

Ten Years of World Bank Sub-National Policy-Based Lending to India: A Retrospective

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1. Introduction

About thirty percent of World Bank lending is provided to support policy reforms. The utility of this form of lending has been much contested. Econometric analysis (such as Dollar and Svensson, 2000) has cast serious doubt on the capacity of Bank loans to influence policy outcomes. To gain a more nuanced understanding of policy-based lending, the literature has turned to case-studies, such as the series of African cases (Devarajan, Dollar and Holmgren, 2001).

While most policy-based lending (PBL) supports central government policy reforms, a growing proportion backs reforms at the state or provincial level through sub-national policy-based lending (S-PBL). This was the approach taken in India. Over the ten-year period of 1997 to 2007, there have been 9 policy-based loans from the World Bank to 4 Indian states for USD 2.1 billion.

This paper tells the story of policy-based lending by the World Bank to the states of India over the last decade – the context that led to its creation, its impact on the ground and lessons learnt from its operation. It is a fascinating story, with successes, failures, and several near-misses and mid-course corrections. It is one of the largest policy-based lending experiences in the world, and certainly the largest at the sub-national level. It is revealing in what it teaches about the political economy of reform at the state-level in India and equally instructive in the context of the ongoing debate over the effectiveness of policy-based lending.

Since the authors of this paper have all been involved in the prosecution of sub-national policy-based lending in India, we cannot claim that this is an independent evaluation. It is, however, one based on a detailed knowledge of the unfolding of the S-PBL story over the last decade.

The paper is structured as follows. Section 2 outlines the role of the states in India's federation, and the emergence and subsequent easing of the state-level fiscal crisis of the late 1990s. Section 3 outlines the increasing emphasis given by the World Bank to state reforms. Both of these trends underlay the emergence of S-PBL as a critical Bank instrument in India over the last decade. Section 4 then provides a brief summary of the different experiences of the states which engaged in policy-based borrowing.

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Having set out the historical record in the first half of the paper, the second half turns to analysis. It is structured around four different topics (in Sections 5-8 below), presented below along with summaries of our conclusions.

- *Learning from success: did sub-national policy lending work?* This section asks what the evidence is that S-PBL has had a positive impact on state reforms. It is impossible to give a rigorous answer. Performance against fiscal targets was largely on-track. While non-PBL states also have achieved some fiscal adjustment, overall PBL states adjusted faster and further than non-PBL ones. We attribute this largely to the effective screening put in place which avoided the adverse selection problem often associated with policy-based lending, but also to the combination of lending, dialogue and monitoring which helped place reform higher on the political and bureaucratic agenda than it would have been otherwise. S-PBL states also recorded a number of important reforms in other areas. Most importantly, but harder to demonstrate, S-PBL was an important part of the Bank's "focus state" strategy which succeeded in its aim of creating a demonstration effect across India's states to build support for reforms.
- *Learning from failure: sub-national policy based lending and the power sector.* This section examines one area where S-PBL was only partially successful, and in some respects a complete failure, namely the power sector. Considerable learning in India went on during the last decade in relation to power sector reform. This required reconsideration of whether power reforms which had been propounded vigorously, and turned into conditions, in fact made sense. Distribution privatization came to be viewed as less attractive than improving efficiency in the public sector, and moving away from free power to agriculture in all but a tokenistic way came to be seen as politically impossible. The lack of success on these key power sector reforms demonstrates clearly the limitations of PBL in terms of leverage. It also teaches that any PBL program, even when undertaken in good faith on both sides, will involve considerable uncertainty, learning and, therefore, mistakes, often important ones. Disengaging from those mistakes will require difficult trade-offs between credibility and flexibility.
- *Learning from commonality: sub-national policy-based lending in a federation.* Policy-based lending has been used at the sub-national level in several countries now, including Pakistan, Mexico, Argentina and Brazil, but nowhere more than in India. The Indian experience confirms that S-PBL can be a useful tool for helping the central government impose fiscal discipline and promote reform among sub-national governments. Indeed, it may be easier to be selective and avoid adverse selection problems at the sub-national than the national level. However, the Indian experience also points to various potential risks, including that S-PBL could actually undermine fiscal discipline. This was averted in India by including sub-national lending in global borrowing limits, and over time restricting its use to debt-swaps. The discretion which is embedded in the PBL approach can undermine a rules-based approach to federalism: this suggests that PBL conditions will differ much less across states than countries. S-PBL can also be seen as discriminating against poorer or lagging states,

yet Indian and global experience both suggest that PBL lending to lagging states will increase risk. Finally, the decision about whether to engage in states individually (retail) or through a central government scheme (wholesale) is a political one, and the right response will vary from country to country. In India, linking Bank policy-based lending to the central government fiscal reform scheme, but not integrating the two, made the most sense.

- *Learning from diversity: determinants of sub-national policy based lending success.* This section asks why some states did so much better at accessing sub-national policy-based loans than others. Political-economy factors, in particular the stability, strength and reform-orientation of the state-level government, emerge as the underlying determinant of S-PBL success, as they have in other studies of policy-based lending at the national level.

Finally, a note on our use of the term ‘policy-based lending’ which we define to mean lending based on an agreed overall (not purely sectoral) policy framework. The policy-based lending literature (which we review briefly in section 5) is focused on adjustment lending (lending which is quick-disbursing and not earmarked for any particular sector), since this is overwhelmingly the modality used for policy-based lending, and the two terms are often used synonymously. Since in India the first S-PBL was in fact not an adjustment but an investment operation² (i.e. with disbursements over several years and earmarked for various sectors) we use this more general definition of policy-based lending to refer to lending based on an agreed overall policy framework, of which, in the case of India, adjustment lending is a large sub-set (8 of the 9 S-PBLs).

2. State reforms and the fiscal crisis³

States in India play an important role in devising and implementing economic and development policies. Under the Indian Constitution, state governments are assigned significant responsibilities in sectors such as agriculture, industry, infrastructure, education, health and social welfare. India’s state governments are key financiers of a number of areas critical for enhancing growth and reducing poverty. In 2000, 57 per cent of India’s total government capital expenditure was financed by the states, as was 97 per cent of irrigation maintenance, 39 per cent of road maintenance, 90 per cent of public health expenditure, and 86 per cent of public education expenditure. In fact, India’s states are responsible for a higher proportion of general government spending than in any other developing country, except China.

² Broadly speaking, World Bank lending comes in two forms: investment lending and adjustment (also called development policy or budget support) lending. A typical investment loan has 5-7 year duration, and it finances goods, works, and services in support of economic and social development sectoral projects. On the other hand, an adjustment loan has a relatively shorter duration (1 to 3 years), and it provides quick-disbursing financing to support policy and institutional reforms. Over the past two decades, adjustment loans have accounted for about 30 percent of total Bank lending. Though adjustment lending was re-labelled development policy lending by the Bank in 2004, we stick with the earlier terminology throughout to avoid confusion.

³ This report draws on and updates World Bank (2005).

One of the striking features of Indian states prior to the 1990s was the relative uniformity of policies across states. State-level policies were mostly decided by the Center. Two events changed this: first, the big push starting in 1991 to liberalize the trade and investment regime led to increased competition between states to attract business and investment; second, the 1990s witnessed an acceleration in the decline of the once nationally-dominant Congress Party and the emergence of regional political parties.

State reforms were also catalyzed by the state-level fiscal crisis of the late 1990s. A slow secular deterioration in fiscal performance over the 1980s and 1990s was catalyzed into a state-level fiscal crisis by the Fifth Central Pay Commission pay awards in the late 1990s. State revenues declined over the 1990s from about 12% of GDP to 10% of GDP. An increase of nearly 30% in real wages for state civil servants beginning in 1997 led to a sharp deterioration in state-level fiscal performance in the late 1990s – deficits rose, the state-level debt stock, which had been declining, started rising rapidly, and off-budget liabilities also grew quickly. There was also a liquidity crunch among state governments, who started finding it difficult to pay bills, and even salaries. *India Today* in its 14 February 2000 issue titled its cover story “States Going Broke: Bankruptcy Stalking a Collapse of Public Services”

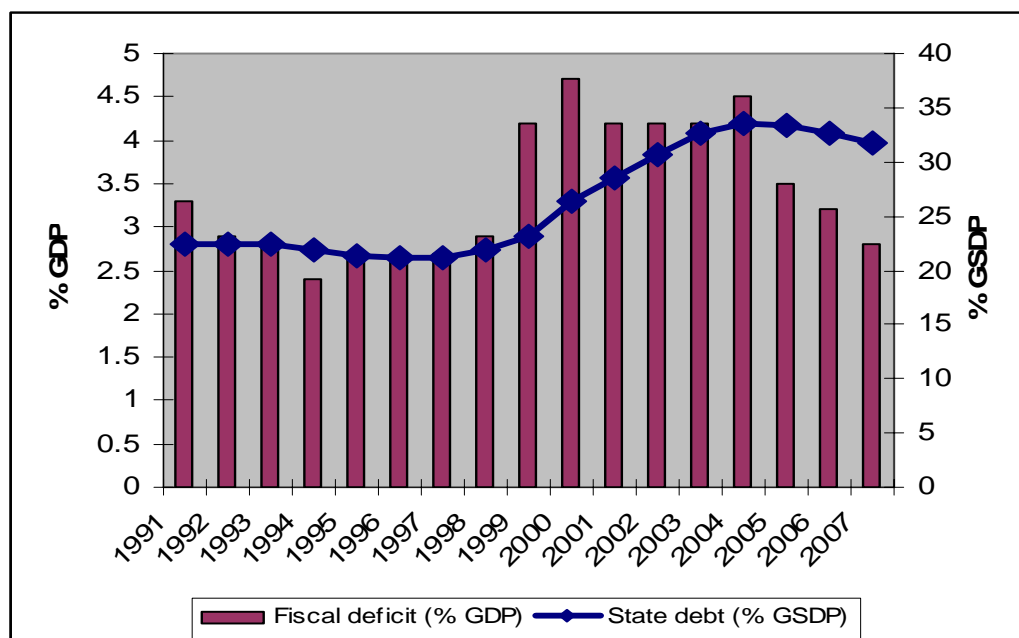
There is a close parallel with the balance of payments crisis of 1991 in terms of impact: just as that national crisis gave rise to a decade of central government reforms, so the state-level fiscal crisis gave enormous impetus to reforms at the state level.

The central government also started taking state reforms more seriously, in particular state fiscal reforms. The weak coalition that ruled India during 1996-99 limited the center’s capacity to influence state level policy. The center encouraged the World Bank’s to engage in policy dialogue at the state level. In 2000, India’s Eleventh Finance Commission, which had the task of formulating the rules by which central revenues would be distributed to state governments for the period 2000-05, was asked by the Government of India to “draw a monitorable fiscal reform programme” and link part of the Commission’s grants to progress under this programme. The result was the Fiscal Reform Facility, a fund of Rs 10,000 crore (about \$2.2 billion), which was made available to states during 2000-05 to reward improvements in their fiscal position. The Twelfth Finance Commission, for the period 2005-10, included provision for much more extensive fiscal-performance-linked grants and debt relief, now being implemented through a large Debt Consolidation and Relief Facility.

Looking back, much has been achieved. Nearly all state governments speak the language of reform, including the ones governed by the Communist Parties. Some reforming governments have been re-elected. Most have been defeated (as most one-term governments are in India), but opposition parties, once elected, have often taken over the mantle of reform. The state fiscal position is much improved relative to the late nineties. As Figure 1 shows, at the aggregate level state fiscal performance started to improve in 2004-05. In 1998-99, the combined state fiscal deficit jumped from under 3% of GDP to over 4% and it stayed between 4 and 5% of GDP till 2003-04. In 2004-05, it fell to 3.5% and in 2005-06 to 3.2%. In 2006-07, the combined state fiscal deficit is budgeted to fall

to under 3%, and the primary and current deficits are budgeted to be virtually eliminated compared to their 2-3% level since the late nineties. State debt has started to decline after an inexorable climb since the mid-nineties.⁴

Figure 1 State deficit and debt, 1991-2007



Source: RBI (2006).

Notes: 1991 is the fiscal year 1 April 1990-31 March 1991 for the fiscal deficit and is 31 March 1991 for the state debt. 2006 are revised estimates, and 2007 budget estimates.

This fiscal correction has come about primarily through revenue enhancement, with revenue receipts increasing from 10.9% of GDP (the average for 1995-2000) to 12.9% of GDP in 2005/06.⁵ Central transfers have increased by 1.2% of GDP over this period, and the states' own revenues by 0.8% of GDP. State revenues have increased rapidly due to: a significant growth acceleration; the Twelfth Finance Commission which significantly increased funding for the poorer states; central tax reforms, which improved central tax buoyancy; and a number of state reforms, most notably the introduction of a state-level VAT in 2005. The effect of the one-time increase in wages due to the Fifth Pay Commission also withered over time and, with real wage restraint and restrictive hiring policies, the wage bill fell from a high of 4.5% of GDP in 1999/00 to 3.2% of GDP in 2005/06.⁶

⁴ The central fiscal deficit has also come down from 6.2% of GDP in 2001/02 to an estimated 4.1% in 2005/06.

⁵ RBI (2006) Table 6, p. 18

⁶ RBI (2006) Table 9, p. 22

3. The World Bank and state reforms

This section traces the shift by the World Bank over the course of the 1990s towards promoting state reforms, and locates the rise of S-PBL within this broader trend. A start was made with the 1995 Country Assistance Strategy (CAS) for India. Whereas the previous two CASs (1992 and 1994) had focused on supporting central government reforms, this CAS argued the case for more attention on state-level sectoral and fiscal reforms. The shift was a modest one, especially by what was to come in the later years. The Bank proposed to undertake more state fiscal and sectoral analysis, and to pay greater attention to the financial sustainability of Bank lending (much of which was to the states).

The real change came with the December 1997 CAS. This led off, as the first of a five-prong strategy, with a “focus on reforming states:”

As the focus of the reforms has shifted to the states over the past few years, the Bank Group’s assistance strategy is itself being reoriented to focus mainly on those states that have chosen to embark on a comprehensive program of economic reforms. (p.9)

From now on, Bank programs in reforming states would be based on a common understanding not only in sectors the Bank might be supporting, but on the “general policy framework” in the state. The share of Bank lending going to support central rather than state programs was proposed to plummet from 61% to 27%.

The shift to the states made good sense given the developments outlined in the previous section. The concentration of Bank effort in a few rather than many states had four main justifications. First, along the lines of the arguments then being developed in the Bank that aid was most effective when used in a good policy environment (Burnside and Dollar, 2000), it would ensure more effective use of Bank funds. Second, it would have a demonstration effect: signaling to other states to the importance of reform, both for its own sake, and to attract Bank financing; and supporting reforms in a few states which, once proved, could be rolled out to others. Third, in a vibrant democracy such as India it made more sense to support willing reformers than to try to cajole unwilling laggards. Fourth, it was a form of selectivity.

There were three immediate, public manifestations of this shift. First, in 1997, the Bank halted preparation of a rural water supply project in Punjab in response to the announcement that the government of that state was introducing free power and irrigation water for farmers. These totemic populist measures did not directly impact on rural drinking water, but the Bank’s refusal to go further with the project was a clear demonstration of its willingness to take into account the “general policy framework” when making lending decisions to states. Second, the West Bengal Government refused to have undertaken, or to undertake itself, a fiscal analysis of the type completed for several other states. As a result, in 1999, three projects under preparation in that state were shelved.⁷ Again, the same signal was being sent.

⁷ Nikhil Mookerju, “The Poverty of Wisdom,” *Outlook* August 30, 1999.

Third, the Government of Andhra Pradesh was selected by the Bank as its initial focus state. Famously, the Chief Minister of AP, Chandrababu Naidu, the pioneer among state reformers, sought a last-minute appointment in Delhi with the visiting World Bank President Wolfensohn, whose visit to India included several states but not AP (Naidu, 2000). Under Naidu, AP became one of the first states to promote reform and fiscal adjustment, and the first to reach out to the World Bank for assistance in this endeavour. The culmination of the Bank-Andhra partnership was the Bank's first S-PBL to India: the Andhra Pradesh Economic Restructuring Project (APERP), a massive multi-sectoral project, underpinned by an agreed multi-year fiscal framework, with a total loan/credit value of \$540 million, was approved in May 1998. AP also benefited from a number of other investment projects. In 2000, the Bank reported that it had committed \$1.5 billion to the state.

The 'focus state' strategy as it was called then, continued to be rolled out. It was endorsed by an independent evaluation of the World Bank program in India (OED, 2001), and re-endorsed by the 2001 CAS (World Bank, 2001). This listed three focus states: UP and Karnataka, alongside AP. The major change in the 2001 CAS relative to 1997 was the official endorsement of adjustment lending as a key instrument to pursue the focus state strategy. When AP was selected as the first focus state, S-PBL had just emerged worldwide in the Bank, with the first loan to an Argentine province in 1996. AP's experience had already confirmed the global finding that adjustment lending was a better instrument for policy-based lending than investment lending, and in 1999, S-PBL was agreed to as an instrument by the Government of India. World Bank S-PBL commenced in India in March 2000 with a \$250 million loan/credit to the state of Uttar Pradesh.

The 2001 CAS gave great emphasis to the importance of S-PBL. If things went well (if the 'high case scenario' held), adjustment lending would as much as \$500-900 million a year – one-sixth to almost one-third of an envisaged best-case total annual lending of \$3 billion to India.

The focus state strategy remained in place during the 2001 CAS period. Adjustment lending never took off to the extent envisaged, but there was a steady flow of about one adjustment loan a year, or around \$150 million a year. UP's reforms, especially in the power sector, faltered in a context of political instability and frequent leadership changes, and the state's partnership with the Bank weakened. Tamil Nadu (TN) joined AP and Karnataka as focus states. A very significant commitment of resources, covering both adjustment and investment lending, was made to these states. A newspaper headline from February 2000 read '*Karnataka set to clinch Rs 10,000 crore [\$2.2 billion] World Bank deal*'.⁸ Even allowing for journalistic exaggeration, these were significant sums, designed to catch the attention of state politicians, both those receiving the funds and those missing out.

The fact that by 2001 the Bank had three southern states as its main focus states epitomized as much as anything else the problems which the focus state strategy had

⁸ *Business Standard*, February 2, 2000.

given rise to. While these states (with the exception perhaps of TN) were poor ones, they were all considered to have good growth prospects: to be leading rather than lagging. This concern – that a focus on reforming or performing states would mean a neglect of lagging states – had been raised from the time the focus state strategy was first enunciated.⁹ The 1997 CAS had straightforwardly noted that lending would end “in states where commitment to reform does not exist. These may include some of the poorest states in the country.” (p.iii). The adoption of Uttar Pradesh as a focus state had helped to mitigate this criticism and the 2001 CAS included a commitment to give preferential treatment to poorer, reforming states. This was not seen to have delivered sufficient results, however. With the growing concern that poorer states were being overlooked, the 2004 CAS (World Bank, 2004) proposed a change in tack:

Though the Bank Group strategy will retain an essentially reform and performance based approach to the states, it will also change in ways that are intended to go as far as possible in opening up new engagements with these largest and poorest states.

The 2004 CAS proposed two main new ways to give more emphasis to poor states. First, to dedicate greater resources to engagement with them, and to provide technical assistance. Regardless of performance, more resources for these activities were promised for the four poorest states of Bihar, Jharkhand, Orissa and Uttar Pradesh. Second, a greater spread of resources was promised for states that could develop reform plans or meet good practice guidelines for at least the sector concerned. No longer would decisions on investment projects take into account the “general policy framework” of the state; rather proposals from all states would be considered on their own merits.

The corollary of this move away from a focus state approach was the much greater importance given to adjustment lending as a vehicle for engaging with reforming states. S-PBL would not only continue (though a more realistic target of 15% of total lending was set), but, rather than being combined with a package of sectoral investment loans, it would now be the sole instrument for supporting a state’s overall reform program.

The rapid rise in importance given over this period to S-PBL in general and state-level adjustment lending in particular is evident. We turn now to examine the results of this experiment.

4. State experiences with policy-based lending

As Table 1 shows, since May 1998, there have been 9 S-PBLs from the World Bank to various Indian states:¹⁰ the AP Economic Restructuring Project, a \$540 million multisectoral investment loan; and eight subsequent adjustment loans, for a total of \$1.5

⁹ It was often referred to as the ‘What about Bihar?’ question, with Bihar being India’s poorest and in the opinion of many worst-governed state.

¹⁰ Other donors including Asian Development Bank (ADB) and the UK Department for International Development (DfID) have also been involved in S-PBL in India, though on a smaller scale than the World Bank. The ADB has lent to four states (Gujarat, Madhya Pradesh, Kerala and Assam), but typically on the basis of only one operation per state. DfID has cofinanced Bank and ADB policy-based operations in AP, MP and Orissa, but no longer does so. The discussion here is limited to the World Bank operations only

billion, an average of 1 loan (or \$193 million) a year. The adjustment operations have all, but the last two, been one-tranche operations based on upfront actions: that is, the loans have been immediately and fully disbursed to the state upon approval, which in turn has been based on the completion of a number of pre-identified reform actions. This pattern of a series of one-tranche operations is now the most common worldwide in Bank adjustment lending, and is often referred to as programmatic adjustment lending. Consequent on new guidelines issued by the Government of India in October 2005, the last two operations (the third to AP, and the second to Orissa) are two-tranche operations, with some portion of the loan value conditional on a second set of milestones being met.

Loans for India's states are disbursed from the Bank to the Government of India. The latter then converts the amount into local currency and passes it on to the state concerned. The adjustment loans have typically been a 50-50 or 67:33 blend of IBRD loans and IDA credits, so one part (IBRD) is passed to the Government of India as a commercial loan, the other part (IDA) as an interest-free loan.¹¹ Until 2005, this amount was transferred from GoI to the states as a 70% loan and 30% grant. Following the recommendations of the Twelfth Finance Commission, the on-lending terms were changed to be "back-to-back" with Bank terms, with the foreign exchange risk to be borne by the borrowing state governments.

The scope of the reform programs being supported by S-PBL has varied over time and across states. Over time, the scope of the programs has grown as Table 1 shows. The early operations were focused mainly on fiscal reforms, in particular on establishing and adhering to a multi-year fiscal framework. This was a natural focus given the states' fiscal crisis in the late 1990s. Subsequent operations, especially to the same state, had an expanded scope which included structural reforms to improve the investment climate and accelerate economic growth, and in some cases, governance reforms to improve public service delivery.

From the first, the Bank S-PBLs also addressed, apart from the need for fiscal adjustment, public expenditure management reform to promote expenditure efficiency and restructuring of public enterprise reform, including privatization. Subsequent operations, starting with UP in 2000, retained these three focus areas, often went into them in greater depth (for example, starting with the UP operation, financial accountability became a much more important part of the public expenditure management agenda), and added others. The UP operation was the first to tackle cross-cutting governance issues, such as civil service reform and measures to combat corruption, and to add an explicit focus on poverty: the focus in UP and many of the later operations was on improving monitoring, but some later operations added to this an emphasis on improving social safety nets. The Karnataka operation in 2002 also included a focus on investment climate reform: measures to make it easier to set up and run a business. The second AP adjustment loan in early 2004 added three specific sectoral foci: power, health and education. Loans undertaken since then have basically had the same extensive coverage as this second AP operation.

¹¹ The last two loans have been a 70-30 IBRD-IDA blend.

This consistent expansion of the reform program could be criticized as mission creep, and vulnerable to the standard criticism of adjustment lending that it is too often over-ambitious and lacking in selectivity. However, an attempt to retain selectivity and focus was made by reliance on a small number of triggers: actions selected from the larger policy matrix and specified as pre-requisites or “upfront actions” for the operation. As Table 1 shows, if anything, the number of triggers has been on a downward trend.¹² The expanding agenda can also be positively interpreted as a response to the improving fiscal position, and the need to move the reform agenda forward. In the midst of a fiscal crisis, fiscal stabilization had to receive top priority; as measures were put in place to deal with this, it made sense to turn to other constraints to development.

Within and across these broad thematic areas, loans were tailored to the specific circumstances and interest of the different states. The Bank encouraged but did not enforce other states to adopt reforms adopted in one. Privatization and restructuring of state owned enterprises featured in all operations, but were much more important in AP and Orissa than in Karnataka or Tamil Nadu.

The remainder of this section tells the story by state, in order of the states’ receipt of their first loan. The focus on this section is on the political context within which the loans were made, and on the factors which allowed or inhibited movement from one lending operation to another.

(a) Andhra Pradesh

AP’s fiscal position deteriorated sharply over the mid-1990s. The state government supplied highly subsidized rice through the public distribution system, and placed a prohibition on liquor consumption, which deprived the state of an important source of revenue. The new government which came to power in 1995 led by Chandrababu Naidu decided to reverse both these policies, and sought Bank support for its reform program driven by an ambitious vision of taking AP to the level of development of East Asian countries by the year 2020.

The Andhra Pradesh Economic Restructuring Project (APERP), approved in 1998, was a large multi-sector investment loan predicated on a medium-term fiscal framework. APERP got off to a bad start. Although the fiscal situation had improved during 1996 to 1998, prior to loan approval, this could not be sustained in the run-up to the 1999 elections, and the state’s fiscal indicators went badly off-track, missing the agreed targets by a considerable amount. Naidu was re-elected in 1999: though the margin of victory was small, the result gave an enormous boost to state-level reform prospects around the country.

¹² Worldwide, there has been a decline in the number of triggers or conditions from above 30 in the mid-1990s to about 11-12 in FY05 (World Bank, 2005b and 2006). This is similar to the trend seen in India if the first adjustment loan (to UP) is taken as the starting point or even if the APERP is taken as the starting point, bearing in mind that this investment operation also had dozens of sectoral conditions, not included in Table 1’s trigger count.

Table 1: Basic Information on Policy-Based Lending to Indian States by the World Bank

No.	FY	Date	State	Name	Modality	Amount	Policy reform content of the operation	No. of triggers
1	1998-99	May 1998	AP	APERP	Investment	\$540m	Fiscal, PEM, PE	11
2	1999-00	March 2000	UP	UP Fiscal Reform and Public Sector Restructuring	Adjustment	\$250m	Fiscal, PEM, PE, governance, poverty	37
3	2000-01	May 2001	Karnataka	Karnataka Economic Restructuring	Adjustment	\$150m	Fiscal, PEM, PE, governance, poverty, IC.	12
4	2001-02	February 2002	Karnataka	Second Karnataka Economic Restructuring	Adjustment	\$100m	Fiscal, PEM, PE, governance, poverty, IC	12
5	2001-02	February 2002	AP	AP Economic Reform	Adjustment	\$250m	Fiscal, PEM, PE, governance, poverty,	14
6	2003-04	February 2004	AP	Second AP Economic Reform	Adjustment	\$220m	Fiscal, PEM, PE, governance, poverty, IC, power, health, education,	14
*	2003-04	March 2004 (withdrawn from Board)	Tamil Nadu	Tamil Nadu Economic Restructuring	Adjustment	\$250m	Fiscal, PEM, PE, governance, poverty, IC, power, reform management	15
7	2004-05	November 2004	Orissa	Orissa Socio-Economic Development Program	Adjustment	\$125m	Fiscal, PEM, PE, governance, poverty, IC, power, health, education,	10
8	2006-07	August 2006	Orissa	Second Orissa Socio-Economic Development Program	Adjustment	\$225m	Fiscal, PEM, PE, governance, poverty, IC, power, health, education,	11 in first tranche and 2 in second
9	2006-07	January 2007	AP	Third AP Economic Reform	Adjustment	\$225m	Fiscal, PEM, PE, governance, poverty, IC, power, health, education,	7 in first tranche and 3 in second

Notes:

* This loan to Tamil Nadu was prepared and negotiated but not approved. See the text for more detail.

1. The fiscal year is the Bank one, from July to June.

2. An investment loan is a loan whose proceeds are disbursed over a number of years, and earmarked for particular projects or expenditures; an adjustment (or development-policy or budget support) loan is one which is disbursed in a small number of tranches (often only one) and whose proceeds are not earmarked for any particular use.

3. Policy reform content of operation based on policy matrices associated with each of the adjustment operations, and with the non-sectoral loan conditions for the first AP investment operation. PEM stands for public expenditure management, PE for public (state-owned) enterprise, IC for investment climate (industrial or agricultural deregulation), poverty for poverty monitoring and safety net reforms. The way the policy content is presented in this matrix does not necessarily reflect the way it is presented in the various policy matrices, since terminology has been adjusted in some cases to ensure comparability across the operations.

4. Triggers are the prior actions specified as pre-requisites for the processing of the operation. Since APERP is not an adjustment loan, triggers are calculated as the number of assurances related to the area of fiscal policy (10) plus one for public enterprise reforms (the six separate assurances in this area are aggregated into one).

APERP continued to disburse, and finally closed in 2007. Its fiscal framework was superseded by those adopted in subsequent adjustment operations. Clearly, a more flexible framework was needed to support reforms. Once sub-national adjustment lending became available for use in India, AP was a natural candidate, and in February 2002, almost three years on from APERP, the state became the third to receive an adjustment loan from the Bank. A new fiscal framework was devised. Though the state again struggled to meet its fiscal targets, the deficit started to fall from 2001/02 (Table 2). A second adjustment loan followed in February 2004, just a few months before state elections.

Naidu's party lost the state assembly elections in 2004. The Congress Party fought elections on a platform of free power for farmers, and implemented it immediately after coming to power, an act which, as noted earlier, had led to the Bank's "blacklisting" of Punjab in 1997. For a time, the dialogue around future adjustment loans was suspended. In other areas, however, the Congress Party seemed to be just as reform minded as Naidu. After some very minor modification of the free power policy by the state government (a small tariff was to be charged to the richest 5% of farmers), adjustment loan preparation resumed, and the Bank approved a third adjustment loan/credit in January 2007.

Adjustment lending to AP was politically controversial in its early days, especially because the reform program of the AP government was itself controversial: in a large protest in 2000 against a large power tariff hike, two protesters were killed (Kirk, 2005). Naidu was regularly criticized by the state opposition for "selling out" to the World Bank. Yet, the transition to a post-Naidu era went remarkably smoothly and, of all the Bank-state relationships, the one with AP has been the most enduring and influential.

(b) Uttar Pradesh

Uttar Pradesh (UP) is India's largest state, with a population of 166 million. UP is perhaps the best example of how the fiscal crisis forced states onto the reform path. A World Bank (1998) report on UP concluded that the state faced a "fiscal crisis of unprecedented proportions." This prompted the state's financial managers to approach the World Bank for assistance to tide over the crisis. With the agreement in 1999 for the introduction of sub-national adjustment lending into India, in April 2000 UP became the first Indian recipient of a sub-national adjustment loan, the Uttar Pradesh Fiscal Reform & Public Sector Restructuring Program (UPFRPSR).

UP lacked a stable political leadership, with an average tenure for its chief ministers of less than two years in the 1990s. The initiation of fiscal reforms in 1999 was spearheaded by a small group of senior bureaucrats, who, with support from the Bank, convinced the then political leadership that additional development spending would have to come from improved revenue performance and expenditure reforms, not from additional borrowing.

Subsequent operations did not materialize, mainly due to the lack of political stability. Both the political and the bureaucratic leadership changed soon after the first operation.

Although one main party led the ruling coalition from 1998 to 2002, it was under three different leaders. The fiscal situation, as reflected by budgetary finances, improved until 2002-03, then went off-track and deteriorated, but has since improved again to the extent that the state runs a current account surplus. But the envisaged civil service reforms never really took off. More importantly, the power sector's performance deteriorated, with mounting losses that added to GoUP's contingent liabilities. While the power sector was not explicitly part of the adjustment operation,¹³ progress in improving that sector's performance was considered by the World Bank to be a pre-condition for moving forward with subsequent operations.¹⁴

UP was a surprising choice as the pioneer for state-level adjustment lending. If AP was the paragon of a new-style reforming state, UP was the archetype non-developmental state, perceived as highly corrupt, lacking stable leadership, and dominated by caste politics. Yet UP was the only option at the time for moving forward with adjustment lending. AP had only just received its large investment operation, and there were no other "reforming" states queuing at the door. The UP operation was controversial within the Bank, but supported in India, perhaps because UP was viewed as trying to do something, because of the state's poverty, and because of its national, and political, importance.

For some, the failure of UP to move beyond its first operation was vindication of the position that the first UP operation should never have been proceeded with. For others, it was simply ahead of its time, and set the precedent for subsequent adjustment lending to other poor states, such as Orissa and, as is now planned, Bihar. Prospects for UP may have recently improved. In 2007, UP voters elected a government with an absolute majority, for the first time in almost two decades. After a gap of 7 years, the central government has requested the Bank to initiate adjustment lending to the state once again.

(c) Karnataka

The same election which saw Naidu re-elected in Andhra Pradesh in 1999 also saw a change of government in Karnataka, with the return to power of the Congress Party under Chief Minister SM Krishna. Karnataka had a dialogue with the Bank prior to the election of Krishna, but it had never led to a large lending relationship. One of Krishna's first moves was to meet with the World Bank Country Director. The element of competition with AP was clear and often explicit. Karnataka felt that AP was threatening it, and that it was in danger of being left behind. The Chief Minister promised reform on a number of fronts, and Karnataka quickly became another focus state of the Bank. In return, the Bank promised significant assistance. A range of areas were discussed, one of them adjustment lending, through the Karnataka Economic Restructuring Loan/Credits.

The initial volume discussed for the first adjustment loan was \$250 million. This was, however, reduced to \$150 million when in 2001 the state government refused to

¹³ A separate investment loan to support restructuring of the power sector in UP was approved by the World Bank at the same time as the adjustment operation, i.e., in April 2000.

¹⁴ The then Country Director was quoted in the media as stating that "the World Bank stands ready to finance the cost of reforms in the power sector, but we are not willing to finance the cost of not reforming".

implement an agricultural power tariff increase recommended by the state's Electricity Regulatory Commission. The power sector was not explicitly part of the adjustment loan series, but, as in UP, was taken into account when considering when and whether to move forward. The reason given by the Government for not moving forward with the tariff increase was heavy rains which had led to bumper harvests and depressed agricultural output prices. Ironically, the next two years were ones of drought, which made it even more difficult to implement power tariff adjustments to farmers with electrically driven pump sets.

The remaining \$100 million was held over to a second loan with another set of triggers in the same thematic areas as the first. This loan was designed like a second tranche of an adjustment operation, to be achievable in a matter of months rather than years. All of the triggers bar one were achieved on time, resulting in Board approval just 9 months after the first operation, and disbursement within the same (Indian) fiscal year.

While this remains a record for the smallest gap between two of the state-level adjustment operations, the second operation was to be Karnataka's last. It turned out that fiscal performance in 2001-02 was worse than expected, with a fiscal deficit of 5.4% of GSDP instead of the targeted 4.3%. Power sector reforms also went much slower than expected. By 2002-03 the fiscal numbers were back on track. While the Bank argued that this course of events justified delay of the next in the envisaged series of annual Karnataka operations from 2002-03 to 2003-04, the Government of India was not prepared to allow the operation to go ahead even then, given that Karnataka had not met its Fiscal Reform Facility targets. Thus, although negotiations for the third KERL were planned at the same time as those for the second AP adjustment loan in late 2003, they did not take place.

In early 2004, state elections saw the defeat of Krishna and his Congress government. Unfortunately, neither of the various opposition parties received an outright majority, and the state entered into a period of unstable and weak coalitions. For a time, Congress returned to power as a minority coalition party, but then in 2005 another coalition took over, and Congress was relegated to opposition.

By 2004, it was clear that Karnataka's fiscal numbers were looking very good indeed, and the Government of India re-authorized preparations for the third state adjustment loan. The Bank took the position, however, that recent progress in the power sector had not been adequate to justify moving forward, and so again the operation was postponed. Meanwhile, political instability and infighting at the state level meant that the reform agenda lost some of the traction it had earlier, and the Bank-Karnataka engagement weakened.

(d) Tamil Nadu

The Bank's engagement with Tamil Nadu, like that in Karnataka, was initiated by a change in government. Following her election in 2001, the new Chief Minister J. Jayalalithaa approached the Bank for assistance. Andhra Pradesh and Karnataka are both

neighbours of Tamil Nadu, and again one sees the forces of competition and demonstration at work. The Bank responded positively to Tamil Nadu's approach, and work on a number of projects began, including an economic report to be followed by an adjustment operation. Three years later, in May 2004, the first of an envisaged series of adjustment operations had been prepared and negotiated and was ready for Board approval.

Unfortunately, just at this time, national elections were held in India, concluding in early May 2004. Tamil Nadu's ruling party did very badly in these, winning not a single seat in the state. This effectively wiped out the party at the national level, and boded poorly for the next round of state elections in 2006. The Chief Minister, seeking to recover her popularity, rolled back a number of reforms, including those on the basis of which the Bank loan had been prepared. These were announced on the very day the project was to be presented to the Bank Board, May 18, 2004, and it was only the 9.5 hour time difference between India and Washington that ensured that the announcements in India preceded the Board's discussion in Washington. Bank management decided to pull the operation from the Board that morning.¹⁵

The Bank probably had little alternative if it was to preserve its credibility. Not only did the measures reverse some of the agreed upfront actions for the loan, in particular by moving backward on food subsidy reductions and re-introducing a "free power" regime in agriculture (following the case of Punjab in 1997, widely seen as a Rubicon-issue). More broadly the announcement by the Chief Minister was interpreted and reported by many as "nullifying the entire economic and fiscal reforms process she set in motion after assuming power."¹⁶

This dramatic turn of events effectively brought an end to Tamil Nadu's adjustment loan prospects. Worried by her election prospects two years' hence (and rightly worried as it turned out; Jayalithaa's party, the AIADMK, was trounced at the 2006 state elections), there was no appetite to reverse or even engage on some of the roll-back areas. Though Tamil Nadu's fiscal position continued to improve, it was too late for the state and Bank to engage on a new or revised reform program. While a number of investment projects went ahead, there was to be no adjustment loan for the state.

(e) Orissa

Initiation of policy reform in Orissa was, as in UP, prompted by an acute fiscal crisis. Orissa was the poorest and most highly indebted among Indian states at the turn of the century. Interest payments, salary and pensions consumed 100 percent of the state's total revenues in 1999/00, leaving negligible room for development expenditure. The historical and structural roots of the crisis included an excessively large and unaffordable civil

¹⁵ It was said to be the first time in the Bank's history that a project had been pulled from the Board on the day of intended presentation.

¹⁶ V. Jayanth, "Jayalithaa chooses the easier option," *The Hindu*, Wednesday May 19, 2004
<http://www.hindu.com/2004/05/19/stories/2004051912120400.htm>

service, an excessive number of loss making public enterprises and inefficient high schools and colleges claiming government grants, and a large debt overhang.

The World Bank was engaged in policy dialogue with the Government of Orissa (GoO) since the mid-nineties. Orissa was the first state to embrace power sector reform and privatization. Based on an economic report completed in 1999, there was some hope that Orissa would follow UP to be the second adjustment state, a supercyclone caused extensive damage to the state in October 1999 and shifted priorities and high-level political attention away from reform in the direction of immediate rehabilitation and reconstruction.

The present Orissa government, headed by Chief Minister Naveen Patnaik, was first elected in early 2000, at the time of the fiscal crisis. It signed a Memorandum of Understanding with the Government of India in 2001, to undertake fiscal reforms in exchange for short-term financing. Starting in 2001, GoO also approached the World Bank once more for a structural adjustment loan.

It took another three years for GoO to demonstrate a sufficiently strong commitment and track record in addressing its fiscal problems. The first adjustment operation, the Orissa Socio-Economic Development Loan/Credit (OSEDL-I) amounting to \$125 million, was approved in November 2004, by which time a significant fiscal correction had already been achieved.

By the time of the first operation, the Naveen Patnaik government had also been returned to power (in May 2004), sidestepping the anti-incumbency which dogged most of his counterparts in other states. Victory of the incumbent in Orissa, at a time when the majority of incumbents were losing in Indian states, strengthened the hands of the reform minded Chief Minister. A second operation with a focus on improving the investment climate and accelerating economic growth in the state was agreed in June 2006 for an amount of \$225 million.

As it turned out, Orissa achieved the largest fiscal correction among all Indian states during 1999-2006, improving its primary fiscal balance by over 1.5 percentage points of GSDP per year. Before 2004, Orissa like other states had relied mainly on revenue enhancement to reduce deficits; after the electoral success, the Patnaik government found the courage to also move ahead on the expenditure front, to reduce unproductive salary and subsidy expenditures and rationalize capital spending.

Orissa has really been the “surprise achiever” among the S-PBL states. The very significant fiscal correction and improved growth performance achieved by the state has put Orissa in a strong position to pursue subsequent adjustment operations.

5. Learning from success: has sub-national policy lending worked in India?

Policy-based lending and conditionality have been much debated over the last twenty years. Some critics such as Collier (1997) and Easterly (2001) have argued that it is “a

failed instrument for promoting reform and growth”¹⁷ Others hold more moderate views. Mosley et al. (1995) argue that conditional World Bank aid has affected the policies of the recipients “a little, but not as much as the Bank hoped” (Mosley, Harrigan and Toye, 1995) According to Nicholas Stern, former Bank Chief Economist, adjustment lending can be “a substantial help at crucial times in moving things forward.”¹⁸

Even if there are various views around the efficacy of policy-based lending, there is widespread agreement that “policy formulation depends primarily on domestic political-economy factors” (Devarajan, Dollar and Holmgren, 2001), not on external leverage. Given this, those who nevertheless support the continuation of policy-based lending normally do so on the basis of one of two possible reasons. First, under the “backing winners” theory, policy-based lending is a mechanism for channeling resources to better performing states/countries, and thus enhancing the productivity of those resources.¹⁹ Second, under the “lending facilitates reforms” theory, policy-based lending can not compete with domestic political-economy factors for reform influence but can nevertheless be useful at the margins to influence policy, either directly in the state/country concerned, or indirectly through a demonstration impact.²⁰

The Bank’s response to these findings has not been to abandon policy-based lending, which currently accounts for about 30% of overall lending. Rather it has been to stress the need for country “ownership” and to highlight “the importance of adapting Bank support to a country’s development priorities and implementation capacity” (World Bank, 2006, p. 2). To implement this shift in approach, there have been various changes in modalities, largely along the lines used in India. There has been a shift from relying on promises to actions (*ex ante* to *ex post* conditionality) as the basis for funds release, often using repeated or programmatic one-tranche operations. The lending process has become more public, with greater emphasis given to consultation.

What does India’s S-PBL teach us about the effectiveness of policy-based lending? Did they work? This is not an easy question to answer. Since the time period is too short, we make no effort to look at what PBL states did better than others in terms of key outcomes, such as growth or poverty reduction. Rather, we focus on intermediate policy variables, especially fiscal performance, which was central to all the operations.

We begin by looking at the original targets and reform objectives of the various operations and see to what extent they were fulfilled. For the five states discussed in the previous sections, we compare fiscal performance against the targets adopted in the various S-PBLs, starting in the year of the operation. We take the fiscal deficit as the measure of fiscal performance, since this was the one most stressed by the loans.

¹⁷ This quote is from Koberle (2003) who provides a good survey.

¹⁸ Reference

¹⁹ Burnside and Dollar (2000).

²⁰ One variant of this argument is that conditionality can be useful as a ‘commitment mechanism’ for governments to convince markets that they are serious about reform (Dollar and Svensson, 2000).

As shown in Table 2, Orissa and Tamil Nadu have consistently done better than their targets. Karnataka under-performed in its first two years, but has since over-achieved. AP went off-track from the start against APERP. Although the fiscal deficit has been on a declining trend since 2001-02, AP also under-performed against the targets of its first adjustment operation (2nd PBL), but achieved the targets of the second adjustment operation (3rd PBL). UP over-achieved for its first three years, then went off-track for two but largely due to a one-off securitization of power sector dues in 2003-04, and then came back on track. Even taking into account that TN was not a PBL state, overall performance against targets was largely on track.

Table 2: Fiscal Deficit: Target vs. Actuals

	FY98-99	FY99-00	FY00-01	FY01-02	FY02-03	FY03-04	FY04-05	FY05-06	FY06-07 (Est)
Andhra Pradesh									
Actuals	5.0	4.0	5.2	5.0	4.7	4.4	4.0	3.7	3.0
AP-PBL1 (target)	3.0	3.4	2.9	2.7	2.5				
AP-PBL2 (target)				5.0	4.5	3.9	3.2	2.5	
AP-PBL3 (target)						4.3	4.1	3.6	
AP-PBL4 (target)									3.2
Karnataka									
Actuals	3.5	6.3	4.0	5.4	4.5	3.5	2.4	2.3	
K-PBL1 (target)				4.3	4.2	3.7	3.0		
K-PBL2 (target)				4.6	4.7	4.5	3.5		
Orissa									
Actuals		9.7	8.6	9.2	8.0	6.0/a	2.6	0.4	1.1
O-PBL1 (target)							7.1	4.7	3.7
O-PBL2 (target)									2.4
Tamil Nadu									
Actuals		4.3	3.6	3.3	4.3	3.3	2.9	3.1	
TN-PBL (targets)						4.1	3.8	3.3	2.8
Uttar Pradesh /b									
Actuals		6.3	5.9	4.7	4.0	6.9/a	4.5	2.9	1.8
UP-PBL (targets)			7.0	6.0	5.3	4.6	3.9	3.2	2.7

Note: Cells marked as indicate the year in which the PBL was approved by the Bank and the money was disbursed.

/a Includes one-time impact of securitization of power utility dues.

/b Both targets and actuals refer to 'adjusted fiscal deficit', excluding an accounting entry called 'appropriation for avoidance of debt', which exaggerates the deficit.

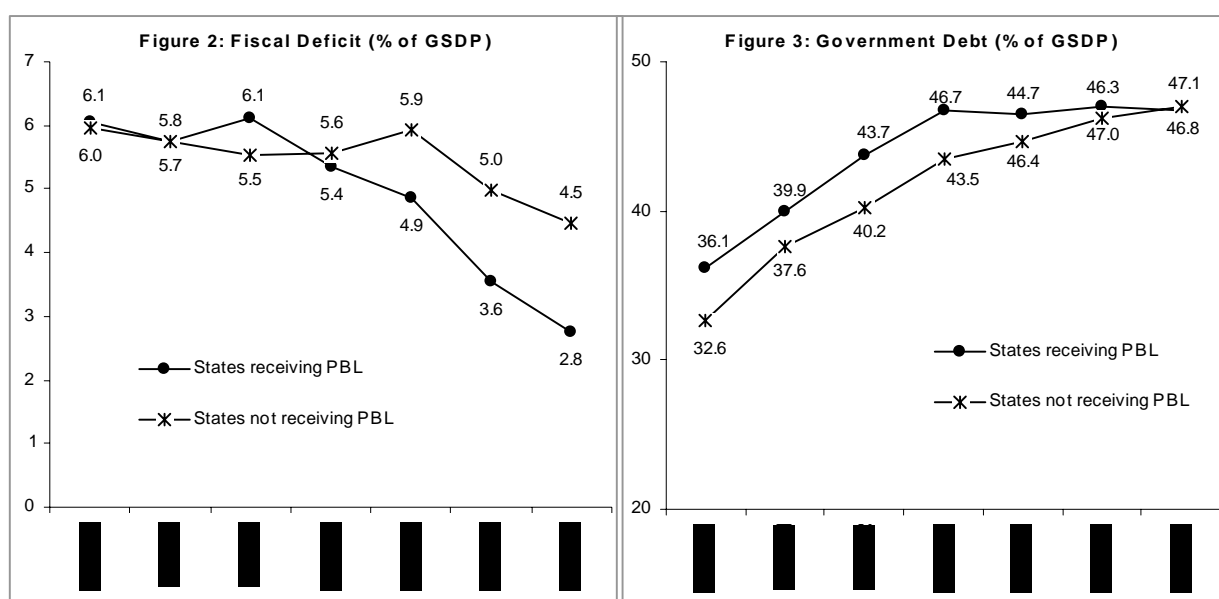
Source: RBI State Finances, World Bank Live Database

The limitation of this analysis is that it says nothing about whether the states which received policy-based loans did any differently to those which didn't. To compare reform progress across states, we again focus on fiscal reforms. Defining the group of states which received policy-based loans is difficult. One would clearly count AP and Orissa. But does one count Karnataka which failed to move past its second adjustment loan, or UP which only received one, or Tamil Nadu which qualified but then did not receive even its first adjustment loan? Moreover, several states have received PBLs from other

donors (see footnote 11), making it difficult to identify a control group against whom the performance of the states receiving support from the World Bank can be compared. We define the experimental group to include all states which have received at least one policy-based operation, that is, UP, AP, Karnataka and Orissa, but not Tamil Nadu. The control group are all the other major states.

A comparison of the fiscal performance between states which received PBL and those that didn't shows that, on average, the former have adjusted faster and earlier. As shown in Figure 2, in 1999/00, both the groups of states had around 6 percent fiscal deficit to GSDP ratio. The ratio fell to 2.8 percent of GSDP in the PBL states by 2005/06, while it remained around 4.5 in the non-PBL states. As a corollary to a larger fiscal correction, the debt to GSDP ratio started to stabilize from 2002/03 in the PBL states, while it has continued to increase in the non-PBL states to 2004-05 (Figure 3).

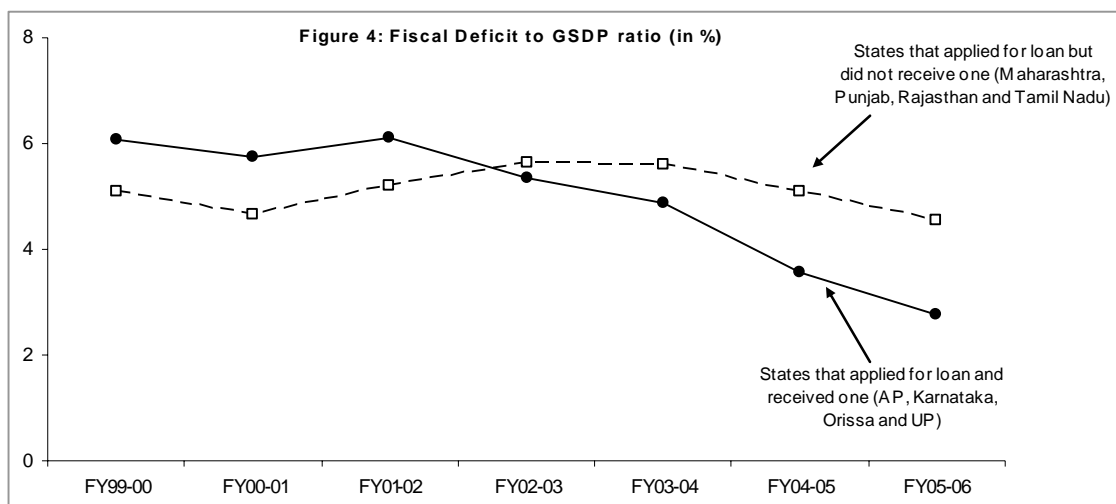
This analysis suggests that PBL states did better overall in their fiscal performance than the non-PBL states. Since the non-PBL states did also start to adjust, however, albeit with a lag, it leaves open the possibility that the effect of the S-PBLs was simply to accelerate a fiscal correction in these states that would have happened in any case.



Assuming that sub-national policy based lending did have a positive impact on fiscal performance, how would one explain this? Was the Bank picking winners or inducing reforms? The four states which received S-PBLs were a sub-set of a group of eight which requested Bank economic reports on their states. Since a report was a pre-requisite for an adjustment loan, we take a report request to be a proxy for wanting a loan,²¹ and we can compare the performance of states which ‘demanded’ but were not selected for a loan

²¹ This gets round the problem that some states might have put in a formal request to GoI which the Bank might not have seen, or might not have put in a formal request for fear of rejection. Reports were also written for Bihar and Jharkhand but at the instance of the Bank rather than the state and so are not included.

(either by GoI or the Bank), and those which were. Clearly, from Figure 4, the selected states did much better than the non-selected.



It is unlikely that this large difference is explicable in terms of Bank influence on its selected states. Much more likely that between the Government of India and the Bank there was an effective screening process in place which considerably boosted the probability of winners being selected. The adverse selection problem in adjustment lending is well-known: it is often the worst-governed states which are the most desperate for a loan, and so most likely to promise but not deliver reforms (Dollar and Svensson, 2000). It appears that this problem was kept at bay in India.

Nevertheless, it is still likely that adjustment lending did, at the margin, induce reform, both fiscal and otherwise. We are aware of several cases where reform champions within a state found the additional pressure of meeting milestones agreed with the Bank as useful for overcoming political or bureaucratic resistance to reforms. More generally, the combination of funding, dialogue and persistent monitoring of reform progress helped give a greater focus to reforms than they would have otherwise received. The primary value of the policy-based lending was not to assist in the design of reforms, but to accelerate their implementation. And in a chaotic democracy where there are any number of ‘reform distractions’ (scandals, natural disasters, political challenges), this was a valuable role.

Benefits of S-PBL other than fiscal adjustment are harder to quantify. The PBL states were frontrunners in a number of reform areas; some of their reform achievements were independent of the adjustment operations, others arose out of them. For example, Karnataka was the first Indian state to pass a Fiscal Responsibility Act. This has now spread to almost all states. Orissa has achieved faster completion of investment projects through improved prioritization under Zero Based Investment reviews; e.g., number of bridges completed during the year has risen from 19 in 2004-05 to 85 in 2005-06, and 128 in 2006-07. Andhra Pradesh was the first state to introduce Single Window

Clearance for new investment and is the only state to have amended its contract labour regulation act to make it easier to hire contract (non-permanent) labour. Andhra Pradesh's power utilities are rated the best in the country. Orissa has retrenched 30,000 workers from loss-making public enterprises.

Some of the positive benefits of S-PBL are less tangible than specific reform achievements. The S-PBLs provided a vehicle to support the conduct of diagnostic reports and more importantly the implementation of their recommendations, such as financial accountability assessments and public expenditure tracking surveys. The S-PBLs provided the opportunity for cross-departmental policy discussions and dialogue at the highest level, not generally achievable with investment operations. The S-PBLs also provided a useful learning framework, where nation-wide problems could be diagnosed and solutions trialled. Examples of this include pension reforms in Tamil Nadu (since spread to most states), efforts to control the widespread problem of premature transfers of civil servants in India in Karnataka (since taken up by the Government of India), and the use of village education societies to monitor teacher performance in Orissa.

Finally, it is important not to lose sight of the possible national impact of S-PBL. Some have argued that the adoption by the Bank of a performance-based approach in its lending to the states encouraged the Government of India to move in the same direction (Kirk, 2006). More importantly, we would argue, the demonstration effect did work. Bank focus on a small number of reforming states did help sensitize states to the needs for and benefits of reform. One cannot prove this statement, but the environment has certainly changed – from the mid-nineties when a “reforming CM” was a rare and celebrated commodity, to the mid-years of this decade where the non-reforming CM is the rarity. Given the high-profile of the Bank at the state level, its association with state reform, and its interaction with many state governments, it would be odd to claim that the Bank had no role, even a minor one, in bringing this changed environment into being. If the Bank did have a role, it was not only through S-PBL – for several years, the entire Bank program was overwhelmingly dedicated to the goal of promoting state reforms. Nevertheless, as outlined in Section 4, S-PBL did emerge over the last decade as the main instrument for backing reform at the state level.

6. Learning from failure: sub-national policy based lending and the power sector.

Electricity is largely a state responsibility and loss-making, heavily-subsidized and highly-inefficient power sectors have been one of the main sources of fiscal stress at the state level. Not surprisingly, therefore, power sector reform was fundamental to the Bank's approach at the state level. Becoming a focus state of the Bank entailed a requirement on the state that it “embark on a comprehensive program of economic reforms, including fiscal and governance reforms and reforms of key sectors such as power.” (World Bank 2001, p. 35). There was a clear expectation that power sector reforms would be initiated and proceeded with as a pre-condition for accessing policy-based loans. For example, a precondition for the first S-PBL, the APERP, was the passage of a Power Sector Reform Bill in the State Assembly. In addition, for some of the adjustment operations, explicit power-sector triggers were used.

Overall, S-PBL states show mixed performance in regards of the power sector. A ranking by the central government of states in respect of their power sectors puts AP first and Karnataka fourth in overall performance out of 29 states. Uttar Pradesh and Orissa did much less well, coming 18th and 21st respectively.²²

Notwithstanding the relative success of some of the PBL states, in an absolute sense power sector reforms failed, or at least did not follow anywhere near along envisaged lines. Power was certainly the sector PBL states struggled with more than any other. More than any other reform area, lack of progress in power sector reforms sunk the Bank's engagement in UP and Karnataka and, to a significant extent, Tamil Nadu. Problems in the same sector delayed loans to AP and Orissa. The difficulties encountered in the power sector can be seen most clearly in respect of two of the reforms promoted most heavily by the Bank: privatization of distribution, and a shift away from subsidized or even free pricing of electricity for farmers.

The privatization of distribution was seen by the Bank as critical to imparting into the power sector a more commercial orientation. Much electricity in India is simply stolen. It was argued that as long as distribution was under government control, it would be impossible to enforce basic commercial disciplines such as disconnection for non-payers. A number of states bought into this argument in a series of state-level power-sector investment operations in the second half of the 1990s: Orissa, Haryana, AP and UP among others. But only Orissa followed through to the point of privatization, which it completed in 1999. The experience of Orissa is still debated, but, whether or not privatization was a success, certainly it didn't transform the sector as quickly or as radically as expected. No other Bank-supported states followed in Orissa's footsteps (though Delhi, the capital territory, did, on its own, without Bank support). Several unbundled distribution in preparation for privatization, but none actually placed the newly-created companies on the market.

Many Indian farmers rely on electricity to extract ground water for irrigation. In most states, this electricity is unmetered and provided at highly subsidized rates, and for free in some. Moving away from this practice was seen as a critical part of the broader challenge facing state governments of moving away from populism to a more developmental approach. Since power was so cheap or free for farmers, it had to be rationed. Free power was shown to mainly benefit large farmers (Howes and Murgai, 2003). All farmers were shown to be worse off having low-price, low-quality power compared to full-price high-quality power (World Bank, 2001). In the late 1990s, several states started to reform the agricultural electricity regime with increases in tariffs, and attempts to meter farmers. In 2001 and 2003, respectively, two states which had run free power regimes, Tamil Nadu and Punjab, introduced tariffs for electricity for farmers. It looked for a while like a fundamental shift was underway. But disappointment was to follow. In 2004, Tamil Nadu returned to free power for farmers. An election change in AP led to free power in that state, also in 2004. Punjab reverted to free power in 2005. More generally, Lal (2006, p.9) observed: "in state after state, power reform has lurched to a halt the moment it has run up against the agriculture sector."

²² TN was 10th. CRISIL and ICRA (2006)

How did the Bank react to these developments? On privatization, the Bank initially took a hard line. Up to about 2001, commitment to the privatization of distribution was a *sine qua non* for Bank engagement. Subsequently, however, this position softened. It was becoming evident that Orissa's privatization experiment was not delivering the results expected, and it became more difficult therefore to urge states down this road if they didn't want to go themselves.²³ In addition, Andhra Pradesh launched a huge anti-theft campaign in 2000 with dramatic results in terms of arrests and improved cash collections. This demonstrated that massive efficiency gains could be had under public ownership.

The more recent adjustment loans to AP contain no privatization commitments, but a heavy emphasis on continued loss and theft reduction. This is not necessarily an easier route for all states. The dialogue with UP shifted from an emphasis on privatization to theft reduction as early as 2001, but with very few results.

The story with free power is an even less happy one, as it was, and remains, a problem without a solution. On the one hand, as with privatization, the Bank appeared to take a hard line. It essentially refused to work in states with free power (Punjab and Tamil Nadu in the late nineties), re-engaged with those states which moved away from free power (the same two states in 2001 and 2003), and suspended adjustment lending to states which introduced free power (Tamil Nadu and Andhra Pradesh in 2004).

On the other hand, it became evident that the Bank was adopting what might be called a fig leaf approach. States knew that the Bank wouldn't lend to them if they introduced free power. But practice showed that the Bank would lend even if they moved only a very small direction away from free power. Thus states would introduce low tariffs but not collect them (Andhra Pradesh, Karnataka), or promise to reimburse farmers for them (Tamil Nadu), or introduce tariffs only on the very largest farmers (Tamil Nadu in 2002, Andhra Pradesh in 2005). These small "delta" moves were fine as long as they could be construed as first steps away from free power, but over time it became obvious that they constituted a new equilibrium between the demands of the World Bank and the political imperatives of a largely rural democracy. It thus became of no real consequence whether a state had a free power policy or not: the only choice for several states was evidently between free and near-free power.

As with the shift away from an emphasis on privatization to efficiency gains under public ownership so too with free power there was an attempted shift away from cutting agricultural subsidies towards making them more transparent and on-budget, and towards compensating farmers for any hike in tariff prices. But, unlike in the former case, this shift did not work. No government has been able to put in place a satisfactory alternative to the current system of unmetered, rationed, virtually free power: perhaps a testament to

²³ There were various reasons for the lack of success of Orissa's distribution privatization (see PPIAF, 2002). Post-privatization, the Bank had little capacity to influence the sector, not least because it had no leverage over the privately-owned companies.

the highly contentious nature of this issue and the low credibility of India's state governments (Keefer and Khemani, 2004).²⁴

The limited success of S-PBL with respect to the power sector teaches several lessons. First, the free power issue in particular demonstrates the limits of incentive-based approaches to reform. Money can induce some reforms, but others are just too politically unpopular or sensitive. In these cases, where there is nevertheless an attempt to induce reforms, the outcomes are fairly predictable: loopholes are found, and compromises which allow both sides to proclaim victory, but there is no real movement on the ground. This is the sort of scenario well known from critiques, where policy-based lending if it tries "to cajole governments to do things that they are really not interested in" degenerates into "farce." (Devarajan, Dollar and Holmgren 2001, p. 35)

Second, less obviously, and certainly less stressed in the literature, this sequence teaches the importance of uncertainty and learning in the adjustment lending context. The learning in the case of privatization was a technical one: privatization was not going to be the panacea it has been envisaged to be, and alternative candidate mechanisms were identified to reduce power sector losses. The learning in the case of free power was a political one: moving away from free power was politically much harder than both the Bank and governments had thought. Rather than viewing developments in this area only as the result of cynical politicians manipulating a naïve World Bank, the usual caricature of adjustment lending critics, one can also view it as the outcome of reform under uncertainty. From our experience, leaders who moved away from free power were not doing it cynically only to keep the World Bank happy. They also viewed the moves as important ones away from populism. It appears that, at least initially, they too had no idea of how difficult moving away from free power would be, and how quickly they would have to reverse their decision. It was only over time that both leaders and the World Bank appreciated just how difficult some of these reforms would be.

The importance of uncertainty and learning has important implications for how we view the failure to achieve various triggers or reform milestones. Failure to achieve reform milestones might imply poor reform performance against reasonable expectations, but it might also imply reasonable performance against unreasonable expectations. This in turn leads to the third observation, namely the need to balance credibility and flexibility in establishing reform programs. Flexibility (a willingness to amend milestones if not agreed) can send the signal that 'anything goes' (that no agreed milestones need to be taken seriously) and thus undermine reform incentives. On the other hand, recognizing that there will be a lot of learning (both technical and political) as a reform or adjustment program unfolds implies that a flexible approach has to be taken: not everything agreed upfront should be stuck to, because some of what was agreed probably doesn't make sense. Taking a flexible approach is much easier when based on technical learning (the switch from privatization to focusing on efficiency gains under the public sector was relatively easy to justify) than political learning (it was always going to be difficult for

²⁴ As early as February 2002, the first AP adjustment loan included a commitment by the Government to establish "alternative subsidy delivery mechanisms for the supply of electricity to farmers". By the third adjustment loan in December 2006, there was no progress to report on these, and no future targets set.

the Bank to just “give up” on free power when so much capital had been invested by it in demonstrating the importance of this issue). There is no easy way around this dilemma.²⁵ In the end, flexibility will prevail (or all lending will grind to a halt), and the only question becomes how to manage that inevitable shift.²⁶

7. Learning from commonality: sub-national policy-based lending in a federation.

Sub-national policy lending has now been used in a number of countries, including Brazil, Argentina, Mexico, Pakistan and Russia as well as India. The Bank began making sub-national adjustment loans to various Argentine provinces, in 1998, before it did in India. Recently, Pakistan has started becoming a major recipient of sub-national loans, with three such loans in 2006. Nevertheless, the Indian experience is clearly the most extensive and expensive engagement with S-PBL, and should have a number of lessons to teach us on the utility of policy based lending within a federal context.

The most obvious difference between S-PBL and PBL is that the latter is based on a bilateral agreement between the sovereign country and the Bank whereas the former is based on a trilateral agreement between the sub-sovereign, the sovereign and the Bank. We begin this section by looking at the approach of the Government of India (GoI) to the Bank’s S-PBL.

Overall, GoI has taken a supportive but cautious approach to the Bank’s use of S-PBL. Following its initial approval of S-PBL in 2000, in early 2002, GoI called for a temporary halt so that a review of progress could be undertaken.²⁷ The result was guidelines for sub-national adjustment lending issued by GoI in December 2002, and then revised in December 2005, following the recommendations of the 12th Finance Commission. These guidelines largely endorsed the Bank’s approach to S-PBL, but introduced several important changes. First, they introduced the requirement that access to S-PBL would be conditional on states being on-track with first the GoI Fiscal Reforms Facility and then its successor Debt Consolidation and Relief Facility. Second, the guidelines opened up access to the instrument: they were no longer to be restricted to ‘focus states’ only. Third, the 2005 guidelines introduced the requirement that adjustment loans should be multiple-tranche rather than one-tranche operations and that the primary use of loan receipts should be the retirement of higher-cost debt. Fourth, not through the guidelines but

²⁵ Replacing one-off multiple-tranche loans by a series of single-tranche loans (i.e. the shift to programmatic lending) helps provide flexibility when what is needed are adjustments to the reform program, but will not help in the cases described here where what is required is a radical shift in position.

²⁶ A final irony in the free power saga is that in 2007 the Bank approved a loan to Punjab for rural water supply: the same loan that the Bank had rejected in 1997 because of Punjab’s introduction of free power. Preparation of the loan had begun again when Punjab reintroduced tariffs for agricultural electricity, but by the time of approval the state had swung back to free power. But this time, there would be no holding back on the loan.

²⁷ “While adjustment lending at the state level has been a very useful instrument for supporting state reforms, its use has not been as widespread as anticipated in the CAS, partly because reforms have not moved as fast as expected, and partly because of a desire on the part of the GoI to review experience with adjustment lending at the state level... The future of subnational adjustment lending in India is currently under discussion between the Bank and the GoI.” (World Bank, 2003b, para. 88)

through the 2004 CAS, the ceiling on adjustment lending as a ratio of all lending was reduced from 20-30% to 15%.

With regards to individual operations, there were few cases where there was an explicit disagreement in position between the Bank and GoI. Karnataka's third adjustment loan was the exception where, in 2003, the Bank was ready to negotiate the loan, but GoI refused to give the go-ahead, and then, in 2004, when GoI did give the go-ahead the Bank declined to proceed to negotiations. In other cases, the decision-making was more sequential. States had to approach the Government of India to forward their application to the Bank for a loan. In general, for much of the period, GoI was cautious in extending the S-PBL to other states. The instrument was regarded as untested, and in need of proving its worth before extending too widely. Several states had their applications rejected including Maharashtra, Punjab and UP (after the first loan). Recently, however, GoI has forwarded a number of applications to the Bank, including for Himachal Pradesh, Bihar and UP.

The rationale for a sovereign government to want the Bank to engage at the sub-national level is well-established. The basic argument is that:

For central governments, which may have limited power to influence the sovereign decision of subnational governments, World Bank involvement offers independent "third-party" support for state-level reform and at the same time provides an external financial incentive for maintaining subnational fiscal discipline.²⁸

This rationale certainly applies to India. One lesson brought out clearly by the India experience is that, when dealing at the sub-national level, the Bank can afford to be more selective than it is at the national level. We showed in the previous section (see Figures 4 and the surrounding discussion) that there was a very effective screening process in place, which enabled the problem of adverse selection to be avoided in India. It is evidently much harder for the Bank to say 'no' to an individual country than it was to say 'no' to an individual state: only 4 out of 27 states received a PBL. And the fact that two entities (GoI and the Bank) had to say yes to individual states lowered the probability that 'lemons' would be selected. This capacity for greater selectivity suggests that policy-based lending might even be more effective at the sub-national than the national level.

While the benefits are well-recognized, very little has been written on the possible costs or risks of Bank engagement at the sub-national level. Our review of India's experience suggests four possible risks or complications in turning to the Bank as a policy disciplining device for sub-national governments.

First, there is the problem of additionality. Bank adjustment loans are meant to provide "rapidly disbursing policy-based financing ... to address actual or anticipated development financing requirements".²⁹ Yet this very additionality can become a problem at the sub-national level. Ter-Minassian and Craig (1997) argue convincingly for

²⁸ World Bank (2006), p. 50. See also Kirk (2006).

²⁹ World Bank (2004b), para. 1

the establishment of global limits on sub-national borrowing. In India, loan resources released by the Bank are transferred to the state for which they are intended as loans. This means that by the standards of good fiscal federalism they should not be considered as additional resources but as substituting for other loan resources within the global limit. Various approaches were taken to, in effect, deny additionality. The Bank stressed that its targeting of the fiscal deficit limits would ensure that access to adjustment loans did not, in fact, entail additionality. Further, following the Twelfth Finance Commission the central government has become much more active in enforcing global borrowing limits on states.

The issue of the proper use of adjustment loan proceeds was also a lively one in this context. Earlier S-PBLs stressed the use of proceeds to finance the costs of reform, including bringing off-budget liabilities on-budget, paying for redundancy payments associated with public enterprise reform, and increasing or protecting priority expenditures. Later loans stressed the use of adjustment lending to retire high-cost debt: a form of earmarking which ensures no additionality.

The revised central guidelines for sub-national adjustment loans, issued in December 2005, make explicit both that such lending is not additional (to centrally imposed annual borrowing limits), but can only substitute other sources of borrowing, and that at least 50% of the funds must be used by the state for debt swaps, i.e., to pre-pay old expensive loans.

So, much effort was put in at various levels to ensure that S-PBLs were not additional. But then, without additionality, what is the incentive which adjustment loans provide to state governments to reform? If Bank adjustment loan resources are not additional, why do Indian states still show interest in policy based lending? There are three possible explanations: (i) state politicians may still (even if mistakenly) see Bank resources as additional; (ii) lending terms of the Bank are cheaper and debt swaps result in lower debt servicing in the future, so there are benefits, even if they are future ones; and (iii) state governments find the framework of policy dialogue, triggers around adjustment lending, and regular monitoring by the Bank useful instruments for pursuing and sustaining politically difficult reforms

Second, there is the problem of discretion. Policy-based lending as normally practiced, and certainly as experienced at the sub-national level in India is a discretionary instrument. While triggers are specified in advance, judgment is involved in choosing the triggers (which, as noted earlier, differed considerably across states), in determining whether they have been met, and in deciding what to do if they haven't. There are good grounds for this discretion, particularly in terms of the need to allow flexibility to accommodate learning, as discussed in the previous section. However, use of a discretionary instrument such as S-PBL has the potential to undermine a rules-based approach to fiscal federal relations. India's federation is already criticized as discretionary, and so open to favoritism and abuse, precisely because of the ability of the

central government to lend (its own and external resources) to state governments.³⁰ The dangers of discretion in a federal context suggests that S-PBL will need to be less discretionary than policy-based lending to sovereigns, i.e., more uniform across states than across countries.³¹

Third, there is the issue of equity. Central governments might want to promote state-level reform, but might also want to support lagging states. The possibility of a trade-off between supporting equity and promoting reforms confronted the Bank in India at several times over the last decade, and, as discussed in Section 3, forced the end of the focus state strategy, when Bank support was perceived to have become too concentrated among non-lagging states. The Bank is now preparing adjustment operations for UP and Bihar, two of India's poorest (and largest) states. While there is no widely-accepted policy and institutional ranking for India's states (akin to the Country Policy and Institutional Assessment for poor countries) it is fair to say that, if there were such a ranking, commonly-regarded lagging states, such as UP, Bihar and Orissa would come towards the bottom of it, though the Orissa ranking may well have improved in recent years given its reform progress. Expanding adjustment lending to low-quality governments goes against international experience which has seen a flight to quality with a concentration of adjustment lending to governments with above-average quality (World Bank, 2006; Stern, Dethier and Halsey Rogers, 2005, p. 379). Thus any move to spread adjustment lending to lagging states will constitute an increased assumption of risk, as is confirmed by the experience of lending to UP and Orissa (where the Orissa experience was positive, the UP one less so). The cautious approach taken in the case of Orissa, where loan preparation and dialogue went on for a period of about four years prior to the first loan approval, might have much to commend it as a risk-mitigation measure for adjustment lending to lagging states.

Fourth, there is the issue of harmonization. Should the Bank develop reform programs directly with state governments (the retail approach to state reform), or should it work through the central government (the wholesale approach)? In the case of India, not long after the Bank began its S-PBL, GoI came out with its own scheme to promote fiscal reform, the Fiscal Reforms Facility (FRF). From a harmonization perspective, one would argue that the Bank should stop supporting individual states, and instead support the central scheme. This was the approach taken in Russia, for example, and it was sometimes suggested that this wholesale approach should be taken in India. It is unlikely, however, that this suggestion would ever be taken up: centre-state relations is just too politically sensitive an issue to involve the Bank explicitly and across-the-board. The S-PBL approach made sense in this context: confining Bank participation to states that welcomed it, while, to ensure consistency of instruments, making good performance under the FRF a pre-requisite for accessing Bank policy loans.

³⁰ EPW (2004). Following the Twelfth Finance Commission, the central government has phased out lending to states except the on-lending of external loans. Under the Indian Constitution, states cannot borrow directly from external sources.

³¹ As noted by Devarajan and Shah (2006).

8. Learning from diversity: determinants of sub-national policy based lending success.

Success with S-PBL shows a great deal of differentiation. Over the last decade, the Bank wrote economic reports for 8 of India's states, with a view that this might be the first step down the road to an adjustment loan.³² Of these 8 states which expressed demand for an adjustment loan (by agreeing to have a report written), only 4 received at least one adjustment loan, only 3 at least two, and only 1 more than two.

Whereas the previous section looked at the common feature behind all the sub-national policy loans to India – the federal context into which they were made – this final section of the paper looks at the variability in the S-PBL experience, and tries to explain it.

Examination of the evidence in this regard points unambiguously to the importance of state level politics. As Section 5 on impact demonstrated, S-PBL recipients did better on reforms than average, and, as many other studies have found, reform performance is ultimately a function of domestic political forces.

The case-studies presented in Section 4 testify to the importance of political considerations, and in particular political stability. Out of the various S-PBL states, the two with the most politically stable environments were AP and Orissa: the two most successful participants in the S-PBL experiment. In AP, Naidu had 8 years as Chief Minister, and Congress will now have at least 5 in government. In Orissa, the current Chief Minister will have had a 9-year term before he faces elections again (in 2009). Karnataka, an intermediate case in terms of S-PBL success, experienced political stability from 2000 to 2004, but has experienced instability since: an instability which has made it impossible for it to get back on to the adjustment-lending wagon. Finally, the relative failure of UP can clearly be laid at the feet of chronic political instability, which rendered fragile any policy reform that an adjustment operation could help to engineer or respond to.

Of course, stability is not a sufficient condition for reform: for 15 years, Bihar was ruled by one party, but it has been, till the 2005 change of government, the archetypal non-reforming government. But political stability is nevertheless an important asset for would-be reformers because instability narrows the time-horizons of politicians and forces them to focus on survival rather than development.

Political strength is also important. Tamil Nadu enjoys stable governments: incumbent governments invariably lose, but only after surviving a full 5-year term. But the ruling party's decimation in the national elections in 2004 caused it to become a lame-duck government in the run-up to the state election in 2006, which it predictably lost. Without power, and pre-occupied with survival, the government was unable to pursue politically difficult reforms.

³² UP, Orissa, Karnataka, Punjab, Maharashtra, Rajasthan, Tamil Nadu, Andhra Pradesh. Of the other states, Gujarat, Madhya Pradesh and Kerala received loans from ADB. Reports were written on Bihar and Jharkhand but not with the intention of entering into adjustment lending.

Political factors at times also influenced S-PBL outcomes directly, rather than through reform prospects. The sequence of events in Tamil Nadu in 2004 did more damage to the states' prospects for an adjustment loan (which it destroyed, due to the timing of events as much as anything) than to its reform prospects, which though damaged where by no means destroyed, as TN's subsequent fiscal performance shows (Table 2).

More generally, the importance of political factors underlies the importance of luck in pursuing both reform outcomes and access to adjustment loans. Election results in India are often determined by factors other than economic reform. A survey by Kumar (2004) in 1998 revealed that only 28% of voters said that they had even heard about economic reforms. Other factors such as protest votes against the national government, coalition and caste alliances are probably much more important for electoral outcomes. But election results are crucial for reform prospects, as they determine both the stability, strength and the reform orientation of the state government for the next five years. So, non-economic issues become a critical exogenous factor in determining economic reform outcomes.

So far we have dealt with state-level politics, but what about federal politics? Has it been easier to access S-PBLs if the state's ruling party is aligned with the party at the centre? Khemani (2002) finds that states in India affiliated with the central government get 10% more borrowing than others. Some observers argued that states politically aligned with the central government were favoured by both the Bank and GoI and given better access to S-PBLs than those which were not. This criticism was particularly made based on a comparison of AP and Karnataka (Kirk, 2004; EPW, 2004). State politics in AP have certainly been well-aligned with national politics over the last decade (with both levels changing – in the same direction – in 2004). The other S-PBL states have seen mixed – rather than full or zero – alignment with central politics. It would be naïve to think that a Chief Minister who was politically powerful at the national level did not have more chance of accessing a S-PBL than one who was not. However, we have also noted the rigorous screening process around the S-PBLs. This would have helped counter any political influence. While it is difficult to quantify the impact of political influence at the central level, it appears to be far from overwhelming, and a more minor determinant of success than the alignment of state politics with reform prospects.

9. Conclusion

The main conclusions of this paper have already been stated in the introduction, and do not bear repeating here. The shift to sub-national policy-based lending in India ten years ago was a bold strategy suited to its time. Its subsequent track-record has confounded supporters and critics alike. S-PBL never took off to the extent originally envisaged. A difficult reform agenda and the need to reach a trilateral agreement around each operation (Bank, GoI, and the concerned state) kept the frequency of use of this instrument to about once a year, and the value to \$150 million a year, only a fraction of the originally targeted \$500-\$900 million. But nor has S-PBL faded away as some predicted. To the contrary, the relatively cautious approach taken to its use has delivered good results, and ensured

durability for the instrument. The last fiscal year was the most successful so far in terms of S-PBL volume, and there is a new list of state candidates (approved by GoI) demanding new policy-based lending.

India today is very different to India ten years ago. The fiscal situation is much improved. Growth is faster. And all states have embraced the national reform agenda. Yet there is much to be done to spread and sustain growth, and, especially, to improve service delivery. How sub-national policy-based lending evolves in this environment remains to be seen, but it will no doubt be another interesting story.

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