PROJECT INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

Report No.: AB7627

Project Name	ADDITIONAL FINANCING - MSIP (EU-IPA)
Region	EUROPE AND CENTRAL ASIA
Country	Macedonia, former Yugoslav Republic of
Sector	Water supply (30%), Public Administration – Water, Sanitation and Flood Protection (15%), Solid waste management (20%), District heating and energy efficiency services (20%), Sewerage (15%)
Project ID	P150342
Parent Project ID	P096481
Borrower(s)	FORMER YUGOSLAV REPUBLIC OF MACEDONIA
Implementing Agency	Ministry of Finance
Environment Category	[ ] A [X] B [ ] C [ ] FI
Date PID Prepared	October 14, 2014
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1. Country and Sector Background

Macedonia has been able to preserve macroeconomic stability in the presence of economic crises. Its exchange rate related to the euro, introduced in 1995, has successfully supported price stability and has maintained inflation rate to 2.4 percent over the last decade. Macroeconomic policies have been geared towards keeping the external balance manageable, and monetary policy has responded quickly to any possible threats to the exchange rate. Between 2002 and 2009, Former Yugoslav Republic of (FYR) Macedonia grew at 3.9 percent annually although since 2009 the average Gross Domestic Product (GDP) growth rate decreased to 2.1 per year. However, economic growth and macroeconomic stability has not led to poverty reduction. The evidence shows that absolute consumption-based poverty has increased for 1 percent over the same period using the regional poverty line of 2.5 USD per day. If using a regional poverty line of 5 USD per day the poverty line increased from 33% to 37%. Inequality, measured by the Gini coefficient, increased between 2003 and 2008 in Macedonia from 37% to 40% using consumption data. Income-based data for the years 2010 and 2011 suggests a modest decrease in inequality with a Gini coefficient of 40.8 and 39.2, respectively though this is still on a high side compared to other countries in the region. During the same period, the welfare of the poorest 40% did not improve, either. According to a recent study on Shared Prosperity in the region of South East Europe, the poor and those in bottom 40% are more likely to live in larger households and have more dependents, and have lower level of educational achievements. In addition, the share of employed adults among those of working age is lower for the less well-off. This is relevant for this Additional Financing as the rural population is overrepresented in the bottom 40%.

Decentralization process of Macedonia was intensified after the adoption of the Ohrid Agreement which ended the conflict in 2001. The number of municipalities was consolidated to

85 in the 2005 Territorial reforms. This resulted in creating larger municipalities with more rural areas included in their jurisdictions. In 2007 the municipalities that have cleared arrears entered into the second phase of the decentralization, the phase of fiscal decentralization, and undertook new responsibilities such as managing primary and secondary education, some social services, cultural institutions and firefighting. Parallel to this, municipalities started to receive block grants to implement new functions. Progressively, municipalities assumed responsibilities for maintenance and improvement of infrastructure such as water supply and waste water treatment, fire protection, public lightening, pre-school, primary and secondary school, local cultural institutions and since 2011 municipalities acquired responsibilities for management of state land. During the decentralization process, regulations for local borrowing were established and municipalities may now borrow for capital investments and maintenance. With this, the share of own source of revenues in overall municipal budget has been increasing. From 2011 to 2012, a share of own source of revenues increased from 43% to 45.5%. Municipalities with the fiscal decentralization opportunities made a lot of efforts and increased own source revenues since 2009. Municipalities managed to increase property tax collection almost five times though its share of overall revenues is modest. The biggest increase of own source of revenues come from Land Development Fees, Lighting fees and other charges for the use of public space. The long delayed process of transferring state owned urban land to local government has begun to yield significant income from asset sales.

While the municipal revenue overall has increased rapidly, this has not translated into higher level of capital investments at local level. Average municipal capital investments for 2008-2012 as a share of GDP for Macedonia is 1.4% and is lower than European Union (EU) 15 and new EU member states. It is also lower than most other countries in the region, except Albania and Bosnia and Herzegovina.[1] Rural municipalities have higher per capita expenditure than urban municipalities in the functional categories of environmental protection, education, and general public services. This is because rural municipalities tend to have lower densities which make service provision for selected public service areas more expensive while smaller population size causes fixed costs to be divided among fewer people. However, urban areas concentrate a larger share of total capital expenditure and thus rural municipalities have greater need for capital investments.

FYR Macedonia continues to face the challenge of underinvestment in municipal services and infrastructure and shortcomings in municipal performance and local capacity. The crisis in the Euro zone puts additional exigency to the Government's goal of improving infrastructure as the basis for accelerated economic growth and development. Municipalities provide key public services and as mentioned above are responsible for rehabilitating, maintaining, and upgrading crucial infrastructure assets. Investments in local infrastructure and services contribute to improving the business climate in municipalities and generating employment. However, in order to enhance fiscal stability and increase public investments by municipalities, the Government places equal emphasis on the need to increase financial sustainability and operational efficiency of local service delivery. Accelerating economic growth to the level envisioned by the Government will require: (i) public service delivery to be more efficient with better performing municipalities, and (ii) higher incentives for the private sector to increase investment.

[1] Fiscal Decentralization Indicators for South East Europe 200602012; NALAS 2014

In its program for 2011-2015, the Government underscored the importance of investments in urban infrastructure and municipal services to support economic growth and employment. The Government program puts increasing emphasis on balanced economic growth across municipalities and regions to help create equal opportunities and facilitate economic integration by improving their infrastructure. MSIP is one of the Government's instruments to provide access to investment funds to municipalities that cannot yet afford to borrow from other sources.

Current State of Municipal Services

Communal services have suffered from delayed maintenance, rigid price control, and poor financial management, leading to a vicious cycle of deteriorating assets and lack of funding for new investments. Most local public services such as water supply and sanitation, solid waste management and urban transit are provided by Communal Services Enterprises (CSEs) owned by municipalities. Although CSEs are legally independent from their municipal owners, most of them in practice do not operate as independent, commercially-oriented utilities. CSEs usually operate based on informal arrangements with municipalities, for example, using infrastructure owned by municipalities or the state to provide services, and proposing tariffs that are approved by the municipalities. In addition to the municipality being the owner, policy-maker, and regulator, it is also a major user of CSE services through its own institutions, which lowers the CSEs' accountability to the average customer. In order to reduce the burden on municipal budgets and free up resources to increase investments, operational and financial management performance of CSEs needs to be improved.

Between March and May 2014, there were a series of consultation meetings with local mayors, jointly organized by project management unit (PMU), the Bank and EU delegation, to collect their views on how to best utilize the Instrument for Pre-Accession Assistance (IPA) funds. Most common views expressed in these meetings were that the available grant funds should be distributed as equally as possible to eligible municipalities and that the IPA window should not limit the type of sub-projects (municipalities shall be in the driving seat in selecting the projects according to their needs and priorities).

2. Objectives

The Project Development Objective (PDO) of the Municipal Services Improvement Project (MSIP) is to improve transparency, financial sustainability and delivery of targeted municipal services in the participating municipalities. This remains relevant to the proposed EU-IPA funding. The MSIP is designed to assist the Government to strengthen the operation of the municipal sector and the quality of service delivery to the local population. One of the Project's key goals is to increase financial sustainability of targeted municipal services. The MSIP promotes responsible local borrowing for investment, accountability to citizens and consumers by encouraging local voice and transparency, while making the financial and supervisory relationship between local governments and their CSEs more sustainable. It builds on the strong disciplinary role already imposed by the central government in its oversight of municipal borrowing.

3. Rationale for Bank Involvement

The rationale for establishing the proposed IPA window for rural infrastructure investments includes: (i) addressing the existing gaps in investments and service coverage between rural and urban settlements; (ii) providing grants for municipalities with relatively weaker financial capacity which cannot afford to borrow; and (iii) helping absorb IPA funds.

Alternative sources of investment funding for municipalities are scarce and decreasing as a result of the global credit crunch. So far, only few larger and creditworthy municipalities, such as the capital City of Skopje, to a limited degree have had access to commercially priced loans. Investments in local infrastructure and services, as drivers for employment generation in municipalities, are an integral part of the Government's crisis response strategy. Although funding from other donors has been made available, including from the EC-IPA, absorption remains low, often as a result of low municipal capacity. In addition, funding is earmarked for pre-identified municipalities or selected sector investments, mostly water supply and waste water, and lacks the flexibility of MSIP to respond to specific municipal demand.

Implementation under MSIP is making good progress and the Project has proven to be an effective mechanism to channel investment funds to municipalities to improve municipal services. The proposed AF meets criteria of suitability and appropriateness: (i) Implementation Status and Results Report (ISR) ratings for implementation progress (IP) and development objectives (DO) have been rated Satisfactory (S) over the last 12 months; (ii) the Project impact to date has been consistent with expectation set out in the Project Appraisal Document (PAD); (iii) the scaled up activities are consistent with the PDO and strategically aligned with the objective of the FY11-14 Country Partnership Strategy (Report No. 54928-MK) to support faster, more inclusive and greener growth while helping to prepare for EU accession; (iv) the Project does not have any unresolved fiduciary, environmental, social or safeguard issues; (v) overall, implementation capacity and project arrangements are adequate to the magnitude and scope of the expanded activities.

4. Description

Component A (Municipal Investments): Provide loans to municipalities to invest in revenue-generating public services and other investment projects of high priority and with cost saving potential.

Component B (Capacity Building and Institutional Reform): Provide consultancy services and technical assistance, including: sub-project preparation support, local capacity building, and national level institutional strengthening.

Component C (Performance based Investment grants): Provides grants to municipalities as incentives and rewards for implementing reform initiatives to improve service delivery performance.

Component D (Project Management, Monitoring and Evaluation): Provide support to the project management unit operation and assist with project monitoring and evaluation.

Component E (IPA-Rural Investment Window): Provide grants for municipalities to develop rural infrastructure.

5. Financing

Source:		($m.)
Borrower		6.79
Free-standing TFs for ECA CU4 Country Unit		20.35
	Total	27.14

6. Implementation

In light of the satisfactory implementation performance and progress to date, the implementation arrangements of MSIP will remain the same, with a well-functioning PMU at the Ministry of Finance. However, adding a new rural infrastructure window will significantly increase PMU's workload. PMU is expected to play an important role in reviewing and helping improve the basic designs prepared by participating municipalities, as well as providing implementation support. Based on the new staffing plan agreed upon by the Bank, the PMU is in the process of hiring additional manpower who will dedicate a significant amount of time to preparation and implementation of the rural infrastructure window. This includes three additional engineers, one procurement assistant, one financial management assistant as well as a firm to assist in sub-project appraisal process.

7. Sustainability

The project is designed to assist the FYR Macedonia government to strengthen municipal services sector operations following decentralization to ensure sustainable services delivery to local people. The project aims to address local- and central-level sectoral issues. At the municipal level, the project promotes responsible local borrowing for investment, accountability to citizens and consumers by encouraging local voice and transparency, and creating more sustainable financial and supervisory relationships between local governments and CSEs. The project builds on the strong disciplinary role imposed by the central government in its oversight of municipal borrowing. Also, the project provides a flexible testing ground to improve local-government functioning by offering a selection of performance targets and financial incentives for practices and investments that improve services and rehabilitate infrastructure.

The project-funded infrastructure improvements are expected to be financially sustainable-mainly rehabilitation or replacement of existing facilities without expansion and selected because they raise revenues or lower costs of services. In the present institutional circumstances of communal services, municipalities have ultimate financial responsibility for the CSEs and will be responsible for loan repayment.

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

The Bank has considerable experience in the Balkans supporting preparation and implementation of municipal services in transition economies, particularly those shifting responsibilities to municipalities; and experience in many newly decentralized countries on how to transfer funds and responsibilities within a framework that encourages local accountability while promoting national oversight and policy developments. These experiences and lessons are incorporated in the project design, specifically adapted to the FYR Macedonia situation.

The project also benefited from collaboration and discussions with other agencies supporting the municipal services sector in FYR Macedonia. The European Bank for Reconstruction and Development (EBRD) implemented a water and sanitation project under similar on-lending arrangements. The KfW Development Bank (KfW) is beginning implementation of a project in eight municipalities after considerable preparation efforts, including developing performance contracts between participating municipalities and CSEs; the MSIP will benefit from these experiences. Both EBRD and KfW projects demonstrated that intensive technical support was needed to negotiate performance environments to ensure investment sustainability, including tariff adjustments, for individual municipalities/CSEs, because no national institutional framework existed. To address the broader policy context for CSEs, the Bank provided a Public-Private Infrastructure Advisory Facility funded study at Government request and has pursued dialogue on its reform recommendations in parallel to the MSIP. Several key study recommendations that can be adopted at the municipality/CSE-level are reflected in the conditions for proposed performance grants.

Donor experience in the municipal sector, including that of the Bank, confirms that most municipalities require continued capacity-building assistance and that strong central-level coordination is required to ensure project implementation. The project design provides for a PMU in the MOF, an approach similar to that used for both the EBRD and KfW projects (which, however, worked mainly with the Ministry of Transport and Communications (MOTC)). The MOF was selected as the central ministry in the project design because of its key role in approving and overseeing municipal borrowing; however, other ministries, notably MOTC, Ministry of Environment and Physical Planning (MOEPP), and Ministry of Local Self-Government (MLSG), will be involved through a coordinating committee chaired by the MOF.

9. Safeguard Policies (including public consultation)

In accordance with the Bank’s Operational Policy 4.1, an Environmental Assessment and Management Framework (EAMF) Report has been prepared for the project and disclosed in the country on October 28, 2008. The final report was submitted to the Bank in November 2008. The EAMF Report presents an overview of the legal framework of environmental and local-self-government sectors in Macedonia; procedures for environmental assessment for the project development required under national legislation; procedures for environmental assessment for project development under World Bank procedures, and analysis of potential environmental impacts caused by sub-projects during implementation of different types of activities. The Report lists the potential negative environmental impacts for each type of project activities and provides lists of environmental mitigation and monitoring activities in order to mitigate and neutralize the relevant impacts. The Report provides a framework outlining how Environmental Mitigation Plans and Environmental Monitoring Plans (EMPs) are developed for each type of sub-project, and when site-specific EA/EIA are needed. The EAMF has been updated in June 2014 to include subsequent development and revisions of the legal framework in the country and to include generic EMPs for all sub-project activities (per type of activity) which are funded by the existing

Project. EAMF has been re-disclosed in country in August 2014 and final version provided to the Bank in September 2014 and disclosed in the Infoshop.
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Although resettlement is not likely to take place and there is very low probability for permanent land acquisition. A land acquisition and resettlement policy framework (LARPF) has been developed for sub-projects to be appraised. The draft LARPF was disclosed in country on October 28, 2008 and the final LARPF published by the World Bank Infoshop on December 18, 2008. The existing LARPF is part of the Operational Manual and there is no need for updating. For appraised sub-projects, all land acquisition and resettlement issues will be clarified and a land acquisition and resettlement action plan (LARAP) developed if there is a need. The particular sub-project LARAP will be submitted to the World Bank for no objection with other sub-project preparation documents. The procedures for the AF will remain the same as established of the original loan.

10. List of Factual Technical Documents
Not applicable

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