public investment such as power, mining, ports, roads, river transport, air transport, and banking have been opened to private investors. However, the domestic economy continues to be subject to excessive regulations, while implicit and explicit subsidies limit competition and efficient resource allocation. Also, major agricultural crops remain subject to barriers to internal and external trade. In sectors such as power, telecommunications, and rail, separation is necessary between the commercial, regulatory and promotional functions. Commercial activities can then be carried out by the private sector. There has already been some progress in this direction in telecommunications and power sectors.

3.20 The institutional framework for the financial sector has improved substantially. Interest rates have been liberalized, domestic and foreign competition increased, and regulation and supervision mechanisms have improved. Nonetheless, the public sector still dominates the financial sector, limiting its ability to allocate resources to the most productive activities in an efficient manner. The trade and foreign exchange regimes, have been substantially liberalized. After several rounds of trade reforms, tariffs were reduced and licensing restrictions on imports of intermediate and capital goods were lifted. Convertibility of the currency has been established for current account transactions. The impetus of trade liberalization appears to have slowed down; in fact there has been some backsliding recently.

3.21 Institutional changes have taken place in the area of taxation. Tax cuts over the last few years have brought down the rates to more reasonable levels, and the number of assesses has increased. Despite such improvements, dependence on customs receipts continue for the central government. The states' reliance on central taxes and transfers is a problem. Cascading state taxes act as a deterrent to interstate and international trade. In addition, the parallel indirect tax systems of the states and the center creates substantial administrative and compliance burdens.

3.22 **Civil service reform.** The civil service in India is bottom heavy. However, issues extend beyond the size of the government. There are other issues needing attention, such as layers of control, lack of transparency, frequent rotation, and centralization of decision making. Also, there is a trend in using public sector employment to dispense patronage. The administrative service is increasingly finding itself in a credibility gap. All these indicate the need for a broad approach to civil service reform. This would involve changes in the organizational structure of the government with a view to streamlining decision making, and reducing duplication of responsibility. Also, issues such as lack of incentives and rewards for productive work needs to be tackled in such a reform. Even though there have been numerous committees and commissions on administrative reforms, only a few of them were directly concerned with the civil service

3.23 Nor has the Bank treated the reforming of the civil service as a priority issue. Unlike the attention given to other public sector related issues such as fiscal deficit or public enterprise restructuring, the reform needs in the civil service have not been adequately addressed in either the Bank's lending or its ESW. It is not clear whether this was because the civil service problems were deemed not sufficiently serious, or because the Bank felt that this was a very sensitive area. Independent observers, however, feel that the civil service system remaining from colonial times has outlived its effectiveness and, reforms are needed at both the state-level and at the center. While the civil service issues may be more interactable to approach at the center, the Bank should expand its efforts to address them in its state-level lending.

3.24 As a matter of fact, the Eighth Plan envisaged a fundamental reorientation of the public sector, including the withdrawal of government from areas where no public purpose is served. Administrative expenditures were to be contained, fertilizer and food subsidies would be cut back, and higher user charges for public utilities would apply. There has been only limited progress in all these areas. For a meaningful reorientation of the government, a thorough review of government expenditures and staffing patterns is needed, which should be linked to a broader assessment of the ways in which government can withdraw from direct involvement in non-priority areas, reduce regulations and red tape, rationalize administrative structures and streamline bureaucratic procedures. Only through such an effort can operational economies be realized, outdated and less important programs be eliminated, and inefficient subsidies be dealt with. In fact, there has not been a credible effort to rationalize public expenditures. There has been no improvement in the mechanisms leading to expenditure decisions, both current and capital. Project evaluation systems which need refinement have not been changed. Many projects continue to be beset by serious implementation problems.

3.25 The Bank prepared a public expenditure review in 1993 (*India Public Expenditure Review*, Bank report no. 12570-IN), a nearly three-year effort, absorbing considerable staff time. It identified many of the same problems previously acknowledged by the government and recommended policy changes. The report was poorly received by the authorities and has never been formally discussed. The circulation of it was highly restricted. In fact, the key players in the government at the time expressed no knowledge of such a study to the OED mission. Not surprisingly, there exists little evidence that the 1993 review had any impact on the policies of the government.

3.26 No further attempt has been made in the Bank for a comprehensive review of public expenditures. However, with the growing interest and involvement in states-wide issues, expenditure restructuring was included in ESW for Orissa, Rajasthan, Andhra Pradesh, Karnataka, and most recently Uttar Pradesh. Expenditure restructuring issues were rather cursory and were dealt with usually in the space of a chapter. Also, as indicated earlier, expenditure issues have been formally incorporated into the aforementioned Andhra Pradesh and Uttar Pradesh projects.

3.27 The shift in the strategy that put the primary emphasis on expenditure restructuring on states is well conceived. States are the administrative units responsible for the provision of basic services in infrastructure, health, and education. The composition of investments, as well as operational expenditures, are of primary importance particularly in view of the extreme resource scarcity experienced by the states.

3.28 The need remains for expenditure restructuring in the public sector as a whole, and in the center in particular. It is understood that the central authorities would not encourage such a review, particularly if it is to make recommendations for expenditure composition. Therefore, the Bank should explore alternatives. The new “process” approach or “informal” reviews that are being tried by the Bank in some countries are not likely to be applicable to India.

4. State-Level Policy-Based Lending

Background

4.1 The Indian states have considerable responsibility in the provision of social and economic services, including education, health, power, irrigation, water, road transport, and urban services. To meet this responsibility, the states rely mainly on the revenue they themselves raise, mainly through taxes. Currently, two thirds of the states` revenue is raised locally, the remaining one third coming from the center in the form of revenue sharing and grants. After an encouraging effort following the 1991 reforms to reduce their chronic fiscal deficit, states` finances began to deteriorate in 1994. This is partly

due to sharp falls in the transfers from the central government. But the main reason is because states are having difficulty in containing wasteful expenditures, reducing the explicit and implicit subsidies and show reluctance to raise additional revenue.

4.2 Nonwithstanding the fiscal problems, with the changing political and economic environment in India, state-related issues are increasingly gaining visibility. In India, the center traditionally exercised control over the economy, and had a strong grip on the economic affairs of the states. Now the situation is changing. The recent liberalization efforts involve dismantling all sorts of controls, and call for a more open, market oriented economy. With reduced supervision from the center, the states are in a position to be in better control of their own economic affairs. On the political front, the end of single party domination has changed the political scene considerably. Recently, smaller parties representing ethnic, religious, and regional interests have been able to exercise power through a series of coalition governments. Coupled with the liberalization efforts, this has given rise to regional aspirations.

4.3 Against this backdrop, several states have launched fiscal and sector reforms in recent years. The state of Andhra Pradesh is leading in reforms. Their program incorporates reforms in key sectors, and attempts to achieve sustainable fiscal adjustment. The state of Uttar Pradesh now has a credible reform program. The state of Orissa pioneered the power sector reform, and has had a good record in public enterprise reform. The states of Karnataka and Rajasthan are likely to follow suit. Gujarat and Madhya Pradesh reforms are supported by the Asian Development Bank (ADB).

4.4 While such positive developments are taking place, there is growing concern about the widening trend of the existing interstate inequalities. This is being caused mainly by the recent acceleration of growth in high income states, which have benefited from the recent economy-wide reforms, because of superior initial conditions such as those in the areas of governance and infrastructure, as well as a more stable political environment. If this trend is left unchecked, it could have significant economic, social and even political implications

Bank Strategy

4.5 While the focus in the Bank's lending program to the states is of relatively recent origin, its importance in India's economy has long been recognized. The Bank's Assistance Strategy document for 1988 stated that "our strategy will be to continue to explore the extent to which the key issues can best be pursued at a state rather than a central level." The 1993 Country Assistance Strategy made a reference to state level support for "policy-based investment operations." The 1995 CAS focussed more strongly on state finances. The document observed that the areas under the responsibility of states, such as infrastructure, basic health, primary education, and anti-poverty programs, suffered from inadequate funding, and it was essential that the states' finances be strengthened. However, the major shift in the strategy came with the 1997 CAS. The document noted that with the change in the political scene, the states could pursue more independent economic policy. It also observed that some states were beginning major

economic reforms, while some large, poor states “seemed to be standing still or going backward.” The strategy adopted in the CAS was to support states committed to reforms.

4.6 Obviously state-level operations in India are not new to the Bank. What is different is that, unlike in the past, lending decisions would be based first and foremost on the strength of the states’ overall reform programs. Nonetheless, the Bank would continue to invest in specific sectors in those states that did not undertake comprehensive reforms but have an acceptable sectoral reform program and implementation record. The strategy in the 1997 CAS, however, called for stopping all new lending, if the policies in a given state ran “counter to the trends in the country.” It is expected that favoring the reforming states would demonstrate to other states the benefits of sound economic management and the Bank Group’s willingness to respond to their needs for assistance. An added incentive to the states, though not mentioned in the CAS, is that good performance would encourage direct investment not only from the residents of other states but also foreign investment, as recently demonstrated in Andhra Pradesh. At present, the Bank assistance to reforming states is treated as “additional” to whatever they are getting from the center. However, since the money is “fungible,” it is yet to be seen if the center will treat the funds from the Bank as truly additional. The Bank should closely monitor this aspect.

4.7 In line with this new strategy, the Andhra Pradesh Economic Restructuring Project was approved in June 1998, providing US\$543 million financial support for the State’s comprehensive reform program. It is a five-year multi-sector program with components in primary education, primary health, nutrition, rural road upgrading and maintenance, irrigation rehabilitation and maintenance, and public enterprise reform. There is also a fiscal reform component of the project which sets benchmarks for overall fiscal performance. The Andhra Pradesh ERP is a complex project, with a somewhat sophisticated design, which includes a large number of performance criteria for individual sectors. Shortfalls in performance in a given component would not stop new disbursements in others; however, non compliance to fiscal benchmarks in a broad sense would effectively stop disbursements in all sectors. This feature of the project leaves a great deal of flexibility to those who are supervising it. The latest supervision of the ERP project reveals that the project has been “broadly” on track.

4.8 The second state-level policy-based lending, in the amount of US\$251.3 million was approved by the Board in March 2000, for the state of Uttar Pradesh. The design of this project is different from the Andhra Pradesh project. The Uttar Pradesh project focuses mainly on fiscal reform and public sector restructuring.

4.9 **Issues in state lending.** Regarding the state-level lending approach, one hears differing views from official and unofficial quarters. Clearly, there is enthusiasm on the part of state officials who are anxious to receive direct financial support from the Bank which would help ease their financial constraints and allow them to start on some badly needed reforms. The authorities in the center also seem to support the state-level lending. If for no other reason, such lending does ease the demand on them by the states. However, there is not yet a clear understanding how the future adjustment operations

would be received by the central government if these programs involve fiscal adjustment. Nonetheless, the Cabinet has recently cleared the use of state lending to two states.

4.10 There is also some criticism of state-level lending outside the government circles, and in the states that are not the focus of Bank interest. The concern is that since the Bank can support only few states, the criteria for this type of lending should be made more transparent and public. Otherwise, there will be some backfiring which could potentially affect the image of the Bank. Some states have expressed their dissatisfaction because they are not included in the list. Clearly, the Bank's already established criteria governing state-level lending are not yet fully understood and appreciated. Additional efforts may be necessary to explain the new Bank strategy which emphasizes state-level lending. There is an additional concern that the need for assistance in social sectors may be even larger in "non-reform" states.

4.11 Despite these concerns, the Bank's focus on state-level lending is clearly in tune with the changing times and the needs of the country. Social sectors such as health and education as well as poverty alleviation are given the highest priority in the Bank's recent lending strategy for India. These are the areas that are under the responsibility of the states. However, for the states to effectively address the issues in these areas, they have to overcome the fiscal insolvency they are facing, and remove the institutional impediments. To the extent that the Bank assistance supports these changes, the state-level lending could prove an effective instrument.

4.12 However, it seems that one of the reasons for a shift of emphasis to the states is that the Bank does not have much "leverage" with the central government to make an impact on outstanding policy issues. It would be advisable not to drop these issues from the Bank's agenda just because the Bank now has a new vehicle in state-level lending. Even though direct lending to the central government may be out of the question, other instruments should be used to at least maintain a dialogue on issues the Bank considers vital. It is understood that the Bank keeps the informal channels open for dialogue, and in many cases this approach has proven to be effective. Nonetheless, analytically oriented, carefully crafted ESW, preferably carried jointly with or even solely by local research and policy institutes, could help keep the spotlight on areas in need of reform, and thus enable the Bank to broaden its support. The past experience also supports the importance of this approach. For example, the impact of the extensive and in-depth work on trade-related issues prior to 1991 was not immediate but eventually was substantial.

4.13 Another challenge the Bank may face in the near future has to do with the local administrations below the state level. The Constitutional amendments of 1993 and 1994 provide the local authorities legal status, and gives responsibility to the states to determine the devolution of expenditure responsibilities and tax powers. So far, the state governments have been slow in taking steps to enable local bodies, which number around 220,000, to execute the devolved functions. If the responsibility for some of the essential services, including education falls to local authorities in the future, the ramifications of such a change for Bank lending is obvious. If the Bank views this as a strong possibility for the near future, lending strategy for India will have to take it into account. This would require in-depth review and analysis of local government and municipality issues.

Ratings for Public Sector Management (1995-1999)

Outcome	Moderately Satisfactory
Relevance:	Substantial
Efficacy:	Modest
ID Impact	Modest
Sustainability	Likely

Annex 2

Institutional Development Impact of World Bank Projects in India
(Based on 1994 and 1997 PIF Surveys by OED)

	<i>Primary</i>	<i>Secondary</i>	<i>N/A</i>	<i>Total</i>
Projects with an ID focus	16	68	16	100

<u><i>NATIONAL CAPACITY</i></u>	<i>High</i>	<i>Substantial</i>	<i>Modest</i>	<i>Negligible</i>	<i>Not available</i>	<i>Not applicable</i>
<u>Economic management</u>						
Relevance	5	6	3	12	3	71
Efficacy	2	2	6	10	4	76
<u>Civil Service reform</u>						
Relevance	0	3	4	10	4	79
Efficacy	0	2	2	8	3	85
<u>Legal/regulatory system</u>						
Relevance	0	11	5	8	3	73
Efficacy	3	3	2	4	4	84
<u>AGENCY CAPACITY</u>						
<u>Planning/policy analysis</u>						
Relevance	13	33	12	4	1	37
Efficacy	0	15	25	20	1	39
<u>Management</u>						
Relevance	14	47	10	3	2	24
Efficacy	3	27	25	16	2	27
<u>Skills upgrading</u>						
Relevance	13	45	14	2	2	24
Efficacy	2	30	33	8	2	25
<u>MIS</u>						
Relevance	4	22	11	7	5	46
Efficacy	1	13	11	17	7	51
<u>Overall ID efficacy</u>						
	5	31	38	21	4	1
<u>Estimated impact</u>						
	2	28	44	24	2	

Governance Indicators (1995)

	<i>Percentage rank in developing countries (a)</i>	<i>India score (a, b)</i>	<i>Developing countries score (a, b)</i>
Government effectiveness and stability	44	3.4	3.7
Rule of law and business environment	65	3.1	3.1
General public administration	73	3.3	2.7
Public finance	73	3.5	3.1

Source: Annex Table 3.1(Summary), Draft Structural Policy Review Report on India.
(a) all figures are unweighted averages, (b) out of a possible 6 point as the highest.

Summary of Discussion at CAE Workshop on Public Sector Management and State-level Policy-based Lending

March 31, 2000

Some participants raised concern about the seriousness of the fiscal issues, in particular the rising public sector deficit. It was pointed out that, in addition to the factors mentioned in the paper, high interest payments played a role in the widening of the deficit. The need for a medium-term fiscal plan was emphasized: More analysis of the fiscal issues by the World Bank was suggested.

Some thought that the operations of the government were not sufficiently transparent, but were rather opaque. It was indicated that the public seemed not to know what was going on in a large number of public works undertaken by the government. No information was available regarding the nature and the cost of these projects. It was suggested that the World Bank ought to make transparency a precondition for project funding.

Privatization strategy of the government was brought into question. It was suggested that the supporters of privatization must also address the question of who purchased the equity in these firms. Under the present program, shares sold by one public sector unit was purchased by another. It was thought that there must be more effective ways to privatize.

On governance issues, some participants suggested that more studies are needed to determine the roots of corruption and where it exists. The importance of administrative reform was underscored strongly. Some suggested that the civil service in India was bottom heavy. Therefore, public employment needed to and could be reduced.

In the area of state-level policy-based lending, some participants thought that criteria used in the selection of reforming states were not sufficiently clear. A participant suggested that the states of AP and UP were not the real reformers. In determining the performance of the states one needed to look at not only the level but the efficiency of expenditures. Some states operated more efficiently than the others. The question was asked regarding why the World Bank was shifting the bulk of its support to the states where corruption is more widespread.

Some participants warned that the new focus on the states should not cause the problems of the center to be ignored. It was also suggested that the Bank ought to concentrate on the districts since many social issues are being addressed by the district administrations.

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