SECTION SIX

South Asia Region (SAR)

The 1990s witnessed increasing demand throughout South Asia for an effective, transparent, accountable, and responsive public sector. There are many reasons behind this phenomenon, including the global impetus that issues of good governance and institutional reform received in the wake of the so-called Asian crisis; the consolidation of democracy in Bangladesh and Nepal; economic liberalization—particularly in India but also elsewhere; the movement toward decentralization and an expanding role for subnational governments; improved economic and social performance, coupled with the growing middle class in many countries of the region; and increasingly innovative and assertive NGOs. With the exception of Afghanistan, these factors can be found in all the eight countries of the region (Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka).

The South Asia Region has responded to these developments through country-level strategies for advancing reforms aimed at fundamentally changing public sector institutions. In support of this strategy, and in collaboration with other multilaterals, bilaterals, and NGOs, the Bank has supported regulatory reform and privatization, as well as the reform of key government functions (for example, reform of service delivery in certain key sectors, civil service reform, financial management, tax administration, and legal reform). The Region intends to consolidate this approach and strengthen it with a new focus on supporting inclusive and accountable institutions, particularly at the local level, and more effectively integrating lessons of experience in our work.

Salient characteristics of the South Asia region

South Asia has the world's largest concentration of people living below the poverty line. Per capita income averaged $430 in 1998, and ranged from $1,171 (Maldives) to $210 (Nepal). With 1.3 billion people, Bangladesh, India, and Pakistan account for the bulk of the region's population and a quarter of the world's population.

All South Asian countries, except for Afghanistan and most recently Pakistan, have parliamentary democracies. India and Sri Lanka have maintained democratic governments since independence, although Sri Lanka has suffered a long and costly civil war. Pakistan and Bangladesh have alternated between periods of military dictatorship and democracy. (In Pakistan, a military government took over in October 1999, but much of the 1990s was spent under democratic rule.) Nepal has emerged from an absolute monarchy to a constitutional monarchy and parliamentary democracy, but has struggled to maintain political stability in recent years. Bhutan has been governed by an enlightened oligarchy. Most of the eight countries of South Asia share similar cultures and institutions shaped to some extent by their common political past and history of colonial rule.

Freedom of the press is well established, and while there is respect for basic human rights, these rights are difficult to enforce uniformly, particularly for the poor. Caste and gender prejudices have led to vested interests and have played an important role in electoral politics, policymaking, and in some instances, state capture. Affirmative action, which has sought to compensate for fragmentation in society, has significantly shaped the public sector through employment and access policies. The judicial system is highly inefficient, and in most countries it is also largely impartial and proactive at its top echelons. Although women are subject to extensive discrimination and exploitative child labor is common, strong women's movements have emerged, and the issue of child labor is on the public agenda. South Asia boasts some of the world's largest and most vibrant NGOs, including the Grameen Bank, BRAC, and ASA in Bangladesh, SEWA in India, and the National Rural Support Program in Pakistan.

Development is impeded in South Asia by the serious difficulties governments face in redefining their role, improving the functioning of core agencies and the delivery of key public services, and in addressing systemic weaknesses in public administration. Poor public management compounds the difficulty of redefining the role of government and transferring appropriate functions to the private sector, and therefore acts as a major obstacle to faster private sector development. Lax tax administrations, harassment of enterprises by the staff of regulatory agencies, slow judicial systems, and improper land registries all increase transaction costs for private citizens, enterprises, and the economy.

Surveys by Transparency International and other domestic and external organizations report deep-seated problems of politicized bureaucracies and both administrative corruption and corrupt actions as a result of state capture. On the positive side, they also highlight (especially in India and Sri Lanka) the independence of the senior judiciary, close compliance with court rulings, and effective recourse to the high courts for challenging government actions.

Reflecting the legacy of central planning, the public sector's influence in South Asian countries has been all-pervasive, a major source of employment covering many sectors of the economy, with entrenched bureaucracies often administering complex regulations that create a scope for corruption. Poor delivery of key public services is of particular concern, ranging from health and education to legal services and road maintenance. While formal institutional mechanisms exist for promoting public accountability (including oversight by parliamentary committees, auditor-generals, anti-corruption agencies and legislation), in practice these have been ineffective. Informal "rules of the game" have evolved to cover many economic transactions, and have shaped the roles of the public and private sectors. Government employees are often perceived as aloof and unresponsive, viewing themselves more as public officials than civil servants.

In parts of South Asia, poor governance goes beyond corruption. In these parts, criminal elements, allegedly with powerful political patrons, extort tolls and run protection rackets, presumably a result of the ineffectiveness or the capture of the police and courts. The links to the political system make the problem difficult to tackle. Partial political reforms or dysfunctional politics in such instances do not allow civil society to enforce political contestability that would hold state officials accountable for civil liberties and public services.

Growing demands for institutional change

In almost all South Asian countries, political, social and economic developments have created strong impetus for improvements in public institutions, and their accountability, transparency, and effectiveness.

Political and social developments. The consolidation of democracy in Bangladesh, more recently in Nepal, and until recently in Pakistan, growing literacy, and urbanization have all importantly shaped the demand for institutional change. The influence of NGOs on improving governance, inclusion, and the delivery of key social services has grown rapidly, not only because of their increase in number, but also because of their innovative approaches to service delivery. These developments have already yielded important lessons for the Bank, even though there is still more to learn and integrate into our work.

Liberalization. Reflecting a changing global consensus, all South Asia countries have been gradually liberalizing their economies and reducing the role of the public sector since the late 1970s. They have progressed at different paces in this endeavor—Sri Lanka the fastest and Nepal the slowest, though South Asian countries as a whole still lag behind other parts of the world. Even in Sri Lanka, for example, trade protection is much higher than in East Asia or Latin America, the public sector continues to dominate the financial sector, public enterprises account for a larger share of GDP, private participation in energy and infrastructure is negligible, and taxation is based on highly differentiated rates falling on narrow bases. Though partial, economic liberalization has nonetheless reduced incentives for state capture, increased competition, and made more evident the costs of ineffective provision of public services that reduce the competitiveness of domestic production.

Decentralization. Responding to grassroots pressures, and in parallel with market reforms, a process of decentralization took off in the mid-1990s in South Asia. Both India and Bangladesh have put in place the legal foundations for elected local governments. In India, economic liberalization has given way to the states' responsibilities that had been circumscribed by central planning. More powers to the states and local governments are expected to increase accountability. Though limited, there are early signs that service delivery is improving (Madhya Pradesh and West Bengal in India, local infrastructure construction in Bangladesh). Strong public pressure for more responsive and accountable local governments have also emerged in Nepal, Pakistan, and Sri Lanka—however, except for the Punjab province in Pakistan, little progress has been achieved in these countries.

Information technology. The spread of information technology, and India's emergence as a leading exporter of software, is beginning to have a significant impact upon public sector management. States like Andhra Pradesh have used computerization and business process re-engineering to radically improve the timeliness and quality of services (and, while doing so, to eliminate opportunities for graft and "speed money"). Other states, ministries and departments are utilizing information technology to greatly improve transparency, by putting forms and information on the Internet, or to enhance convenience and accountability by creating one-stop shops for service delivery.

High-profile corruption cases. Several recent high-profile legal actions—including against a former Pakistani Prime Minister and several Indian ministers—

have sought to censure corruption in high places and are also a reflection of the growing public demand for institutional change that addresses both administrative corruption and state capture.

Experience to date in the South Asia region

South Asian governments have both sought Bank support for strengthening the performance of public institutions and have also initiated reforms independent of Bank assistance. Our assistance for public institutional reform has had three main objectives:

- reorienting the public sector,
- establishing regulatory frameworks and agencies to enhance private competition and protect consumer rights, and
- reforming *key* government functions where there is a clear role for the public sector.

These elements have been pursued through sector lending and analytic services by each sector unit, in line with the regional strategy of mainstreaming this work in our country programs, the matrix organization, and the substantial decentralization of the Region.

While the Bank is engaged in extensive dialogue on these issues, political considerations in each country have often made leaders reluctant to pursue measures to reform the role of the state. Our work has therefore focused on country-level strategies for improving incentives for reorienting the public sector. For example, in India, our strategic approach and assistance are concentrated on states willing to reform, and where the nature of these reforms is expected to help improve institutions, including in power, irrigation, tax administration, and privatization (Box 22). In Nepal, the assistance strategy and lending program depend on reforms that will fundamentally change public sector institutions, also including Bank assistance to local governments that are willing to reform. The Bangladesh CAS makes public institutional reform its central focus. Through a process of unbundling politically complex and time-consuming reforms, Bank assistance seeks to match client commitment and strengthen existing institutions or help create new ones, such as in banking, power, and the social sectors. In Pakistan, power sector reforms are leveraged by the lending program, and are likely to have substantial repercussions on how public institutions perform. In Sri Lanka, support for privatization is also leveraged by the lending program.

Reorienting the public sector. The Bank has encouraged governments to exit progressively from commercial activities and service delivery that can be carried out more efficiently by the private sector. South Asian governments have now opened most areas of the economy to the private sector, including areas that had been reserved for public sector investment for many decades. However, because of strong opposition from vested interests (principally unions and bureaucrats), privatization of state-owned enterprises has been slow, and government officials continue to dominate company boards. In India, the states have made more progress on privatization and in promoting competition in the private sector than has the central government.

Notable among the efforts to reorient the public sector are the institutional changes being made in the power sector, which are encouraging substantial private investment in power accompanied by a very different way of doing business (Box 23). The Indian states of Orissa, Haryana, and Andhra Pradesh are in the midst of major reform programs to privatize power utilities with Bank assistance, and several others (Gujarat, Rajasthan, Uttar Pradesh) have declared their intention to follow suit. The Bank has started a dialogue on the long-term reform of the power sector in Bangladesh, but the process is at an early stage. Privatization outside the power sector has also been initiated in Bangladesh, BOX 22

Subnational Assistance for Governance and Public Sector Reform in India

The 1997 India CAS urged a "focus mainly on those states that have chosen to embark on a comprehensive program of economic reforms." Bank assistance to Andhra Pradesh represented the first such partnership. The Andhra Pradesh Economic Restructuring Project (APERP) is a multi-sector loan within a fiscal framework that shifts expenditures toward growth enhancing social and infrastructure investment, while containing growth of debt, public guarantees, and debt service expenditures. Sectoral components of the loan include support for strengthening rural irrigation, primary health and education services, rural roads development, and child nutrition. The APERP also supports the state's efforts to restructure and divest public enterprises, many of which constitute a major drain on the budget. The Bank continues to work closely with the Government of Andhra Pradesh to provide assistance and make available information about promising reform efforts in other countries.

Uttar Pradesh represents the second phase of this state-focused approach, based on a multi-year, multi-sector reform strategy that includes governance and fiscal reforms as core elements. The Bank's program in Uttar Pradesh brings together a diverse set of instruments, from adjustment to investment lending, and from poverty to judicial assessments. These are being delivered in an integrated manner, akin to the approach envisaged by the CDF, and through an overall Bank-Government dialogue rather than the traditional sector-specific approach. The governance reform program covers a broad spectrum of issues, including civil service renewal, expenditure management, public enterprise reform and privatization, decentralization, anticorruption, and financial management and accountability. These reforms to core systems and procedures of government are being closely integrated with policy and institutional reforms in key sectors such as power, irrigation, forestry, health, and roads, as part of a broad, multi-sector program.

Depending on client interest, this integrated approach to economic policy, governance, and institutional reform is likely to be adapted to other states in India. With the Bank's encouragement, Karnataka recently began developing a strategy for public sector reform involving topics such as right-sizing, public sector restructuring and electronic governance. Dialogue is just beginning with other states, such as Rajasthan and Orissa.

BOX 23

Power Sector Reforms in South Asia

South Asian countries are transforming their power sectors. Pakistan and several Indian states have pioneered this transformation, and important lessons have been learned in the process. The power sectors have been dominated by inefficient and poorly governed public utilities. The bulk of the rural population and many urban residents do not have access to electricity, even though they can pay for it. Load-shedding and power outages have added greatly to business costs. Public power utilities have been subject to political pressures to set tariffs that subsidize the well-off, and to hire staff even while poor pay makes it difficult for the utilities to retain qualified employees. These factors, coupled with laxity about dealing with electricity theft, have led to the accumulation of huge losses. The utilities relied on the government to provide investment capital and to cover operating costs.

Starting in the early 1990s, donors and multilateral institutions began holding back their support for the power sector in the absence of fundamental reforms. At the same time the private sector started to display considerable interest in investing in power generation. The growing demand for better services, growing financial requirements, and the failure to find resources elsewhere led political leaders to consider reform.

In the early 1990s, Pakistan was among the first to attract private investments for new generating plants. In the process, mistakes were made and lessons learned. Pakistan paid insufficient attention to financial and economic consequences and failed to fully implement planned reforms of the publicly owned utility, a process that should have preceded the entry of private capital in generation. These reforms include:

- Unbundling power plants from the power system;
- Creating a separate transmission company that can operate at arm's length from generators and distributors;
- Unbundling distribution into several utilities to facilitate regulation and create quasi-competition in natural monopoly settings;
- Creating an independent regulatory body, supported by adequate legislation, so that pricing is determined on the basis of objective criteria.

The process of power sector restructuring in South Asia has been far from easy, given the interest of stakeholders, unions, workers, and managers. Experience demonstrates, however, that involving workers' representatives early in the restructuring exercise can facilitate the process. Compensation for honest losers from the restructuring is also needed. More difficult to overcome is the resistance of those who wrongfully benefit from corrupt practices.

Nepal, Pakistan, and Sri Lanka. Each is now active in creating the minimum consensus and conditions to allow privatization to proceed. In Sri Lanka, the Bank helped privatize public enterprises ranging from tea estates and the national airline to the post office and telecommunications. In Pakistan, the Bank has supported privatization of public banks. Bank support for privatization in Bangladesh has, however, not been very successful, and a large structural adjustment credit (for jute mill privatization) had to be cancelled.

Establishing regulatory frameworks and agencies. Recognizing that without a competitive environment privatization cannot be effective and could result in abuses, the Bank has given considerable attention to helping governments establish effective and appropriate regulation. The dangers of inadequate regulation have been clearly demonstrated in South Asia's banking systems. In Bangladesh and Nepal, poor banking supervision and enforcement have allowed unrecoverable loans to accumulate to high levels, often through fraud. In India, Pakistan, and Sri Lanka, progress has been made with Bank assistance, but their respective banking systems continue to be dominated by inefficient public sector banks. Appropriate regulation is also needed to protect the public interest from environmental and other hazards.

Together with its support for privatization, the Bank is also supporting the establishment of independent regulators in power, telecommunications, the environment, irrigation, and water management. Reforms in power have focused on regulatory agencies (in several states in India, Pakistan, and Bangladesh) that can oversee the privatization of generation and distribution. In telecommunications, the Bank has supported

BOX 24

Transforming Water Management in Pakistan

Pakistan's agricultural production comes predominantly from irrigated agriculture. Consequently, the efficient management of irrigation and drainage is crucial in the Indus Basin, the world's largest integrated irrigation network. For decades this responsibility was entrusted to a federal agency, the Water and Power Development Authority, and four Provincial Irrigation Departments, all of which acquired reputations of being rigid, centralized bureaucracies. Little effort was made to involve farmers in irrigation management. There was mounting criticism of the agencies' wastage of resources, low operational efficiency, unresponsiveness to stakeholders, and poor financial sustainability.

This situation has been changing substantially in recent years with water management reforms supported by several IDA-financed programs, notably the National Drainage Program. Water users' associations have been set up with delegated authority to operate and maintain irrigation canals. These users' associations, the changed mandate and structure of the Authority and the Irrigation Departments and measures to increase their operational efficiency and financial sustainability, and the extensive use of public awareness campaigns to build public support have been key to the reforms. The private sector's role in service delivery has also been enhanced by contracting out operation and maintenance.

the entry of private operators and a transfer of regulatory functions to independent agencies. Progress in this direction has been most marked in Sri Lanka, where service has improved substantially. Irrigation reform has been based so far on the formation of water-user associations in charge of the maintenance of distribution canals and cost recovery. In Pakistan this has led to a radical transformation in the way the sector is managed (Box 24).

Reforming key government functions. Overstaffing, poor compensation, inadequate training, and civil service incentives that discourage initiative have been identified as important reasons for poor public sector performance. Administrative practices and laws inherited from colonial regimes have remained largely in place, and little has been done to modernize them. Given these serious systemic problems, it is not surprising that reforms have generally progressed slowly, with considerable resistance to change from powerful vested interests (corrupt politicians, union leaders, civil servants, and business monopolists) that perceive reform as disadvantageous. The difficulties encountered are well illustrated by the case of Bangladesh (Box 25). Progress hinges critically on public sector downsizing that would release funds to be used for paying better salaries and for funding increased operations and maintenance—an approach that is opposed by public sector unions. The Bank has helped to meet the cost of staff redundancies in a number of cases (jute mills in Bangladesh), but there has been no concerted action so far by any government to create a smaller, higher-paid, well-trained, and better-performing civil service. Given the importance of improving key government functions, and notwithstanding the difficulties, the Bank's efforts in this area are extensive and diverse, covering budget systems and financial controls in most countries; civil service reform in Sri Lanka, Pakistan, and some Indian states; land records in Sri

BOX 25

Addessing Public Sector Management Reform in Bangladesh

In 1996 the Bank completed a study, *Government That Works: Reforming the Public Sector*, with the participation of senior Bangladeshi government officials and local researchers. The report laid out a candid assessment of governance issues and proposed a comprehensive set of reforms in the hope that the new government, which took office after the June 1996 elections, would be willing to act. Indeed, the Minister of Finance circulated the report to his Cabinet colleagues and to Members of Parliament. Subsequently, following a workshop attended by senior officials and some political leaders, a number of priority measures were endorsed by Cabinet.

However, none of the substantive measures were implemented over the next three years, even though the need for reforms was apparently accepted. This experience serves to underline the political difficulties in supporting public management reforms from the top. It highlights the need to pay much more serious attention to the incentives faced by all stakeholders, both formal and informal, and to find ways to build public support for reform that go well beyond senior officials and the elite in society.

Lanka; tax administration in Pakistan, Bangladesh, and several Indian states; a public sector modernization project under preparation in Bangladesh; legal reform in Bangladesh and Sri Lanka; and procurement procedures in several countries. Assistance has been provided through both structural adjustment loans and technical assistance. Extensive domestic public debate, helped in some countries by reports by the Bank and other donors, has helped to fuel growing public pressure for reform of public administration, and the topic is now very much on the political agenda. In Pakistan, for example, the Bank has issued a major report on reforming the civil service, which will be a basis for further dialogue. This is also the case with the Bank's study on the state of Uttar Pradesh in India, which discusses governance as a central focus of our assistance.

We recognize that there will not be quick results, but rather a long and difficult process of change that will need to be pursued with persistence and patience. Partnerships with other donors—for example DFID, UNICEF, and USAID in India for the state-focused work, and with ADB and OECD for power reforms in Bangladesh—are important in this process of long-term change.

The challenges ahead

Using the lessons from the Bank's extensive assistance in South Asia to address public sector weaknesses, we are now moving to more strategic and systemic work on institutional development, public administration and governance. We realize that new approaches and new skills are required to become more effective. Our strategy will assist privatization and deregulation where the role of the public sector needs to be redefined; mainstream public institutional concerns in our sector lending and nonlending services; form partnerships with NGOs and others in civil society to foster the demand for institutional change; and ensure that institutional concerns are central to our country dialogue. Our aim will be to help governments, both at national and subnational levels, strengthen the core functions of public administration and to support the building of inclusive and accountable institutions for improved service delivery. We see the need to build partnerships with other donors and across sectors to tackle this task in more coordinated ways. Through operational learning, we will identify and disseminate good practice that fits local conditions.

There can be little dispute that the two crucial factors underlying the performance of institutions are the incentives that drive the behavior of the main stakeholders and the absence or presence of accountability frameworks. Our work has often proceeded under the assumption that the key to performance lies in formal organizational structures and rules, without full consideration of informal practices and their impact on development outcomes. We have tended to advocate technocratic, "best practice" solutions based on global experience, while ignoring the underlying social context in which the institutions are rooted and which shape the informal rules. An IGR recently completed in Bangladesh examines these issues as part of its assessment of institutional performance. The challenge ahead is to understand better this local reality, to listen better, and to help design "best fit" solutions that combine worldwide "best practice" and local "good fit". Ultimately, the solution to these problems must be home-grown—coming from within each country's administration, NGOs, and civil society and responding to a growing public demand for reform. The Bank can and should foster this growing demand by helping to make available promising practices, particularly those derived from within the region, and by placing the issues firmly and openly on the table through good analytic studies and dialogue with governments and civil society.

Nurturing inclusive and accountable institutions. There appears to be a growing consensus in South Asia that decentralization is one of the most promising strategies for greater inclusion of citizens in governance and development and for bringing government closer to the people. In India, the 1992 constitutional amendments provide for the establishment of stronger elected local authorities. Bangladesh is in the process of creating a three-tiered system of elected local government. These changes could have profound implications for the way public services are delivered and create opportunities for citizens to participate more directly in the process.

Unless effective accountability is ensured, the benefits may be captured by local elites. Consequently, the links between local NGOs, community-based organizations, and elected bodies need to be nurtured to achieve inclusive and accountable arrangements, and to give "voice" and representation to vulnerable groups. The Bank has already begun and will intensify a dialogue on center-state relationships and support for local government administrations (in Sri Lanka, Bangladesh, Pakistan, and several Indian states). We plan to undertake a number of studies to enhance our understanding of these issues and to improve the design of future Bank-supported operations. This work will also address the need to create more effective systems for monitoring and measuring accountability and inclusiveness.

Improving accountability mechanisms will be a general goal, not limited to local government settings. For example, we are very interested in seeing countries improve overall financial management accountability in the public sector. CFAAs have been started for almost all countries in South Asia. These will go hand in hand with our efforts to help improve countries' anticorruption efforts and will include support for civil society institutions, such as local chapters of Transparency International. Related to this effort is support for diagnostic surveys on service delivery and corruption that will generate hard data on what is actually happening as experienced by households and enterprises.

Operational learning. Recognizing the complexity of institution-building, we see a need to be much more cautious than in the past in advocating the transfer to South Asia of institutional models developed in other countries and contexts. Instead, there is an imperative to learn more from in-country experience. Furthermore, in supporting new initiatives, much value is to be gained from a highly participatory approach in order to arrive at appropriate project designs. This approach will be applied not just to village and municipal level programs (including school boards and community management of health facilities), but also to efforts to reform core public administration functions such as tax administration, public expenditure management, and personnel management. We are also proposing to undertake a review of the experience with institutional development activities in Bank projects to strengthen our understanding of what works and what does not at the project level. Such operational learning will be important since much of the South Asia Region's assistance for institution-building will continue to be incorporated in its sector projects. This will build on closer coordination and knowledge sharing between sector units, including the PREM and social development units.

Organization, staffing, and partnerships. To enhance attention to the institution-building, public management, and governance dimensions of our work, new staff are being hired with specialized expertise, particularly in core public sector reforms. At the same time, there is no intention at this juncture to create a separate public sector group in SASPR, as the Region sees institution-building as an integral part of all sector units' work, requiring staff with requisite skills and orientation to deal with these issues in each sector. To facilitate learning across sectors and countries, the Region is considering setting up a small working group on governance and public sector management involving staff from both sector and country units. In the area of financial management, we have already recruited specialist staff for Bank offices in the field. A new chief financial officer has joined recently and will help guide the Region's financial accountability framework.

The fuller recognition of the need to understand social, cultural and political aspects of our work will require the social development unit to give attention to wider aspects of governance and the management of the core functions of the state, as well as to intensify its work at the local level. Success in addressing institutional weaknesses will depend on both a multi-disciplinary and a cross-sectoral approach. It will also depend on more fully integrating "best practice" and the knowledge generated elsewhere in Bank and the networks, and integrating the services of WBI more closely in our work.

Since many development agencies are active in assisting South Asian countries with institution-building, public management, and governance, we are placing strong emphasis on donor coordination, especially at the country level. The aim will be to agree on common approaches and to ensure that we draw on each other's strengths to deliver the best possible support to our clients in South Asia.

EXAMPLES OF INNOVATIVE INITIATIVES

India: Uttar Pradesh Fiscal and Governance Reform

Type of Activity: Loan/Credit
Timing: Approved: April 2000; Single-tranche operation
Loan/Credit Amount: $250 million ($150 million IDA and $100 million IBRD)

Summary of Contents

Uttar Pradesh is India's most populous state and one of its poorest. It has experienced prolonged economic stagnation, fiscal crisis, and collapse in its development programs. There has been little progress against its massive poverty (41 percent poor) in recent decades. This Loan/Credit supports the government of UP's reform program aimed at addressing the fiscal crisis and improving governance. It is a single-tranche loan, the first subnational adjustment loan in India and also the first in a sequence of three or four loans to support fiscal and governance reforms. The operation is part of a State Assistance Strategy that seeks to support the state's efforts to turn around its economic and social performance. That state strategy includes support for reforms in the power, water and irrigation, health, education, roads, urban and rural sectors. The proposed loan/credit will support the initial phase of the state's program to restore fiscal sustainability and reform governance, critical as they are to accelerating growth and reducing poverty. The actions triggering the presentation of the operation to the Board emerged from the economic policy dialogue with the government of UP spanning the last 18 months during which this operation was prepared.

Innovative / Risky Elements

This operation, designed to support CAS objectives and part of the UP State Assistance Strategy, is key in an ongoing effort to improve the fiscal situation and introduce structural reforms in Indian states. The operation reinforces recent initiatives by the Government of India to stimulate such reforms. Expected direct benefits include: (a) improved fiscal situation; (b) improved governance; (c) higher growth and reduced poverty; (d) contribution to reduction in the overall public sector borrowing requirement; and (e) encouragement of similar reforms in other Indian states. The major risks are: (a) possible reversal of reforms caused by political resistance; (b) lack of adequate institutional capacity; and (c) significant unanticipated decline in central government transfers to the state.

Partnerships

The Bank has initiated a dialogue on UP within the donor community and has briefed various development partners about its assistance strategy. Given UP's massive population and poverty, there is both room and need for a much stronger effort by development agencies there. Over time, following the reforms supported by this operation, many opportunities for collaboration are expected to open up in a new context of reform and restructuring. Some of this has already begun, for example in the power sector, where the Bank typically works alongside bilateral cofinancing. Bank staff are also keeping the IMF briefed on the status of these reform efforts.