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IDA/R2006-0233/1

December 19, 2006

**Streamlined Procedure
For meeting of
Board: Tuesday, January 9, 2007**

FROM: Vice President and Corporate Secretary

**Bosnia and Herzegovina - Community Development Project
Additional Financing**

Project Paper

Attached is the Project Paper regarding a proposed additional financing credit to Bosnia and Herzegovina for a Community Development Project (IDA/R2006-0233). This project will be taken up at a meeting of the Executive Directors on **Tuesday, January 9, 2007 under the Streamlined Procedure.**

Distribution:

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Report No: 37912-BA

PROJECT PAPER
ON A
PROPOSED ADDITIONAL FINANCING CREDIT
IN THE AMOUNT OF SDR 3.4 MILLION
(US\$5.0 MILLION EQUIVALENT)
TO
BOSNIA AND HERZEGOVINA
FOR A
COMMUNITY DEVELOPMENT PROJECT

November 21, 2006

Human Development Department
South East Europe Country Unit
Europe and Central Asia Region

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CURRENCY EQUIVALENTS

(Exchange Rate Effective November 6, 2006)

Currency Unit = Convertible Mark (BAM)
BAM = US\$ 0.65
US\$1.00 = BAM 1.53

FISCAL YEAR

January 1 – December 31

ABBREVIATIONS AND ACRONYMS

BiH - Bosnia and Herzegovina
CDP - Community Development Project
DEF - Development Employment Fund
EU - European Union
FBH - Federation of Bosnia Herzegovina
ISDS - Integrated Safeguards Data Sheet
ODRAZ - Foundation for Sustainable Development
PIU - Project Implementation Unit
RDA - Regional Development Agency
RS - Republika Srpska
SAA - Stabilization and Association Agreement

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**Bosnia and Herzegovina
Community Development Project
Project Paper
ADDITIONAL FINANCING CREDIT**

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Project Paper Data Sheet

Date: November 21, 2006		Team Leader: Maniza Naqvi	
Country: Bosnia and Herzegovina		Sector Director: Tamar Manuelyan Atinc	
Project Name: Community Development Project		Country Director: Orsalia Kalantzopoulos	
Project ID: P103703		Environmental Category: FI	
Borrower: Bosnia and Herzegovina		Guarantor:	
Responsible agency: MINISTRY OF FINANCE AND TREASURY of Bosnia and Herzegovina; Ministry of Finance of the Federation of Bosnia and Herzegovina (FBH); Ministry of Finance of Republika Srpska (RS); "Odras" Foundation Sarajevo FBH; Contact Person: Mr. Fejsal Kirlic (FBH) Tel: 387-33 227 370; Development and Employment Fund; Contact Person: Mrs. Slobadanka Dukic (RS) Tel: 387 51 221 270 Email: fkirlic@odraz.ba , sdukic@rsdef.org			
FY	2007	2008	
Annual	2.5	2.5	
Cumulative	2.5	5.0	
Current closing date: December 31, 2006			
Does the restructured or scaled-up project require any exceptions from Bank policies?		[<input type="checkbox"/>] Yes [<input checked="" type="checkbox"/>] No	
Have these been approved by Bank management?		[<input type="checkbox"/>] Yes [<input type="checkbox"/>] No	
Is approval for any policy exception sought from the Board?		[<input type="checkbox"/>] Yes [<input checked="" type="checkbox"/>] No	
<p>The proposed Additional Financing Credit would support:</p> <ol style="list-style-type: none"> 1. Performance Based Grants (USD 4.00 million) 2. Institutional Capacity Building (USD 0.65 million) 3. Project Implementation (USD 0.35million) 			
Does the additional financing trigger any new safeguard policies? - Yes, Environmental Assessment (OP/BP 4.01)			
None of the activities financed under the additional financing are expecting to have an adverse environmental impact. Nevertheless, appropriate environmental aspects would be considered when assessing financing of rural roads and other infrastructure proposals. The Operations Manuals for both RS and Federation include the environmental and social screening process.			
For Additional Financing			
[<input type="checkbox"/>] Loan [<input checked="" type="checkbox"/>] Credit [<input type="checkbox"/>] Grant For			
Loans: Total World Bank financing (US\$5.0m.equivalent)			
Source			
	Local	Foreign	Total
Borrower		0.00	1.0
IDA		0.00	5.0
Total		0.00	6.0

BOSNIA AND HERZEGOVINA
PROJECT PAPER
FOR THE
COMMUNITY DEVELOPMENT PROJECT

I. Introduction

1. This Project Paper seeks the approval of the Executive Directors to provide an additional financing credit in an amount of SDR 3.4 million (US\$5.0 million equivalent) to Bosnia and Herzegovina for the Community Development Project (CDP).
2. The proposed additional financing credit has been requested by the State Ministry of Finance and both Entity Prime Ministers, as well as mayors of participating municipalities. It would help finance a subset of the pipeline of proposals received from the poorest municipalities in the country which were unable to be financed under the existing CDP credit. No changes are proposed to the design or implementation arrangements of the ongoing project.
3. Results Outcomes: The additional financing is expected to further strengthen the results and outcomes achieved under the CDP by a continued focus on financing investments which strengthen local government abilities to leverage and mobilize resources while increasing the participation of citizens in budget planning and decision making. The additional financing would continue to strength the results outcomes of the CDP by reaching 200,000 beneficiaries in addition to the 1.3 million citizens covered to date under the CDP. The project would continue to work through elected municipal governments to finance basic small-scale non-revenue generating social and economic infrastructure investments that are part of the municipalities strategic development plans which have been identified as priorities by urban and rural poor local communities as essential for social and economic development. The project would continue to strengthen participatory processes in local governments to increase citizen's access to municipal services.
4. The project would continue to be implemented through municipal governments in partnership with local communities and would aim to continue the high level of public and private co-financing (equal to 47% of IDA financing in the Federation and 41% in the RS) by citizens, municipal and cantonal governments and private organizations.

II. Background and Rationale for Additional Financing

5. Bosnia and Herzegovina (BiH) has achieved substantial progress in economic reconstruction and state building and has experienced high rates of economic growth (5.3%) in the last decade which are consistent with post war recovery. Along with this progress, BiH has begun the process of negotiations with the European Commission on a stabilization and association agreement (SAA). While the post-war reconstruction agenda in BiH has been completed, the country is faced with a resource constraint for continuing investments which would further solidify social cohesion, enabling business growth and state building. The economic growth has been fueled largely by international donor assistance. However, this assistance has declined substantially, from a high of US\$750 million annually to less then US\$300 million in recent years. Growth has been concentrated in the more developed regions, cantons and municipalities of the country, while poorer

municipalities--which constitute the majority--continue to face a resource and capacity constraint. Poverty and unemployment rates remain high.

6. EU accession and the strengthening of the State and the local governments is firmly the development agenda for policy makers in BiH over the next five to ten year horizon. This agenda will guide reform and integration in the country at all levels of governance. The focus is likely to be on strengthening functions at the level of the central government while on the other side empowering municipalities to mobilize revenues and deliver services. Development efforts would need to focus on strengthening the state and local governments and institutions in line with EU standards. The current situation is, however, characterized by a “governance gap” that exists at the state and municipal levels which is not only affecting overall macroeconomic policies but may affect the country’s readiness for EU accession. This gap would need to be addressed by strengthening the capacity of municipalities to deliver services; govern in accordance to EU standards and principles; strengthening their capacity to absorb EU accession funds (particularly regional development funds which are earmarked for poverty reduction in underdevelopment regions); and creating a local environment which encourages business and economic growth.

7. The country is characterized by the two government entities, the Federation of Bosnia and Herzegovina (FBH) and Republika Srpska (RS). In the FBH there are ten cantons and 79 municipalities with an average of 7 municipalities per canton, while in the RS there is the entity level government and 61 municipalities and two cities. In addition to these, there is a district of Brcko which is a separately administered local government unit. Over 60 percent of the country's population is concentrated in eight regions and approximately 60 municipalities within the five cantons in the FBH (Tuzla, Sarajevo, Zenica, Mostar, Bihac) and in three of the RS regions (Prijedor, Banja Luka and Doboje) around the company towns for steel, coal, heavy machinery such as Zenica, Tuzla and Prijedor. The Government structure is complex and the sharing and flow of revenues within entities between cantons and municipalities is complicated and inefficient.

8. Over half of the municipalities (74-80) are under-developed and citizens are largely poor; another 20 are marginally better off; while approximately 30 are better off and are able to borrow for investments. In the poorest municipalities, local level social assessments conducted under the Community Development Project point to the need for basic public infrastructure and services in need of repair, reconstruction or construction. Citizens express the high transaction costs for the poor in accessing basic services or having their voices heard and the problem of joblessness. These factors make investments in their localities for businesses difficult. The young in particular express frustration with the lack of opportunities and the need to migrate in search for jobs elsewhere.

9. Redistribution of revenues is often inconsistent and progressive and result in smaller and poorer municipalities not receiving their due allocations. Some of the poorest municipalities have annual budgets of less than US\$1.0 million equivalent each and more than 50%-80% of these budgets are spent on covering administrative costs. This resource constraint translates into an inability and a lack of capacity to plan and address citizens increasing demand for basic services, rehabilitation and maintenance of social infrastructure (libraries, parks, sports centers, youth centers, street lighting, garbage recycling, schools, clinics, citizen friendly municipal offices). While investments in the private sector are increasing, these areas of public common goods are not being financed. Responsibility for such investments rests with the municipalities. The financing of such investments will be through public sector investments.

10. A majority of municipalities in BiH, 88 of the total of 140, received financing for sub-projects under the CDP. A majority of CDP projects in these poorest municipalities prioritize social and community level infrastructure through participatory means of identification and budgeting which create the capacity for good governance and inclusion. Preliminary findings from the ongoing impact evaluation suggest that the CDP, in the post Dayton municipalities in particular, has had a significant role in building the capacity of municipal governments to plan budgets and deliver municipal services. In these municipalities in particular the CDP has had a significant impact on delivery of services and on enhancing economic opportunities for residents as well as encouraging the return of internally displaced people. Without CDP financing many of the communities would have been without services. Changes in the population figures for the year 2000 and more recently seem to indicate returns which could easily be attributed to accessible roads and services which made return possible after the war's destruction.

Original Project Design:

11. Through CDP, the World Bank has been an important source of financing for investments by the poorest municipalities and a critical leverage for municipal reform as well as for participatory processes for citizen involvement and planning. Municipalities have been the central partner for implementation of the CDP which focuses on the poorest municipalities. In taking this approach the project has financed stability at the community level and invested in long term sustainability of the peace process and has launched a process of long-term institutional change based on citizen participation. The CDP is due to close on December 31, 2006. These municipalities will continue to require assistance. The CDP has reached over 1.30 million beneficiaries (334,900 households) or 25 percent of the country's population in the poorest municipalities. Average number of beneficiaries per project is 3,289 people.

12. The CDP has invested in the poorest communities with performance grants through municipal governments for non revenue generating investments. This approach has been characterized by citizen driven decision making through performance grants and participatory budget planning between municipal governments and citizens who agree to work amongst communal groups for common goods. Experience shows that local government is a critical site of empowerment. In BiH under the CDP, 74 municipalities were identified as the poorest municipalities (rural and semi urban) and by September 2006 over 88 (63 in the FBH and approximately 37-40 in the RS¹) were assisted through technical assistance and performance grants for non revenue generating physical and social infrastructure and capacity building for participatory budget planning. The CDP aimed to decrease transaction costs for citizens who were poor to participate in decision making for 397 community level municipal investments and governance. Because these 88 municipalities (more than half of the total number of municipalities) are the poorest in BiH, these performance grants can represent up-to 20 percent to 80 percent of total municipal financing. The project has achieved a high level of co-financing from municipalities and citizens.

13. This approach under the World Bank financed CDP focuses on citizens' participation in municipal decision making for investments based on citizens' identification of needs (for rural roads, water supply, electricity, schools, clinics, street lighting, parks, libraries, sports facilities, radio stations, agriculture cooperatives etc).

¹ due to changing profiles of poverty

14. The CDP original financing was a total of SDR 11.8 million (IDA credit of US\$15.0 million equivalent) with counterpart financing of US\$2.63 million equivalent. Total project cost was US\$17.63 million. IDA financing was on standard IDA terms with a grace period 10 years; a maturity of 35 years; a commitment fee of 0.5%; and a service fee of 0.75 %. The CDP credit was approved on June 26, 2001 and became effective on March 26, 2002. Both IP and PDO have been rated as Satisfactory throughout the implementation of the original project.

15. As has been done under the original project, the additional financing will provide support to the existing three project components:

- *Component 1-Performance Based Grants (US\$4.25 million):*

The proposed project would provide grants as a mechanism to target non revenue generating investments to low-income municipalities and their poor communities with a focus on improving service delivery, cost recovery, the financial management capacity of local governments; and public accountability/community participation. The additional credit will finance a subset of the same municipalities which participated in the original CDP (only the poorest municipalities would be eligible to receive assistance from the additional credit). These requests for community investment financing were made over the past year by participating municipalities and could not be financed under the original credit due to limited availability of financing. The credit would finance the pipeline of subprojects (approximately 60 out of the 120 requests in the pipeline) that were unable to be financed under the existing CDP credit. Given that the additional financing will not be able to finance the full list of projects in the pipeline—the selection of projects would be carried out in close consultation with the line ministries and the PIUs.

- *Component 2-Institutional Capacity Building (US\$0.50 million):*

The project would increase the capacity of municipalities to improve service delivery through technical assistance and training. Capacity for municipalities would be developed in the areas of participatory inclusive procedures such as citizens score cards. This component will be implemented in close cooperation with the World Bank Institute.

- *Component 3-Project Implementation (US\$0.25 million):*

The project implementation arrangements would remain the same as for the CDP. The project would be implemented in partnership between PIUs, municipalities and citizens associations and NGOs. In the FBH, the PIU responsible for the implementation will operate as a part of the Federation Foundation for Sustainable Development (ODRAZ). In the RS, the Development and Employment Fund (DEF) will be responsible for project management.

16. Supervision ratings for the Ongoing Project: Satisfactory.

Reasons for Additional Financing:

17. The ongoing project has achieved its development objective and a multiple of social and economic outcomes. Client demand is very high and exceeds the financing available under the CDP. A large number of project applications from municipalities have been received which were unable to be financed under the existing CDP credit. The Government has requested the World Bank to continue to finance the CDP. Additional financing of the CDP had been requested by the Governments of both Entities, the State Ministry of Finance and Treasury and the participating municipalities and their local communities. The additional financing would enable the CDP to

cover these investments. The capacity of the CDP to disburse and monitor results effectively is now well established. In strategic terms, this financing would continue the Bank's assistance and engagement with the majority of the municipalities in BiH which are also the poorest over the 18 month period during which the Bank would prepare a municipal development project. The Bank has developed a good working relationship with municipal governments which has allowed for uninterrupted implementation despite the administrative complexities and uncertainties of BiH. This should be continued and strengthened.

18. Implementation Arrangements for the Additional Financing: All implementation arrangements will continue to be the same as under the original project, which have consistently been rated satisfactory on both Development Objectives and Implementation Progress. Counterpart financing was rated as highly satisfactory. Significant here is the co-financing from citizens, which in the FBH is 17 percent of total financing and 26 percent of IDA financing. In the RS it is 9 percent of total financing and 13 percent of IDA financing. In the FBH municipal governments' and community and citizen organizations co-financing together signify 47.8 percent of IDA while in the RS this amount is 41.0 percent of IDA. In the FBH the CDP is implemented through ODRAZ Foundation which is a quasi independent government foundation, and in the RS the project is implemented through the Development Employment Fund (DEF) which is also a quasi independent government foundation. The foundations work in partnership with the participating municipal governments in the project.

19. The financial management system to be used under the proposed additional financing is the same as that used under the ongoing project. The financial management of project activities has been satisfactory. A recent financial management supervision mission noted that the project has maintained satisfactory financial management arrangements. Internal control procedures are documented and duly followed by project staff. The project maintains its accounting records correctly and reconciles regularly all general ledger account balances with relevant source documents. Budgets are prepared on time and agreed with all relevant Government agencies and the Bank. Audit reports for 2005 of project accounts were submitted on time and were acceptable to the Bank, with one minor management letter issue reported. The Guidelines of Fiduciary Management for Community-Driven Development Projects (CDD Guidelines) are taken into consideration, where applicable.

20. The two foundations ODRAZ and DEF are responsible for the financial management and procurement under the project and for supervising and monitoring of all activities financed under the project. Both foundations are audited annually and audit reports are submitted to the Bank. The project is under the supervision of Bank's FMS. 100 percent of projects under the CDP have been reviewed by the Bank for social and for procurement clearances.

21. Environment (OP 4.01): The ongoing project is a Category FI; the same rating will apply to the activities supported by the additional financing. An ISDS has been prepared for the additional financing.

III. Expected Outcomes

22. The proposed additional financing credit will benefit 200,000 poor citizens in rural and urban local communities in the FBH and the RS through the implementation of approximately 60

non revenue generating socio-economic infrastructure and productive subprojects. The results outcomes from the monitored performance indicators (attachment 1) of the CDP are that:

- (i) municipalities view citizens as partners for investment decision making;
- (ii) investments identified in municipal strategies for financing are high priorities for local communities and have been identified by local communities;
- (iii) co-financing of project investments by local governments; citizens and private sector was high;
- (iv) internally displaced citizens have returned to their municipalities;
- (v) conditions have been created for economic development and opportunities for people to stay;
- (vi) improvement of living conditions for citizens through restoration of basic services has enabled return of residents;
- (vii) created enabling environment for economic activity; and
- (viii) created enabling environment for lasting peace.

IV. Benefits and Risks

23. The economic, social and political benefits of the additional financing credit have been discussed in detail throughout this project paper. The project will directly affect an additional 200,000 citizens in the poorest communities in BiH; continue to strengthen the capacity of participating municipalities to deliver quality services to citizens while increasing citizens access to municipal services. The project also allows for the Bank to have a presence and a visibly positive involvement at the local community and municipal level.

24. The risk of not continuing with the CDP is that the municipalities which are currently unable to raise revenues for capital investments will not be able to meet the needs of their citizens for basic service delivery. They will continue to lag in terms of creating an enabling environment for stability and economic development and will be further delayed in their development towards credit worthiness and their ability to absorb other sources of financing such as EU accession funds when those become available.

25. Generally the financial management capacity and accountability in the public sector is low, encompassing poor governance and corruption that undermines the effective implementation of projects and the achievement of their development objectives. The project will be implemented by two experienced project units with long experience with implementation of Bank financed projects and with elaborate procedures securing proper internal controls. The Bank's supervision which includes 100% prior review of subprojects financed under the CDP is designed to follow-up on these procedures and monitor the achieved outputs of the project.

V. Financial Terms and Conditions for the Additional Financing

26. The additional financing credit would be provided on IDA hardened terms, with a grace period 10 years; a maturity of 20 years; a commitment fee of 0.5%; and a service fee of 0.75 %.

VI. Allocation of Credit Proceeds

Project Components	Borrower Contribution (US\$M)	IDA Financing (US\$M)	Total Project Cost in US\$M
1. Performance Based Grants	0.75	4.25	5.00
2. Institutional Capacity Building		0.50	0.50
3. Project Implementation	0.25	0.25	0.50
TOTAL	1.00	5.00	6.00

27. Counterpart funding will be provided from the entity budgets, participating local governments and their communities. Counterpart funding by participating local governments and local communities may be in cash and in kind (labor, material) and may not be less than 15% of the total value of a given sub-project. Counterpart funding for the project implementation (i.e. incremental operating costs) will be covered from the entity budgets.

Attachment I
Project Development Objectives: Performance Indicators

Indicator	Baseline	Progress to Date in CDP	Expected Results
PDO Indicator	Date:03/26/2002	12/31/2006	Additional Financing
<p>1. Municipalities and citizens identified investments in social infrastructure in the poorest municipalities of BH (80 municipalities) through performance grants.</p> <p>2. 400 sub projects to be completed</p>	<p>Weak cooperation between citizens and municipal administration in deciding about priority investments.</p> <p>Low level of investments in social infrastructure in the poorest municipalities.</p> <p>Less then 20% of annual budget of poorest municipalities for capital investments.</p> <p>Target municipalities in war destroyed regions with low returns of citizens displaced by war.</p>	<p>397-400 sub projects completed.</p> <p>334,900 households reached</p> <p>1, 306,110 beneficiaries or over 25% of Bosnia Herzegovina citizens.</p> <p>52 water supply projects</p> <p>75 local roads projects</p> <p>3 bridges</p> <p>3 irrigation systems restorations</p> <p>24 sewage piping</p> <p>13 local power networks</p> <p>9 clinics</p> <p>18 schools</p> <p>7 parks and recreation centers</p> <p>53 youth sports, cultural, music and theater centers. Learning equipment, musical instruments , sports and other equipment for schools, youth centers, sports clubs, cultural centers and theaters</p> <p>40 repair/reconstruction and supply with computer equipment and books of public libraries</p> <p>38 sports fields</p> <p>2 equipments for agriculture cooperatives</p> <p>33 trainings sessions for self employment</p> <p>7 ecological projects</p> <p>6 projects for handicapped and marginalized groups.</p> <p>14 Capacity building programs for local governments.</p> <p>Population increases between 2000-2006 in target municipalities seem to indicate returns that could be directly attributed to sub projects.</p>	<p>-At least 60 of the 120 subprojects in the pipeline financed in a subset of municipalities covered under the CDP.</p>

<p>2. Strengthening of Capacity of poorest 80 municipalities in participatory processes for planning, identifying and financing municipal social investments.</p>	<p>Low capacity in the poorest municipalities for project financing; citizen outreach and participatory planning of municipal investments.</p> <p>Projects implemented by municipalities without citizen participation</p> <p>Non transparent, non participatory planning procedures in poorest municipalities</p>	<p>Citizens identified priority investments in Municipal Development plans through town hall meetings based on social assessments and formation of community action groups and local community councils in 88 poorest municipalities.</p> <p>Each municipality received an average of 5 performance grants which were co-financed by municipalities, citizens and private partnerships of upto 47% of each grant.</p> <p>Total performance grants per municipality on average increased investment financing by five to ten times in that municipality.</p> <p>Increased level of municipal government, citizens, private and NGO participation. Their co financing upto 40-47 percent of IDA financing.</p> <p>Municipal governments viewed citizens participation and transparency of financial decision making as key to improvement in investments; service delivery and ability to raise financing.</p> <p>80 newly elected mayors received training in participatory budget planning in 2005.</p> <p>Capacity of CDP and relationship with municipalities is being tapped into by other Bank projects for implementation as well as information collection (remittance migration survey for ECA regional study) and dissemination (Social Audits, PEIR).</p>	<p>Increase capacity of municipalities to deliver services—</p> <p>Increase access of citizens to municipal services.</p> <p>Increase interaction between citizens and municipal governments</p> <p>Increase citizen's participation in budget planning.</p> <p>Increase cooperation and coordination and partnerships between ODRAZ, DEF, RDAs.</p> <p>Leverage financing for municipalities through continued higher rates of co-financing..</p>
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