

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

Report No.: AB615

Project Name	Karnataka:Panchayats and Rural Service Delivery Project
Region	SOUTH ASIA
Sector	Sub-national government administration (80%);Other social services (20%)
Project ID	P078832
Borrower(s)	GOVERNMENT OF INDIA
Implementing Agency	
Environment Category	<input type="checkbox"/> A <input checked="" type="checkbox"/> B <input type="checkbox"/> C <input type="checkbox"/> FI <input type="checkbox"/>
Safeguard Classification	<input type="checkbox"/> S ₁ <input checked="" type="checkbox"/> S ₂ <input type="checkbox"/> S ₃ <input type="checkbox"/> S _F <input type="checkbox"/>
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1. Country and Sector Background

Most of India's poor live in rural areas. Of India's 1.05 billion people, 756 million are rural and of these 30 percent are below the poverty line. Compared with other countries India spends a larger proportion of GDP on rural development, about US\$7 billion by some accounts, but despite some progress, results are not commensurate with the magnitude of the expenditures. Rural areas continue to lag in poverty and social and economic indicators and regional disparities are increasing both between and within states. Traditional delivery mechanisms (state line agencies) are unable to cope with the magnitude of the challenge of providing services to more than 700 million rural people often in locations of limited accessibility. Central and State funding is fragmented into a large number of schemes (budget items) with large administrative costs. Schemes are tied into administrative procedures and narrow objectives that are not adaptable to the diversity and heterogeneity of the Indian countryside. A large proportion of central funds remain undisbursed.

India opted for decentralization to increase the accountability of government, improve services and expenditures, and reach out to rural people. In 1992 a revision to the Constitution (73d and 74th Constitutional Amendments) created once and for all rural governments at the district, block and village levels and urban governments at the city and township levels, mandated states to hold periodic elections for these bodies and devolve functions and funds to them. Decentralization to rural governments thus became a state subject. States proceeded at different speeds. Progress has not always been easy in part due to vested interests often opposing the process. The current administration at the Center sees rural governments as the key mechanism for delivering key services to rural people and one of its priorities is to make this approach work in some states to serve as an example and a model for the rest of the country.

Karnataka is often considered one of the fastest developing states in India. It is mostly known for its booming IT sector and ability to attract private investment. However this performance benefits primarily the urban sector and hides increasing disparities between urban and rural areas and between different regions of the state. With 53 million people Karnataka ranks seven among 28 states in absolute number of poor people, and eighth in absolute number of rural poor, more than any other southern state. In terms of percentage of poor people Karnataka ranks seventh in India, close to Marahastra, Uttar Pradesh and West Bengal. It ranks poorly also in children malnutrition and road access. A state High Powered Committee (2002) reviewed the status of regional disparities according to several indicators and identified

39 rural blocks concentrated primarily in Northern Karnataka as the most backward with another 75 considered to be lagging in development indicators (out of 175). These blocks also show the highest concentration of low caste, *dalit*, and tribal people.

Karnataka is the ideal candidate for a model of decentralized service delivery to set an example for the rest of India. The poorest parts of Karnataka have many features typical of more northern states, with high incidence of poverty, difficult access and severe resource constraints. But Karnataka also has a long history of rural local governments, more than any other state in India. For many years it was a pioneer in sub-state devolution. Its 1983 reforms served as the basis for the Constitutional Amendments. It is now regaining leadership in this agenda through some bold steps.

Karnataka's recent policy reforms on decentralization are path breaking in India. GoK recently completed a Report on Rural Decentralization that outlines the strategy to improve rural governance and empower local governments. As a result of this strategy the state undertook a series of policy initiatives towards devolution. Key among these are the Amendments to the state Panchayat Act, devolution of 29 subjects and 20% of public expenditures to district, block and village governments, clearer expenditure assignments, untied block grants in the transfer system, improved financial management, improved planning guidelines. Recently a Government Order mandated line agencies to transfer to Panchayats activities that had been devolved to them and required international organizations, including the Bank, to implement its projects through the Panchayat system.

Notwithstanding these bold steps the reform agenda is incomplete. There are challenges in implementation, and there are questions about its sustainability. **First**, and despite some consolidation, the transfer system is still mostly based on tied schemes that limit the ability of local governments to adjust resource allocation to local preferences. The block grants are small and unpredictable. Moreover these grants are the same for every Gram Panchayat independently of population, poverty or need. The system needs to move to one that is equalizing, allows for autonomy, creates incentives for service delivery, and increases the funds available to the poorest Panchayats to enable them to catch up. **Second** fiscal stress at the state level makes it difficult to finance the huge needs of rural governments, particularly in the most disadvantaged areas. Some estimates have estimated these needs to be around one billion US dollars. On capacity building alone the challenge is daunting, requiring a continuing process for over 5,000 local bodies and 100,000 local elected representatives and the ability at the state level to oversee and manage the process. **Finally** devolution threatens vested interests and resistance from both the bureaucracy and state politicians could still reverse some of the reforms or slow down the process. State line agencies still need to undergo institutional reforms to bring them in line with the Panchayat system.

2. Objectives

At the national level the project would have a demonstration effect. It would create a model of service delivery through rural governments in one state that could then be replicated across other states in India. At the state level the project would contribute to improve public services and investment under the responsibility of Panchayats in the poorest ones, contributing to improving the MDGs and fostering local economic growth in disadvantaged areas. It would also help sustain the decentralization reform process, by consolidating reforms already undertaken, leveraging further reforms through a demonstration effect, and financing some of the implementation costs of the reform during a period in which the state is fiscally stressed.

The objective of GoK's Panchayat program is to **improve the capacity of rural governments to manage public resources and deliver services that benefit the rural poor**. Under current conditions the state is not able to finance the entire needs of the program and the proposed credit would cover the gap. More specifically the **development objectives** of the project are to :

- Increase financial resources to the most needy and poorest jurisdictions to allow them to catch-up;
- Improve incentives for the delivery of priority services for the rural populations through greater accountability to rural people and a more inclusive and transparent planning process;
- Strengthen the Panchayat and state capacity to implement and manage the process; and
- Increase the likelihood that the Panchayat program will be sustained and deepened in the context of the state's fiscal stress and opposing vested interests,

3. Rationale for Bank Involvement

There are strong reasons for supporting the decentralization process in Karnataka. **Firstly**, the Bank is actively involved in Karnataka through both sectoral investment credits and loans and economic restructuring loans (third tranche under preparation). Several of the sectoral projects (e.g. health, education, watersheds, tanks, rural water) need to rely on local bodies for implementation, but the Panchayat system is still weak and the policy framework is incomplete. Because the issues spread across sectors, this calls for a non-sectoral operation that strengthens the environment and creates the capacity of local bodies to deliver across a range of services. Without such an operation, the combination of state schemes and Bank supported sectoral projects would create the risk of Panchayats being transformed into service agents for higher levels government only, rather than into true local governments with autonomy and discretion as the Constitution of India and the State Panchayat Act demand. **Secondly**, rural local governments in Karnataka have been given responsibility over sectors directly related to the Millennium Development Goals, such as some areas of primary health, primary education, drinking water and sanitation, and local economic development. Increasing their capacity to deliver will make it more likely that MDGs will be achieved. **Thirdly**, since 1999 the Bank has been involved in a dialogue with GoK on matters related to decentralization and has accumulated considerable experience and knowledge on the subject. The proposed operation would help implement many of the recommendations emanating from Bank's ESW (Fiscal Decentralization to Rural Governments, 2003; Overview of Rural Decentralization in India, 2000, Panchayats and Resource Allocation in South India, 2004, and Local Organizations for Decentralized Development in India, 2004) as well as from several workshops on the subject. **Fourthly**, together with the economic restructuring program and a proposed urban development operation, the proposed operation would offer an opportunity to tackle systemic issues at both state, urban and rural governments, ensuring coordination and consistency across the various tiers. And **finally** support to rural decentralization is a key area in the current Country Assistance Strategy.

4. Description

The proposed instrument is a programmatic loan in the form of a Sector Investment Credit (SIC) through which IDA would pool funds with the state government. The SIC would finance a time, expenditure and geographical slice of the GoK's program. IDA would rely on GoK's own rules and procedures to implement the program including for financial management, reporting and auditing. Special provisions on environmental safeguards would be introduced until an Environmental Framework for Panchayats is put in place as one of the outputs of the proposed operation.

The project would be considered satisfactory if the following targets are achieved:

- Higher transfers to the poorest Panchayats disbursed in a predictable way and according to a transparent formula.
- No major policy reversals;

- Increased own revenue effort and potential by local governments;
- Frequent Gram or Ward Sabhas with high and representative participation and relevant agendas.
- by putting in place a new financial management system (accounting, reporting, auditing) for GPs; this would also include computerization of all GPs and development of relevant software, and IT training.
- *Environmental framework for Panchayats.* This activity would consist of the design and implementation of an environmental framework for the three tiers of rural local governments, environmental audits, and district environment profiles to support district planning.

5. Financing

Source:	(\$m.)
BORROWER/RECIPIENT	10
INTERNATIONAL DEVELOPMENT ASSOCIATION	150
LOCAL COMMUNITIES	10
Total	170

6. Implementation

Implementation of the program is split between three GoK agencies. The Department of Finance would host the Decentralization Cell. The Cell would be responsible for releasing funds to Panchayats, implement and operate a Monitoring and Evaluation System on Panchayat fiscal and service delivery performance, and carry out specific studies and analyses to support policy-making related to decentralization. The Cell would provide technical support to State Finance Commissions when these are set up.

The Department of Panchayats would be responsible for providing technical support to Gram Panchayats by creating resource centers at the block level and strengthening the capacity of districts to monitor service delivery at the Gram Panchayat level. It would also carry out or contract out the information campaigns for constituents, contract out TA to provide assistance to organizations of poor people, manage the technical assistance funds to assist with reform of line agencies, oversee the implementation of the financial management framework and computerization of Panchayats, oversee the environmental framework for Panchayats, and monitor the quality of GS and WS.

The State Institute of Rural Development would carry out all the capacity building activities at the Panchayat level, including the installation and operation of training centers at the block level.

At the Panchayat level all tiers would benefit from the capacity building programs. District Panchayats would assume a special role in monitoring service delivery performance and standards at the village level. Block level Panchayats would provide assistance on special matters such as accounting, social mobilization or engineering services to Gram Panchayats. Gram Panchayats would develop participatory village service delivery plans following the Guidelines recently issued by the state. These plans would be developed through interactions with Gram or Ward Sabhas and would need to be approved by them. The quality of Gram Sabhas would be closely monitored. They would be financed through the untied grants or existing schemes where available (e.g. rural water supply)

7. Sustainability

There are three main aspects of sustainability. The **first** is the sustainability of the devolution process. In a democracy as large as India it takes time to debate and build consensus and the advances that happen are what is politically feasible. However there is strong evidence of a national consensus on the need for decentralization. The 73^d and 74th Amendments to the Constitution issued in 1993 enshrined devolution in the Constitution of India and mandated states to hold regular elections and transfer funds and functions to local bodies. The devolution process continued steadily but slowly since 1992. With the Constitutional Amendments decentralization to rural and urban bodies became a state subject. All states have had elections for local bodies now, some for the third time, although some had to be brought to the High Courts through litigation to get the process started. All states have enacted state Acts regulating the decentralization process. All have set up State Finance Commissions as per the Constitutional Amendment to propose the share of state revenues to be transferred to local bodies. Because of the slowness of some states in devolving resources the 11th and 12th Central Finance Commissions (that oversee Central/State fiscal relations) intervened and made ad-hoc allocations to rural and urban bodies. The Central Government rechannelled several Centrally Sponsored Schemes (Central government budget items) to local governments. The new administration that came into power in May 2004 has been particularly vocal about the need for decentralization. It created a new Ministry of Panchayats to raise the profile of the process and the new Ministry has started a process of national debate towards a clearer devolution of activities to local bodies, avoiding concurrency and giving them a more important role in development. Among states Karnataka is a pioneer in devolution and as discussed above it has been taking important reforms to deepen the devolution process. On the other hand there are vested interests that could slow down or try to reverse the process. Central or state politicians may fear losing credibility if faced with competition from local politicians. State or district officials on the other hand may resist the loss of powers. Therefore one of the objectives of the project is to create an environment of fiscal stability for GPs over a period of time to give them space to establish and strengthen themselves reducing the risks of policy reversals.

The **second** aspect of sustainability relates to the fiscal situation of the state and its ability to absorb a larger Panchayat bill at the end of the project. At 0.08% of government expenditures the Gram Panchayat bill is miniscule, even by developing country standards, so even the doubling of this share would be relatively easy to absorb. In any case all the indications are that the state would increase the vertical share of Panchayats even without the project. Determining the vertical share of Panchayats is a responsibility of the State Finance Commissions. Both State Finance Commissions and Central Finance Commission have been increasing funds allocated to Panchayats at about 10 to 20% a year, which would more than cover the implicit liability arising from the project.

The **third** aspect of sustainability applies to service provision. Here the project is expected to have a positive impact in making those services more sustainable. As a result of the project own revenues would increase improving the financial situation of GPs, thus enabling them to sustain higher levels of services to rural people. Because the project would also increase accountability to rural people and therefore lead to expenditures that are more consistent with local preferences there would be strong incentives for Gram Panchayats to maintain and operate the assets created. Studies carried out by the Bank for Karnataka have shown that higher revenue collection and service provision are highly correlated.

8. Lessons Learned from Past Operations in the Country/Sector

The project builds on lessons from Bank supported ESW as well as a number of rural poverty and local governance projects. The Bank has conducted four studies on local governments in Karnataka and other Indian states: Overview of Rural Decentralization in India, Fiscal Decentralization to Rural Governments, "Panchayats and Resource Allocation in South India", and "Local Organizations for Decentralized Development in India". Some of the key conclusions of these studies were:

- Panchayats are unable to perform the functions assigned to them due to lagging fiscal and administrative decentralization. In Karnataka twenty percent of state expenditures are channeled through *Panchayats*, but only 7% of these flow to the lowest level, the *Gram Panchayats*, which have a very limited role. The state government has since increased funds to Panchayats.
- Unclear expenditure assignments between state government and *Panchayats* and between the three tiers of *Panchayats* create overlaps, confuse authority, and undermine accountability; the state government has since taken steps to address this problem.
- Limited expenditure discretion of local governments that limit their ability to meet local needs and preferences; the state government has since increased the proportion of untied funds.
- Weak revenue effort and collection; the state government has since taken actions that doubled demand.
- Complicated, non-transparent and non-equalizing transfer system; for example Panchayat entitlements are about US\$5,000 per Panchayat independently of need or fiscal capacity. The proposed project would contribute to addressing this issue.
- Unpredictable transfers that make it impossible for *Panchayats* to carry out meaningful planning; for example during the past few years the state government has not disbursed half the *Gram Panchayat* entitlement of \$5,000, and most in the last quarter. The proposed project would help address this issue.
- Widening horizontal disparities, with higher expenditure by more affluent *Gram Panchayats*. The proposed project would help address this issue.
- Outdated local government accounting systems, with no linkages between planning, budgeting, spending and monitoring. A new system has been designed. The proposed project would assist with implementation.
- No adequate information on *Panchayat* finances which reduces accountability. The proposed project would address this issue.
- Reserved seats for women and scheduled castes and tribes improve resource allocation towards these groups. The proposed project would develop the capacity of these people.
- Experience is one of the main determinants of the quality of local governance. The proposed project would address this issue through training.
- Gram Sabhas (village assemblies) improve resource allocation at the local level. The proposed project includes incentives for regular and high quality *Gram Sabhas*.

There is also considerable experience with the community driven rural poverty projects. Some of the relevant lessons are:

- Presence of organized groups of poor people help to ensure transparency and accountability of local governments to them;
- Panchayats need to be involved in local infrastructure to ensure its sustainability;
- Gram Sabhas (village assemblies) generally take place when they have relevant decisions to make.

Where communities contribute towards local investments these are implemented at lower costs and are more likely to be sustained.

9. Safeguard Policies (including public consultation)

Safeguard Policies Triggered by the Project	Yes	No
Environmental Assessment (OP/BP/GP 4.01)	[X]	[]

Natural Habitats (OP/BP 4.04)	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Pest Management (OP 4.09)	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Cultural Property (OPN 11.03 , being revised as OP 4.11)	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Involuntary Resettlement (OP/BP 4.12)	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Indigenous Peoples (OD 4.20 , being revised as OP 4.10)	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Forests (OP/BP 4.36)	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Safety of Dams (OP/BP 4.37)	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Projects in Disputed Areas (OP/BP/GP 7.60)*	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Projects on International Waterways (OP/BP/GP 7.50)	<input type="checkbox"/>	<input checked="" type="checkbox"/>

10. List of Factual Technical Documents

Author	Title	Publisher
	Overview of Rural Decentralization	
	Draft Proceedings of Decentralization Workshop	
	Government of Karnataka Working paper on Decentralization	
Government of Karnataka	Report of 2 nd State Finance Commission	Government of Karnataka
V.K. Natraj and Kripa Ananthpur	Delegation of Devolution : Working paper no 184	Madras Institute of Development Studies
Government of Karnataka	Reframing the Property Tax	Government of Karnataka
S.S. Meenakshisundaram	Panchayati Raj Institutions in Natural Resource Management, Findings from Karnataka	Magazine "Kurukshetra" (?)
V. Vijayalakshmi	Working paper 125	Institute for Social and Economic Change
	Brief review from Secretary, Rural Development and Reconciliation of Electricity bills	
	Guidelines for preparation of development perspective of the district	
Government of Karnataka	Karnataka transparency on Public Procurement Rules 2000	Government of Karnataka
Government of Karnataka	Excerpt of Budget speech for 2003-2004 increasing internal grants from 3.5 lakhs to 5.0 lakhs	Government of Karnataka

* By supporting the proposed project, the Bank does not intend to prejudice the final determination of the parties' claims on the disputed areas

	Belu Declaration – Joint Statement of Karnataka PRIs, upon books and State Government meetings on commitment to decentralization	
	Increase in Property tax	
	Comments received from report of finance regarding Aide – Memoire	
	List of topics for Panchayat training	
Government of Karnataka	Property taxes issues faced by GPs	Government of Karnataka
Government of Karnataka	Karnataka Activity Mapping	Government of Karnataka
Government of Karnataka	Proposal of format to intergovernmental ds to taluks	Government of Karnataka
Government of Karnataka	Guidelines for preparation of development report of Gram Panchayats	Government of Karnataka
Government of Karnataka	Report of the High power committee for Redressal of Regional Imbalances	Government of Karnataka
B.G. Madappa, Joint Controller (Retired)	The Karantaka Panchayat Reference (Panchayats Accounts and Budget) Rules 2003	Government of Karnataka
Government of Karnataka	The Karnataka local fund authorities fiscal Responsibility Bill, 2003	
Department of Ecology and Environment	State of the Environment Report and Action Plan 2003	Government of Karnataka
Government of Karnataka	Project Concept from the Government of Karnataka	
	Power Point presentation on the Karnataka Panchayat Regional	
Department of Economic Affairs	Letter from DEA proposing the project for consideration	
B.G. Madappa	Consultant report on capacity building on Accounting and Financial Management	
Environment Management & Policy Research Institute	Draft Report on “Environmental Report for the proposed Karnataka Rural Poverty and Panchayat project”.	
Geeta Sethi	Fiscal Decentralization to Rural Governments	Oxford University Press

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