

# FAST TRACK BRIEF

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*The IEG report “World Bank Engagement at the State Level: The Cases of Brazil, India, Nigeria and Russia,” was discussed by CODE on September 21, 2009*

## World Bank Engagement at the State Level: The Cases of Brazil, India, Nigeria and Russia

- ◆ Beginning in the late 1990s, the World Bank significantly expanded its engagement at the state level in Brazil, India, Nigeria, and Russia. This pilot cross-country study reviews the selected cases of World Bank’s lending and analytic work at the state level in those four large federated countries. In each case, state governments were the Bank’s principal development partners. The study looks at the evolution of the four country strategies and the Bank’s mode of engagement at the state level, in order to draw lessons from that experience both for the Bank and for its federal and state partners.
- ◆ State-level engagement posed several strategic and operational questions, among them which states to engage, the scope of engagement, and the modalities of engagement. The Bank set out its approach to selecting states in country strategy documents. Two tendencies—often in tension—featured in most approaches. One was to support better-performing, reformist states (“lead or focus states” approach). The other was to support the poorest states as a more direct route to reducing poverty. Concerning the scope of engagement, the initial and principal area of engagement was typically fiscal reform - fiscal sustainability, medium-term fiscal frameworks, strengthening the public financial management capacity of state governments, and fiscal federalism. In some states, Bank involvement extended beyond fiscal reform to multisector engagement focused on the growth and poverty reduction agenda. The modalities of engagement and the instruments deployed by the Bank evolved over the review period and included state-level development policy loans, multisector results-based investment lending, and reimbursable technical assistance. There was considerable successful innovation in this area, yet little knowledge sharing between countries.
- ◆ The following findings are worth highlighting. First, the study confirms the desirability of continued selective Bank lending in a few states. However, the poverty impact of those interventions could be enhanced by balancing states’ propensity to reform and the concentration of poverty within them, giving greater weight to the needs of poorest states. Second, continued focus on public finance management as the core area appears sound, irrespective of whether engagement is confined to this area or serves as an entry point for broader engagement. And third, there is considerable scope for greater impact from analytic work, knowledge transfer, and expanded knowledge sharing -- not so much concepts and theories as practical experience of what works and what does not.

## Evolution of Bank Strategy

### *Why State-Level Engagement?*

Over the past decade, the World Bank significantly expanded its engagement at the state level in four large federations: Brazil, India, Nigeria, and Russia, mainly through lending, but also through policy dialogue, technical advice, and analytic work. Both demand and supply factors contributed to this expansion.

On the *demand side*, federal governments focused on fiscal stabilization following the financial crises of the late 1990s. They saw the potential for the Bank to provide state governments with incentives for reform through financing, while encouraging discipline through agreed policy measures and providing technical support for implementation. Federal governments had limited scope for differentiating between states based on factors such as commitment to reform and saw in the Bank's capacity to do this a means of assisting states willing to take a lead, with the possibility of a demonstration effect for other states. State governments were also eager to borrow from the Bank because its loans, denominated in foreign currency, generally came at lower rates than provided by the federal government or the domestic market. Bank loans, while often financially modest at the federal level, could be a major source of financing at the state level. State governments welcomed the Bank's focus on their economy as well as the associated dialogue, advice, and analytic work. In addition, with the increasing concern about meeting or achieving outcomes with regard to the Millennium Development Goals (MDGs), both federal and state governments saw the Bank as having a comparative advantage in supporting better service delivery in the relevant social and economic sectors at the state level.

On the *supply side*, with the combination of fiscal stabilization and improvement in the fiscal situation of the four countries during the commodity boom of 2000-07, there was a limited appetite to borrow from the Bank for federal programs (this trend was more pronounced in Brazil and Russia; Nigeria, an IDA borrower, was an exception; in India, federal level borrowing increased slightly in 2004-07). A level of Bank engagement commensurate with the size and importance of these countries therefore almost mandated the shift to the state level, where demand remained buoyant. The increasing focus of the Bank on poverty reduction after 1995 was also an important factor. There is a distance between federal-level programs and results on the ground in such large countries. Most of the public expenditure categories most closely associated with poverty reduction in the short and long term usually are state responsibilities in these countries. Therefore, increasing the Bank's impact on poverty reduction meant increasing the focus on and activities at the state level. In addition, many Bank country and sector staff found work at the

state level in these countries more rewarding given the client's greater interest in the Bank's financial and knowledge resources.

### *Which States?*

The shift to the state level presented the Bank with a number of operational issues. Among them was which states the Bank should engage. The four countries have large numbers of states—26 states and a Federal District in Brazil, 28 states and 7 Union Territories in India, 36 states and a Federal Capital Territory in Nigeria, and 83 Regions (“subjects of the federation”—republics, *oblasts*, *krais*, and *okrugs*) in Russia. Working in all of them would obviously be beyond the Bank's budgetary and human resource capacity. The Bank defined the strategic approach to the selection of states in its Country Assistance Strategies (CASs). Some attempts were made to develop quantified criteria for selective engagement, but the Bank generally preferred to keep the criteria broad to allow for flexibility. It is clear from all the countries reviewed that there was tension between the Bank's interest in identifying progressive, reforming states that could serve as demonstrations to others and its interest in supporting poverty reduction by assisting the poorest states. In addition to these two key criteria—effectiveness of assistance and need (poverty)—another no less important criterion was the political economy, unique in each country and including (but not limited to) relations between the federal center and the states; capacity and political affiliation of the state-level leadership; level of trust and relationship of the Bank teams with the clients; and local politics and electoral cycles.

In *Brazil*, the shift toward states was proposed in the 1995 CAS, directing lending to creditworthy reforming states. The 2000 CAS continued this approach using criteria established by the federal Fiscal Responsibility Law (FRL) and stressed the intention of providing assistance to the states of the North-East region with highest poverty levels. Lending to states became more multisectoral, and significant innovations were introduced, such as state-level sectorwide lending (multisector SWAp) and state-level development policy loans (DPLs). Both instruments were applied in states that had turned the corner fiscally, despite significant disparity in their income levels. The 2008 Country Partnership Strategy (CPS) focused on a technical assistance program of modest size with the federal government and a major demand-driven lending program with states, conditioned on perceived commitment, ownership of reforms, and fiscal responsibility. The Bank engaged with some of the more prosperous and reformist states. Although initially the Bank attempted to expand investment lending, this proved cumbersome given the two-tier approvals required by the state and federal government. As a result of joint consultations with state and federal counterparts, by 2008 the composition of state-level lending shifted toward cross-sectoral operations in

support of economic policies and public sector reforms (DPLs and multisector SWAs).

In *India*, the Bank shifted its focus to the state level following the 1997 CAS. At that time, states were facing financial problems, and both the federal and state authorities were keen to tap the Bank's resources and take advantage of technical assistance. The Bank opted for major involvement in progressive reforming states ("focus states" approach). The 2004 CAS signaled a change of strategy, noting that the focus on reforming states was resulting in neglect of the lagging states. Therefore, the CAS proposed the provision of technical assistance to the lagging states and to try shifting lending to them as well. This proved to be difficult. As the 2009 CAS completion report noted, while lending at the state level remained a large share of the overall program, the share of lagging states in the program had actually declined.

In *Nigeria*, the Bank reactivated and intensified its lending activities after return to civilian rule in 1999. During that period, Bank strategy passed through two phases: a period of interim strategies (FY00-05) following re-engagement; and the FY05-FY09 CPS, when the Bank adopted a medium-term focus. Engagement at the state level in Nigeria was largely driven by the social and poverty reduction agenda, with focus on improving infrastructure and providing support for agricultural and rural development. During the CPS FY05-09 period, the Bank's strategy formally moved to focus on well-performing states ("lead states"), seeking to leverage state efforts and resources by granting them access to a "performance package." Five states were selected based on the government-led SEEDS benchmarking process.

In *Russia*, the 1997 CAS emphasized regional investment projects (despite recognition that they were expensive to prepare and supervise). The next CAS (1999) outlined a phased shift in lending away from investment projects in infrastructure and energy in favor of increased emphasis on systemic aspects of institutional development. The 2002 CAS continued the strategy shift, emphasizing support for reforms at the regional level, particularly in strengthening public sector management. The 2005 CAS Progress Report stated that work at the regional level was to be carried out in a multisectoral manner and would concentrate on a small number of regions in agreement with the federal government. The 2007 CPS added a finishing touch: the plan for gradual shift to the new modalities of cooperation and instruments, such as the subnational facility that allows the Bank Group to provide funds without a sovereign guarantee to states and municipalities; and provision of technical assistance on reimbursable basis (fee for service).

## The Scope of Engagement

The second issue for the Bank was the *scope* of its engagement. In *Brazil*, *India*, and *Nigeria*, the Bank had had numerous state-specific projects in the past as part of its support for nation-

wide sectoral programs. The decision about which states to engage, for example, in support for agriculture and rural development in *India* or education in *Brazil*, was sometimes a matter of strategic choice, but more often a matter of historical engagement or the availability of analytic work, based in turn on opportunistic involvement of the Bank in particular states. In the new context, the Bank was steering toward a new model of engagement. This tended to have two elements: support for *fiscal reform* and broader *multisector engagement* at the state level.

### Fiscal Reform

The Bank expanded its involvement in fiscal reform in selected states. With the focus on stabilization and the need to reduce growing state deficits or enhance state public expenditure management capacity, the Bank engaged in two areas. The first of these was *fiscal federalism*. Fiscal relations between the federal and state governments are politically highly sensitive, since this is often at the core of balancing regional interests. From a strictly economic perspective the resources available to the state governments need to be balanced with their expenditure responsibilities. For many taxes it is more efficient to centralize collections. Hence, generally there is an imbalance between the revenues collected by the states and their developmental mandate. In *Brazil* this imbalance is relatively modest, but in *Nigeria* it is very large. This means that the federal government is required to transfer resources to the state, generally based on various formulae that take account of population, per capita income, and the state government's own tax effort. In the countries reviewed, federal transfers have not been very effective in reducing disparities in expenditure capacity between states. A second key issue in fiscal federalism concerns discretionary transfers from the center to the states, usually intended to provide an incentive to states to undertake high priority programs. The Government of *India* has used such schemes a great deal. For the Bank, the political sensitivities make fiscal federalism a difficult area for intervention unless there is an explicit request from the federal government. The Bank has undertaken substantial analytic work in this area, with *Russia*, where new fiscal relations were being defined in the past decade, as a very good example.

A second and far larger part of Bank engagement in fiscal reform is its direct support to *public finance management* at the state level, including enhancements in tax capacity, modernizing the tax structure, developing a sustainable fiscal policy and medium term expenditure framework, and improving budget and expenditure management. The Bank's engagement model generally started with a trigger mechanism that required states to show commitment to fiscal reform. This requirement was highly formalized in *Brazil* where the federal government requires strict adherence to the Law on Fiscal Responsibility (FRL). In *India* and *Nigeria* the requirements were less forma-

lized but generally related to timely budgeting and reporting. In *Russia*, criteria were established for participation in the fiscal reform projects supported by the Bank. Once the triggers were met, the Bank was able to further support fiscal reform through an engagement model that combined analytic work with multisector lending and focused technical assistance in the areas of fiscal and governance reform. Elements of this model are present in each country. In *Lagos, Nigeria*, for example, intensive analytic work at the state level was combined with investment lending and technical assistance, but the Bank is only now considering the possibility of using multisector lending in support of its approach. In *Andhra Pradesh* and *Orissa* in *India*, the Bank carried out analytic work and subsequently used multisector loans to support fiscal reform, but technical advice, except insofar as it was embedded in the analytic work and lending activities, has not been a focus of the approach. The Bank's involvement with tax policy has been relatively light, with the focus of its efforts being on budgeting and public expenditure management systems and increasingly on governance issues associated with transparency and accountability for efficient service delivery.

#### *Multisector Engagement*

In addition to fiscal engagement, the Bank has also undertaken a broader *multisector engagement* at the state level, which has focused on the growth and poverty reduction agenda. This has involved a mix of analytic work, adjustment lending, and investment lending. In only a few cases has the Bank produced an explicit strategy for its activities in a particular state. Usually these were covered in broad-brush fashion in the CAS. At its most developed, as in *Andhra Pradesh* in *India* and in *Ceará* in *Brazil*, the Bank programs combined investment lending in most of the core economic and social sectors with multisector lending. The objective was to derive synergies from the combination of activities. In *Andhra Pradesh*, for example, the Bank was explicit in its view that the difficult measures required for fiscal reform needed to be matched by increased investment in agriculture, rural development, health, and education to provide a politically acceptable package of reforms. The selection of states for this broader engagement focused more on fiscal reform than on the broader poverty issue. The Bank spent a great deal of time in these countries supporting relatively high-income, high-capacity states (such as *Minas Gerais* in *Brazil*, *St. Petersburg* in *Russia*, and *Karnataka* in *India*). While this support added value, it came at the expense of Bank efforts in poorer states that lack capacity.

### Modalities of Engagement

*How to engage* was also a concern for the Bank during the period, with considerable evolution in the approach. The first bridge to be crossed was the use of adjustment (development policy) lending at the state level (the first such adjustment loan was made in March 2000 to the state of *Uttar Pradesh* in *India*). Until that point

the Bank had struggled to find an instrument to attach its policy dialogue and strategic approach to at the state level. The multi-sector restructuring loan in *Andhra Pradesh*, an investment loan undertaken in 1998, was a way to accomplish this, but it was an enormously costly operation to prepare and supervise. Adjustment lending rapidly became the instrument of choice to support fiscal reform and statewide strategies in *Brazil* and *India*, but in *Brazil* there was a sense that it was less effective in reaching out to the line ministries in key sectors. The Bank's Brazil country team developed the innovative approach of a multisector SWAp, a results-based instrument with target indicators defined for each sector and disbursements associated with achievement of the targets. This had very positive outcomes in that it brought to the fore the linkages required to achieve results, such as the need for improved water supply in order to reduce infant mortality. Another important innovation was the pioneering of reimbursable technical assistance at the state level in *Russia*. Bank budgets rarely allow the level of analytic work demanded by intensive engagement in three to five states, and an approach whereby states can pay for additional work has considerable promise for other middle-income countries.

### Findings

Overall, the analysis leaves little doubt that the Bank engagement at the state level did add value. There was a great deal of enthusiasm at both the federal and state levels in these countries regarding the Bank's contribution and a large number of specific achievements, ranging from fiscal reform in *Orissa, India*, to effective technical assistance and capacity building in *Lagos, Nigeria*, to a wide range of achievements in *Ceará, Brazil*, and improved fiscal management in *St. Petersburg, Russia*. Although state level engagement often requires additional effort and can be resource-intensive, it is usually worth the cost. In many states and regions the Bank's program was pivotal in reinforcing the efforts of pro-reform government officials and helped to develop an expert community and a pool of local consulting institutions that were drawn into the process of public policy formulation and implementation.

The main findings of this review, which may be helpful in guiding the organization of future work at the state level, include:

On *selection* of states:

- The strategy to concentrate lending services on a few states to enhance the impact of the Bank's program is right in principle, but selection criteria and the mode of implementation could give greater weight to the needs of the poorest states.
- Bank engagement with high-performing states clearly added value, both strengthening in-state capacity and



encouraging state-to-state knowledge transfer, albeit mainly between the high performers. However, there is little evidence that it had the desired demonstration effect on poor, lagging states on the scale that the Bank hoped for, or that the Bank had an exit strategy to permit increased focus on poorer states over time. At the same time, experience shows that it is possible to achieve results in the poorest states through persistent work with committed state counterparts and strong partnership with the federal government and other donors.

- It is important to stay engaged not only in states that are able to borrow from the Bank, but also in states that have no fiscal space to borrow but demonstrate a genuine commitment to development that can be supported through analytic work and technical assistance.

On the *scope* of engagement:

- Continued focus on public finance management as the core area for state-level work appears sound, whether engagement is confined to this area or it serves as an entry point for broader engagement.
- The lending programs and Bank budgets in some states are often larger than for many countries the Bank engages with. For those states where the Bank plans or has a major engagement, a brief state strategy document could be a useful tool for defining the scope of engagement and developing a medium-term outlook.

On *modalities* of engagement:

- There is considerable scope for greater impact from knowledge transfer and expanded knowledge services. In particular, there is strong demand for better knowledge sharing, both within the Bank and across the countries concerned. This is not so much a matter of sharing of concepts and theories as of practical experience regarding what is working and what is not.
- Widening the scope and increasing the amount of analytical work at the state level could be helpful in identifying high-impact, high-priority areas. There seems to be a potential for closer partnership between state governments and the Bank in this area.

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