1. Country and Sector Background

Acceleration in economic growth has propelled India onto the global stage as an emerging economic giant. The country has experienced an average annual GDP growth rate of over 8 percent during the past three years with real growth rate projected above 9 percent for 2006-07. Growth is broad based, with robust consumption, investment, and exports. The acceleration in economic growth has coincided with millions of Indians moving out of poverty, and the poverty head count ratio has fallen from 36 percent in 1993-94 to 28 percent in 2004-05.

Along with structural reforms to improve the investment climate greater openness has led to increased competition, higher levels of investment and generated robust and durable growth in the Indian economy. The aggregate investment rate in the economy has increased to 34 percent of GDP in 2005-06, from about 23 percent in 2001-02, much of it due to greater private investment financed by higher domestic savings of 32 percent of GDP.

The external position of India’s economy has improved dramatically. The rapid growth of exports and high volume of remittances has resulted in a comfortable reserves situation (US$ 212 billion as on June 22, 2007). The current account deficit was a reasonable 1.3% of GDP in 2005-06. India’s vulnerability to an external crisis is limited by its record level of reserves, equivalent to more than 7 months of imports and exceeding India’s gross external debt. The fiscal position of state and central governments has continued to improve and the general government fiscal deficit (states and central governments combined) has fallen from more than 10 percent of GDP in 2001-02 to about 7.4 percent in 2005-06. General government debt has remained high—although declining—at nearly 83 percent of GDP in 2005-06. The key downside macro risks facing the Indian economy in the short term are higher oil prices, inflation, rapid credit growth, and a slowdown in the global economy, although they are unlikely to derail the overall momentum.

Himachal Pradesh (HP) the beneficiary of this operation is a small mountainous ‘special category’ state in India. Special category states receive generous Central government plan grant assistance. HP has significant achievements in terms of economic growth and social development, in spite of its natural constraints. Since the mid-1990s, HP has grown marginally faster than the rest of the country and has the second lowest poverty headcount ratio in India of 11.6 percent and is on track to achieve most MDG indicators. Service delivery and infrastructure provision is also superior to most Indian states.

---

1 “Special category” states are those having characteristics like strategic border locations, hilly terrain, inadequate infrastructure, large tribal population, and limited resource bases compared to development needs. There are eleven “special category” states in India.
HP’s achievements mask several challenges that confront it. Most importantly, HP’s achievements have been largely led by the public sector. HP realizes that, to a great extent, the state may be reaching the limits of its traditional source of growth and development: one that is heavily dependent on public spending, financed largely by borrowing and central government assistance.

The Government of Himachal Pradesh (GoHP) recognizes that the sustainability of HP’s success will depend on: (a) shifting the growth strategy that is still far too heavily dependent on public expenditures—to an increasing focus on growth led by the private sector; (b) creating productive employment opportunities for HP’s young and educated labor force, so that reliance on the public sector—which currently accounts for about 85 percent of organized sector employment—as an employer decreases; and (c) leveraging the state’s rich environment and natural resources in a sustainable manner to create growth and employment opportunities. HP’s articulated medium term development priorities focus on precisely these issues. The priority is to put in a framework for the development of hydropower and tourism in an environmentally sustainable manner; strengthen the environment management framework in the state, promote private sector development for faster growth and productive employment—all supported by enabling fiscal and governance reforms.

The major constraint faced by the state is the creation of fiscal space to finance the state’s development vision while moving towards a fiscally sustainable position. About 65 percent of Government of Himachal Pradesh’s (GoHP) expenditure is committed to salaries, pensions, and interest payments squeezing fiscal headroom for investment. GoHP also carries high debt stock of about 74 percent of GSDP straining its debt servicing ability. However, GoHP has recently begun to receive substantial non-tax revenue from hydropower royalty, implemented tax reforms (most notably VAT), and achieved expenditure compression putting the state on track to achieving fiscal sustainability. GoHP would now like to consolidate these achievements.

2. Operation Objectives

The overarching objective of the proposed HPDPL1 is to support the implementation of critical structural, fiscal, and administrative reforms needed to achieve sustainable and rapid economic growth and inclusive development over the medium term, while sustaining the environmental heritage of the state. The priority areas for the first operation will be fiscal adjustment, and promotion of environmentally sustainable development with particular reference to hydropower. The overall program will also support measures to enhance growth and livelihoods, and improve governance and public administration.

Depending upon a strong fiscal adjustment program and financing needs, adjustment support from the Bank is envisaged to be up to US$ 500 to US$ 600 million over 4-5 years. It is expected that this support would be in the form of three or four two-tranche operations, disbursed against upfront actions.

3. Rationale for Bank Involvement

HP’s continuing development would be vulnerable if the state is unable to sustain its macroeconomic performance. GoHP recognizes that state-led development has certain limits, and generous financial transfers from the Central government cannot be assumed indefinitely—especially as HP’s development achievements influence the redistribution of resources progressively to weaker states. Accordingly, GoHP has sought World Bank involvement to strengthen its fiscal performance, improve public financial management, promote better environment management, and develop a framework for sustainable development its two most valuable sectors—hydropower and tourism. The operation would provide a valuable learning experience for other states rich in natural resources seeking to harness their development potential sustainably. These provide adequate rationale for staying engaged with HP over the medium term.

One of the strategic principles of the World Bank’s 2004-2008 India Country Strategy is to selectively target limited resources to activities where assistance is welcomed, and can be most effective. The additional financing that the Bank can provide will provide financial backing for
the state’s reform program and enable HP to finance the direct costs of reforms as well as to substitute cheaper for costlier debt. The concessional terms of Bank assistance would enable HP to achieve a more rapid decline in its debt service burden than would otherwise be possible. Since hydropower is a national priority, and the Country Strategy supports the Bank’s re-engagement in the hydropower sector, the special focus on developing a framework for sustainable development of HP’s hydropower potential strengthens the case for Bank involvement.

4. Financing

<table>
<thead>
<tr>
<th>Source:</th>
<th>($m.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Borrower/Recipient</td>
<td>Nil</td>
</tr>
<tr>
<td>International Bank for Reconstruction and Development</td>
<td>135</td>
</tr>
<tr>
<td>International Development Association (IDA)</td>
<td>65</td>
</tr>
<tr>
<td>Total</td>
<td>200</td>
</tr>
</tbody>
</table>

The loan will be in two tranches of US$75 million and US$125 million respectively.

5. Institutional and Implementation Arrangements

The Department of Finance and Planning will be GoHP’s nodal coordinating agency for overall implementation and monitoring of reforms proposed under HPDPL1. A multi-departmental group of officials has been working with the Bank team towards preparation of the proposed operation, and will oversee the implementation and monitoring of relevant sector components. Agreed monitoring indicators form part of the program policy matrix. Overall outcomes will be monitored through data published by the Department of Economics and Statistics, GoHP, administrative data maintained by various departments, surveys as undertaken, and budget figures made available by the Department of Finance and Planning, GoHP. GoHP has held workshops on reforms, and important strategy papers and Plan documents are made available on the website.

Monitoring from the World Bank’s side will be undertaken through implementation-support missions—in close consultation and collaboration with GoHP. The Program Policy Matrix of the proposed operation provides a results framework that describes expected outcomes. During the missions, the benchmarks indicated in the matrix will be regularly evaluated, and interim steps taken by GoHP will be monitored.

6. Benefits and Risks

Benefits

HP’s articulated medium term development priorities recognize the state’s unique challenges and opportunities. The government aims to achieve an annual growth rate of 8.5 percent during the Eleventh Five Year Plan. In order to achieve this, the state seeks to capitalize on its comparative advantage, by increasing the productivity and economic value of its natural assets, and specializing in sectors where it can compete effectively in a globalized economy. The priority areas are: (i) creating fiscal space to fund the state’s development vision; (ii) exploiting the untapped potential in sub-sectors like hydropower and tourism in an environmentally and economically sustainable manner; and (iii) protecting the state’s environmental wealth, and improving the overall institutional approach to environment management. These areas are to be supported by measures to improve governance and public administration, and promoting private sector development for faster growth and productive employment.

Key policy focus areas for the proposed operation include sustainable hydropower development and environmental sustainable development of the state. Both are important issues in the national context. Increased water pollution or compromised river flows in HP can have implications for the productive capacity of the entire Indo-Gangetic plain. Given that HP has 13 percent of the total hydropower potential estimated for India, its sustainable development can help alleviate the power shortage in
India’s Northern Electricity Grid. Yet, given India’s federal structure, these issues cannot be dealt with by the Central government alone, but require active intervention by the state government.

Although the state had been performing well in recent years, its continuing development would be vulnerable if the state is unable to sustain its macroeconomic performance. There is a broad consensus emerging in HP on the need to transition to a more private-sector-led environmentally sustainable growth path—to avoid slipping into poverty in the medium term. The DPL will strengthen HP’s overall fiscal situation, improve public financial management, promote environmentally sustainable development to harness the potential of its two most valuable sectors—hydropower and tourism.

**Risks**

The main risks include political risk, vulnerability to natural shocks, and limited administrative capacity. The nature of these risks and the corresponding mitigation strategy is as follows:

- **Political Risk.** HP faces state assembly elections in early 2008. There is a significant risk that the administration might change prior to the release of the next tranche. Should a different government assume office after elections next calendar year, the reform program may have to reflect the new government’s priorities. In order to mitigate the risk of discontinuity, broad ownership of key objectives has been built among various stakeholders through extensive consultations. These consultations have helped align the operation to HP’s development priorities over which there is broad political consensus.

- **Fiscal Risk.** Non-adherence to the targets set in the Medium Term Fiscal Plan could derail the state’s adjustment path, and affect future tranche release. Enactment of the Himachal Pradesh Fiscal Responsibility and Budget Management Act, 2005, reduces the risk of deviating from the fiscal correction path. Linking of World Bank assistance, as well as Central government debt relief to annual fiscal adjustment, further strengthens the incentives for the GoHP to adhere to the MTFP. The award of the Sixth Pay Commission of Government of India (GoI), which is yet to be announced, will increase the salary expenditures of state governments as they typically adopt the Central pay award for their civil servants. The underlying fiscal model used for the operation provides for a reasonable increase in salary resulting from the yet unknown award. However, a higher than assumed increase will necessitate other fiscal correction measures to maintain adjustment. The operation is being designed with back loading of tranches to mitigate against risk of unacceptable fiscal slippage. GoI’s framework for DPLs provides for tranching, and evaluation of progress on tranche release conditions for release of the subsequent tranche. The fiscal risk is therefore relatively low.

- **Limited Technical Capacity.** While capacity in HP is arguably as good as that in other DPL states, the state may face technical constraints in implementing its first multi-sectoral DPL. In order to help alleviate these constraints, a program of technical assistance is being made available to follow through on the reform measures supported by the proposed operation. The risk is relatively low.

- **Environmental Risk.** One of the key challenges facing GoHP is to overcome the widespread perception that private investment-led economic growth could harm the eco-system and the livelihood opportunities of the poor and tribal population in the state. This risk is medium in nature. To help address this challenge, an analytical study will be launched by GoHP with support from the Bank to undertake a “gap analysis” of the environment—to eventually lead to an Environment Master Plan that will outline an environmentally and socially friendly path to industrial development and hydro power exploitation.

- **Reputation Risk:** Hydropower and tourism being environmentally sensitive sectors, failure to adequately address environmental issues can subject the operation to risk. As a mitigatory measure the program focuses on: (i) institutional building in the environment sector and environmental management capacity in other relevant agencies especially in sectors with
large environmental footprints such as infrastructure (ii) policy reforms (iii) improved
environmental stewardship and planning through an overarching Environmental Master Plan
for the state and (iv) overall strengthening of implementation and accountability mechanisms.

- **Vulnerability to Natural Shocks.** Poor economic performance as a result of natural shocks
could undermine the fiscal correction and slow down economic growth. Although calamity-
mitigation resources available at the disposal of the government can meet these contingencies,
this risk is being mitigated by basing the MTFP on reasonable assumptions. The likelihood of
this risk materializing is low.
7. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

Poverty is already low in HP, and the reforms supported under operation, and, more broadly, under the state’s reform program, are expected to make contributions to reducing poverty in several ways. Fiscal reforms will enable a greater share of resources to be focused on poverty-related expenditures or social-infrastructure. The Medium Term Fiscal Policy of the Government seeks to reorient public spending towards high-priority development spending (social sector spending, non-wage O&M, capital spending) that will provide primary education, health, basic social and infrastructural service to the poor, including support for improved agricultural performance.

Structural reforms towards private sector development seek to improve the investment climate by easing the regulatory burden on the private sector. This will enhance economic growth and employment opportunities. Governance reforms would reduce corruption and harassment, which tends to hurt the poor disproportionately.

Environment Aspects

HP’s environmental institutions and regulations build upon a comprehensive national level policy framework for environmental and forest management, which set out elaborate regulations and procedures that cover all aspects of environmental and natural resource management. Implementation of these is left to state level institutions. However, the environmental regulatory capacity in Himachal Pradesh is in its nascent stage and needs substantial strengthening.

It is in this context that this operation seeks to strengthen the capacity of the environmental agencies. It: (i) supports the establishment of a Department of Environment and Pollution Control; (ii) calls for a review of capacity and gaps and a time bound commitment to implement the recommendations of the assessment; (iii) establishes systems and procedures to mainstream and strengthen environmental management within key sectors (especially the large footprint sectors such as roads and hydropower); (iv) establishes mechanisms to enhance public participation and promote accountability; and (v) most importantly, supports the preparation of an Environmental Master Plan, accompanied by a time bound action plan for the execution and implementation of the Plan.

The Environmental Master Plan is envisaged as a strategic management tool to strengthen the sustainability of growth in the state and encourage stakeholder participation. It would facilitate comprehensive and holistic environmental management by providing a platform for integrating cross-cutting issues, engaging non-environmental agencies, establishing environmental baselines, identifying fragile areas and assisting in monitoring performance over time. This would provide a crucial information base that would allow environmental stewardship to be integrated into mainstream policy and decision making.

GoHP has identified hydropower as one of the state’s growth pillars. This operation recognizes that to optimize the potential of this sector there is a need to assure sustainability and equity through strengthened environmental management. There are weaknesses in the implementation of Compensatory Afforestation Treatment plans that will be addressed through this loan/credit.
8. Contact point

Contact: Mohan Nagarajan
Title: Senior Economist
Tel: (91-11) 24617241 X 257
E-mail: mnagarajan@worldbank.org

Contact: Ananya Basu
Title: Senior Economist
Tel: (91-11) 24617241 X 138
E-mail: abasu@worldbank.org

9. For more information contact:

The InfoShop
The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 458-5454
Fax: (202) 522-1500
Web: http://www.worldbank.org/infoshop)