

**PROJECT INFORMATION DOCUMENT (PID)
CONCEPT STAGE**

Report No.:AB3507

Project name	Regional and Municipal Infrastructure Development Project
Region	Europe and Central Asia Region
Sector	Roads and highways (30%); Water supply (30%); Sanitation (30%); Sub-national government administration (10%).
Project ID	P110126
Borrower(s)	Georgia
Implementation Agency	Georgia Municipal Development Fund (MDF), 7b, Yetim Gurjy st. 0105, Tbilisi. Tel: +995-32-943240 ; Fax: (99532) 940439 E-mail: mdf@mdf.org.ge ; web site: www.mdf.org.ge
Environment Category	<input type="checkbox"/> A <input type="checkbox"/> B <input type="checkbox"/> C <input checked="" type="checkbox"/> FI
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1. Key development issues and rationale for Bank involvement

Background In the years following the fall of the Soviet Union, there was almost no maintenance of infrastructure. This, combined with civil strife produced a dramatic decline in the state of municipal infrastructure services. Deteriorating local infrastructure has reduced the quality of life of the populace, and has also become a key obstacle for broad-based private sector growth. For services such as water supply and sanitation, the legacy of soviet era norms-based tariffs has led to inefficient service use practices and extensive subsidization of most utility services. Water and sanitation tariffs cover only a very small portion of direct operation and maintenance costs and no depreciation costs. Very poor service quality has contributed to very low willingness to pay for services, and tariff collection rates are very low.

To improve the effectiveness of local governments following the “Rose Revolution” in 2003, GOG has recently launched a range of decentralization and related institutional reforms. Consolidated local governments are now in the process of building their capacity to execute their enhanced responsibilities, but limited financial resources have constrained their ability to overcome the legacy of severely deteriorated infrastructure.

Key development issues related to the design of the proposed project include:

- ③ *Severely deteriorated public infrastructure.* Infrastructure managed by most local governments is twenty or more years old and maintenance has been very poor. Installed technology is often very inefficient from an energy use perspective, or poorly designed, or both.

- ③ *Lack of access to financing for infrastructure rehabilitation or service expansion.* Local governments have limited but improving revenue streams
- ③ *Growing but still weak local government capacity* to plan and execute increased responsibilities under decentralization, and under territorial and administrative reform. Local governments need revised tariff structures based on consumption to help manage service demand, stronger capacity for the management of assets to provide services in a sustainable manner, better strategic planning to achieve service improvements and strengthened technical capacity to ensure financial, physical, and environmental sustainability when infrastructure is rehabilitated;
- ③ *At the central level, high transaction costs for accessing and administering external financial resources.* Complex administrative arrangements for managing financial resources from multiple sources, each with different requirements leads to inefficient and expensive management at the central level;
- ③ *Inadequate database for strategic planning* and for monitoring the impacts and outcomes of interventions

Government Response and Relevance to CAS The process of building transparent inter-governmental fiscal relations is still in process. The Government has recently taken measures to show its commitment to municipal development through: a) aggregation of the 1,111 Local Self Governments (LSGs) into 69 Local Government Units (LGUs), b) municipal election and appointment of Head of Administration (Mayors) by elected local councils, c) adoption of a local budget law with a simple equalization grant formula, c) increasing local revenues through arrangements to share tax revenues, d) development of a sub-national fiscal database at Ministry of Finance, and e) building central and local capacity to implement an integrated system to monitor municipal budgeting and financial reporting systems.

Georgia's current reformed administrative structure became effective along with Local Elections on October 5, 2006. As provided in the Law on Local Self-Government Units (adopted in December 2005), a two level administrative framework was applied consisting of central government and local self-government levels; the previous 1,100 LSGs were consolidated into 69 units (consisting of 59 former rayons, 4 former Districts, and 5 special status cities - Tbilisi, Kutaisi, Batumi, Rustavi, and Poti, and a special administrative area associated with autonomous regions). Respectively, new local councils (self-governments) were elected in these 69 units to represent 3,736 settlements (cities, towns and villages).

The new Law on Budgets of Local Self-Governments was adopted in June 2006. Inter alia, it provides for equalization of local budgets based on objective formula. The equalization was applied to the 2007 budget to ensure a more objective allocation of resources between the local self-government units. The government is now refining the equalization fund mechanism in order to ensure adequate resources are available annually for each local government unit to carry out its functions. The level of equalization grants will greatly influence the capacity of local self-governments to provide quality services and investments for rehabilitation and maintenance of infrastructure. The central government realizes that it should ensure that transfer of responsibilities related to

decision-making and provision of services and infrastructure is aligned with the capacity of local governments to effectively accomplish these tasks. The Government considers that the MDF is best positioned to take the lead at the central level to develop the capacity of municipalities for this purpose.

An infrastructure project was envisaged for FY09 in the current CAS and the proposed project is reflected in the CPS Progress Report and Portfolio Review, which has been discussed with the Government. More recently, the project has formally been requested by the Government as a priority in using additional IDA funding that has been made available for Georgia.

Rationale for Bank involvement The World Bank has supported a series of projects aimed at improving municipal services in Georgia. The first IDA-funded Municipal Development and Decentralization Project (MDDP I, 1997-2002) aimed to strengthen local governments and their ability to provide basic infrastructure services. A major objective of the MDDP I was to set up the Georgia Municipal Development Fund (MDF) as a mechanism to enable local governments to finance needed infrastructure repairs. In doing so, the project helped to prevent a total break-down in basic infrastructure and municipal services in twelve municipalities and halted the deterioration of the quality of life of the population caused by inadequate water supply, sewerage, solid waste collection, local road repair and municipal services. A key achievement has been the progressive growth of MDF capabilities under World Bank stewardship to the point where it is now the focal central institution for external agencies to support local government infrastructure and utility services improvements.

The MDDP I also supported the Georgia Municipal Development Program Phases I & II which assisted the devolution of some responsibilities to 67 district Governments and 1,111 lower-level local self-Governments as required by the 1997 law on local Government.

The MDDP II (2002-2007) built on the existing framework of MDDP I and had two thrusts: (i) to further support development of the legal framework of decentralization and municipal development, and (ii) increase the availability of financing for investments in local infrastructure and municipal services. The project financed 40 infrastructure subprojects in the 5 Republican Cities and 4 LSGs and provided technical assistance to support key municipal development elements: New Law on Local Budget drafted and adopted in June 2006, which provided, inter alia, an equalization grant system based on objective formula; TA provided to develop a subnational fiscal database at MOF, and built the central and local capacity to implement an integrated system of monitoring of municipal budgeting and financial reporting systems, while several other tailored TAs were provided to LGUs.

In 2006, the Bank and the U. S. Millennium Challenge Corporation (MCC) entered into a new and innovative partnership around the MDF. The MCC has agreed to provide \$60.00 million for municipal infrastructure development through the MDF (2007-2012). It has also entered into an agreement with the World Bank, on a service-for-fee basis, to help quality-assure and supervise the projects MCC finances. In this way, the MCC is

able to leverage the impact of their funding with the accumulated knowledge and expertise of the World Bank. The EBRD has also decided to provide funding through the MDF in a coherent and coordinated effort with IDA and MCC programs. Other potential financial institutions which are now in discussion with the GoG concerning support for municipal development *through MDF* include ADB, and Council of Europe Bank.

Considering that this project is multi-sectoral in nature and will involve various Government agencies, the Bank plays a main role at the policy front and coordinating dialogue with the various key players. In addition, the Bank has sustained long-term dialogue on the issues being addressed in this operation under MDDP I and MDDP II and has several cities in identifying priority investments that could not be financed under MDDP II or MCG due to resources commitment. Furthermore, the preparation of this project also benefits from the experience gained during the implementation of two successive municipal development projects, while a comprehensive beneficiary survey is currently being conducted to inform the ICR of MDDP II and the preparation of this project.

Finally, the Bank's comparative advantage is to operate simultaneously at the central and local levels, linking capacity building and investments to policy reforms and the strengthening of local government levels. The Bank has the global knowledge in similar projects in all regions, as well as the ability to leverage additional financial resources from the donor community and to coordinate the process.

2. Project Objective(s)

The project development objective is to improve the efficiency and reliability of selected municipal services by rehabilitating high priority infrastructure, and building the capacity of participating local governments to provide sustainable services.

Similar to MDDP II, the project will, through the MDF, make financing available to creditworthy LGUs to implement their high priority municipal services and infrastructure projects. The project will provide technical and institutional support to MDF in order to increase the capacity of municipalities to provide services in a sustainable manner, including the support for the ongoing water utility reforms in Georgia. Particular attention will be given to planning and implementation of fiscal reforms for improved service delivery and tariff restructuring.

Special efforts will be made under the project to build a municipal development market by demonstrating to a selected number of commercial banks that lending to creditworthy municipalities could be a safe new line of business.

3. Preliminary Project Description

The project would aim at i) strengthening the capacities of selected local government to provide adequate public services to their constituents through financing rehabilitation and expansion of infrastructure, along with development and implementation of plans for sustaining services, and ii) continue and expand support to MDF to administer and

coordinate financial and technical assistance to local governments within the context of the ongoing program in Georgia supporting effective local government and territorial reforms.

Similar to the Municipal Development and Decentralization Project II (MDDPII), closing date December 30, 2007, the follow-up project will make financing available, through the Georgia Municipal Development Fund (MDF), to creditworthy LGUs to implement their high priority municipal services and infrastructure projects. The project will provide technical and institutional support to MDF in order to increase the capacity of municipalities to provide services in a sustainable manner, including the support for the ongoing water utility reforms in Georgia. Particular attention will be given to planning and implementation of fiscal reforms for improved service delivery and tariff restructuring.

Selection of local governments for participation in the project would be limited to about five, selected on the basis of measurable eligibility criteria including the eligibility to borrow, availability of viable action plans or strategies to move to sustainable service provision through tariff restructuring and collection, etc.

Component 1: Infrastructure Investment

- Provision of financial resources to creditworthy local governments in order to finance rehabilitation and expansion of priority municipal services and infrastructure needs on a sustainable basis through access to credits. Selection of local governments for participation in this component would be based on transparent and quantifiable criteria related to execution of decentralization reforms and local administrative capacity, including their capacity for planning and managing sustainable services. It is expected that the subprojects to be supported would be mainly in infrastructure services (water supply, wastewater and drainage), but could also include other municipal functions such as local roads, street lighting and urban transport, or refurbishment of facilities under municipal provision. The broader development objective of the project would be to promote continued strengthening of local self governance.

Component 2: Technical Assistance and Institutional Development

- Component 2.1: *Support the Municipal Finance Framework* by further developing the policy framework for municipal finance, including the intergovernmental fiscal relationship.
 - Building on MDDPII and the Poverty Reduction Support Operation (PRSO) achievements to enact a new Law on self-Government Budget in 2006 with clear procedures for inter-government finance, further TA support will be provided to the Local Budget Unit, Ministry of Finance, to monitor the newly enacted budget rules that are being implemented in developing the 2008 budget, and improve the formula-based expenditure transfer mechanism. Follow-up TA will also be provided to support the mechanism for reporting and monitoring local budgets.
- Component 2.2: *Technical Assistance to LGUs*
 - Support to improve the capacity of municipalities and utilities in operation and maintenance of infrastructure and utility services, including support for fiscal reforms related to selected utilities services and support to increase the capacity of

municipalities in road maintenance (e.g. tariff restructuring for water supply and sanitation services, financing strategies for municipal road management).

- Support to strengthen the fiscal management and participatory strategic planning capacity of newly consolidated LGUs, inter alia through the development of local government development strategies and investment plans.

Since the project can only work with a limited number of municipalities, the approach under this component will be to work with the national regulatory bodies, e.g. the electricity and water regulatory body, in participating municipalities, and disseminate results and tools to other municipalities through workshops and other media.

- Component 2.3: *Institutional Support to MDF*
 - Support to strengthen the financial and institutional performance of MDF to a) become the technical vehicle of support municipal development sector in Georgia, b) leverage additional financial resources for LGUs, c) initiate dialogue with commercial banks to promote municipal lending, and d) manage the lending portfolio efficiently. This would include an institutional assessment of MDF's financial model and performance, and based on this, the development of a package of capacity building interventions that may include training on LG credit assessment and finance, support to attract additional funds from international financial institutions and local banks, and development of monitoring and evaluation tools to track local services performance (e.g. through participation in the International Benchmarking Network for water and sanitation services) and MDF effectiveness.
 - Strengthen the technical capacity of MDF to design and appraise infrastructure projects in accordance with international standards and specifications, and development in collaboration with donor agencies of unified standard procedures for managing external funds from all sources.

4. Safeguard Policies that might apply

The project environmental category is FI (Financial Intermediary). Specific subprojects for Year 1 operation will be identified and prepared during the project preparation, while subsequent subprojects will be prepared during project implementation. The Operational Manual (OM) will include procedures and implementation arrangements to ensure that all civil works supported under the project will comply with the Bank's environmental safeguard policies. This section of the Operational Manual will be prepared before appraisal. Specific subprojects proposed to the MDF for funding will be screened as per the OM, and necessary environmental assessment will be carried out as part of the feasibility study of respective subprojects. The role of the Ministry of Environment and Nature Resources will also be described. Public participation in the review of sub-projects mitigation plans will also be explored.

5. Tentative financing

Source:	(\$m.)
Borrower/ Recipient	0.20
International Development Association (IDA)	10.00
Local Governments	1.80
Local Sources of Borrowing Country	3.60
Total	15.60

6. Contact Point

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