PROJECT INFORMATION DOCUMENT (PID)
CONCEPT STAGE

Report No.: PIDC24764

Project Name	Second Municipal Services Improvement Project (P154464)
Region	EUROPE AND CENTRAL ASIA
Country	Macedonia, former Yugoslav Republic of
Sector(s)	Water supply (30%), Wastewater Collection and Transportation (15%), Solid waste management (15%), Energy efficiency in Heat and Powe r (20%), Sub-national government administration (20%)
Theme(s)	City-wide Infrastructure and Service Delivery (60%), Municipal finance (25%), Municipal governance and institution building (15%)
Lending Instrument	Investment Project Financing
Project ID	P154464
Borrower(s)	Ministry of Finance
Implementing Agency	Project Management Unit
Environmental Category	B-Partial Assessment
Date PID Prepared/ Updated	29-Jun-2015
Date PID Approved/ Disclosed	10-Jul-2015
Estimated Date of Appraisal Completion	09-Nov-2015
Estimated Date of Board Approval	04-Feb-2016
Concept Review Decision	Track I - The review did authorize the preparation to continue

I. Introduction and Context

Country Context

Former Yugoslav Republic of Macedonia (FYR Macedonia) is a small, land-locked country in South-East Europe with a strong track-record of macro-economic stability. FYR Macedonia has made impressive progress in steadily recovering from the economic, political and social fallout from the 2001 ethnic conflict and obtained European Union (EU) candidate status in 2005. Economic growth has been above the regional average since 2009. The country also has been able to preserve macroeconomic stability in the presence of economic crisis. Between 2002 and 2009, FYR Macedonia grew at 3.9 percent annually, although since 2009 the average GDP growth rate decreased to 2.1 per year. In 2014, the economy grew by 3.5 percent and the country reached the highest growth among the six South East Europe countries. Macedonian currency is pegged to the Euro, since 1995, and 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.

Economic growth in FYR Macedonia, however, has not yet translated into significant poverty reduction or improved welfare of the poorest 40 percent of the population. While average consumption growth (used as a proxy for measuring shared prosperity) increased by 1.1 percent between 2003 and 2008, consumption growth of the bottom 40 percent decreased by 1.5 percent annually in the same period. Although not comparable to the consumption-based data prior to 2008, most recent income-based data for 2010 and 2011 shows a similar pattern: a slight decline in overall income, more pronounced for the bottom 40 percent. Although since the outbreak of the crisis FYR Macedonia managed to decrease unemployment from 32.4 percent in 2009 to 28.6 percent in 2013, unemployment remains high at around 28 percent of the labor force, and productivity and wages are low. High unemployment is a critical feature of the story, with poor labor market outcomes disproportionally affecting the bottom 40 percent, many of whom also have less education and lower quality housing. Sustaining the recent employment creation momentum and translating economic growth into jobs and income will help reduce poverty and improve the standard of living of all Macedonians. Therefore, helping the authorities to tackle these important challenges is a crucial reason for continued World Bank Group (WBG) engagement.

According to the last official census of 2002, FYR Macedonia is an ethnically diverse country, with 64.2 percent of the population made up of ethnic Macedonians, 25.2 percent ethnic Albanians, 3.9 percent ethnic Turks, 2.7 percent Roma, 0.5 percent Vlachs, 1.8 percent Serbs, 0.8 percent Bosnians, and 1.0 percent others. The Roma are a particularly vulnerable group in FYR Macedonia. According to a 2011 World Bank/EU/United Nations Development Program (UNDP) survey, the absolute poverty rate for Roma (PPP US$4.30 income based) was 41 percent, as compared to 14 percent for the non-Roma population. While unemployment rates are high in FYR Macedonia as a whole despite recent progress with its reduction, 53 percent of Roma adults (ages 15-64) are unemployed, as compared to 28 percent of the whole population. Roma are also among the group of workers that are likely to receive less than the minimum wage from their employers. Differences exist also in health and housing conditions, educational level, and Roma women lag behind men on most counts.

Sectoral and Institutional Context

Improving the living standards of the population requires more effective and efficient public service delivery. Given the unfolding decentralization process that was launched in 2005 and brought delivery of many of the basic public services to the municipal level, better performing municipalities are crucial to delivering this ambitious agenda. The number of municipalities was consolidated from 123 to 85 in 2005 and then further reduced to 81 in 2013 due to the changes in the Law on Territorial Organization. The changes led to creation of larger municipalities with more rural areas included in their jurisdictions. In 2007, the municipalities that have cleared their arrears entered into the second phase of decentralization process - i.e. fiscal decentralization to undertake 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 these new functions and then progressively assumed responsibilities for maintenance and improvement of municipal infrastructure such as water supply and wastewater treatment systems, solid waste management, local roads, street lighting, pre-school, primary and secondary school, local cultural institutions. Since 2011 municipalities also acquired responsibilities for management of state land. To date, municipalities provide key public services and infrastructure for their citizens and local businesses. Local authorities also influence, shape, and maintain stable interethnic relations at the level closest to citizens.

Municipal governments control over 7 percent of public spending at the moment. During the decentralization process, regulations for local borrowing were established, and municipalities may now borrow for capital investments. From 2009 to 2013, a share of own source of municipal revenues increased from 26 percent to 35 percent. Property tax collection increased almost five times, though its share of overall revenues is yet 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 governments has also begun to yield 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 FYR Macedonia was 1.4 percent, which was lower than EU 27 and new EU member states. It is also lower than most other countries in the region, except Albania and Bosnia and Herzegovina. Furthermore, communal services have suffered from delayed maintenance, rigid price control, and poor financial management. This leads 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 work 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 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.

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. The crisis in the Euro zone puts additional exigency to the Government goal of improving infrastructure as the basis for accelerated economic growth and development. On-going Bank-financed Municipal Services Improvement Project (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.

Relationship to CAS

The proposed Second Municipal Services Improvement Project (MSIP2) is aligned with the World Bank engagement in FYR Macedonia and builds on the Bank’s continuing dialogue and partnership with the Macedonian Government. Enhanced access to basic and municipal services is one of the key outcomes of the Country Partnership Strategy (CPS) for FYR Macedonia for the period FY2015-2018. Through facilitating improvements in transparency, financial sustainability and delivery of targeted municipal services, MSIP2 will contribute to both of the interrelated themes outlined in the CPS: (a) Growth and Competitiveness, and (b) Skills Development and Inclusion. MSIP2 will also benefit from the successful experience and lessons learned under on-going Municipal Services Improvement Project. Furthermore, the CPS suggests that the Bank will apply a social filter to its entire pipeline to help task teams in the country address obstacles that limit poverty reduction and shared prosperity for specific groups (women, minorities, in particular Roma, etc.) and to design activities and policy reforms that promote a more inclusive and cohesive society. In this connection, MISP2 envisages to improve municipal services in poorer and marginalized communities through its grant component.

II. Proposed Development Objective(s)

Proposed Development Objective(s) (From PCN)

The proposed Development Objective of MSIP2 Project (PDO) is to improve transparency, financial sustainability and inclusive delivery of targeted municipal services in the participating municipalities.

Key Results (From PCN)

The key results of the Project include, but will not be limited to:

(a) increased transparency in the operations of municipalities, as evidenced by percentage of participating municipalities that regularly publish benchmarks & sub-project progress information on their municipal or CSE's websites and Project Management Unit (PMU) project portal (this indicator also is a citizens engagement indicator);

(b) institutional strengthening of participating municipalities to plan, implement and operate municipal services infrastructure through capacity building TA and the incentives built into the project such as performance grants;

(c) improved financial performance of municipalities, as evidenced by percentage of participating municipalities achieving increased revenue earnings and/or cost savings in completed sub-projects; and

(d) achievement of targeted improvements in delivery of selected services, as evidenced by percentage of participating municipalities achieving improvements in delivery of selected municipal services in completed sub-projects.

MSIP2 will also contribute to the WBG core citizen engagement and social inclusion indicators and sector indicators on number of piped household water connections, number of people in the urban areas provided with access to regular solid waste collection, number of people in urban areas provided with access to all-season roads within a 500 meters range, km of rural and non-rural roads rehabilitated.

Therefore, key indicator for MSIP2 will be as following:

- Number of piped household water connections affected by rehabilitation works undertaken under the project (core sector indicator)
- Number of people in the urban provided with access to regular solid waste collection under

the project (core sector indicator)
- Number of people in the urban areas provided with access to all-season roads within a 500 meter range (core sector indicator)
- Kilometers of rural roads rehabilitated (core sector indicator)
- Kilometers of non-rural roads rehabilitated (core sector indicator)
- Percentage of Participating municipalities that regularly publish benchmarks and sub-project progress information on their municipal or CSE's website (citizens engagement indicator)
- Number of participating municipalities that met agreed performance criteria
- Percentage (or number) of sub-projects that generate improved financial performance, either through increased revenue earnings or cost savings
- Percentage (or number) of sub-projects that focus on social inclusion

Intermediate Results indicators will be as follows:

- Number of municipalities that have completed applications for sub-loans
- Number of sub-loans signed
- Number of sub-projects successfully completed
- Number of participating CSEs and/or municipalities supported by TA activities
- Completion of TA contracts to clients satisfaction
- Number of municipalities receiving a poverty/social inclusion investment grant
- Citizens and communities are involved in planning project-supported activities (yes/no, citizens engagement indicator)
- Number of participants in consultation activities during project implementation, with breakdown on number of female (core citizens engagement indicator, gender informative)
- Share of vulnerable and marginalized people of the total project beneficiaries (percentage, core social inclusion indicator)

III. Preliminary Description

Concept Description

The proposed Second Municipal Services Improvement Project (MSIP2) of EUR25 million presents the second phase of the on-going Municipal Services Improvement Project with an aim to respond to the strong demand by the municipalities for the local infrastructure financing. It will be built on the experience of MSIP and its lessons learned to enhance the impact of a well-performing project.

MSIP aims at improving the transparency, financial sustainability, and delivery of targeted municipal services. Its implementation is progressing well, and the sub-project results so far demonstrate good progress towards achieving its PDO. To date, a total of 51 sub-loan agreements have been signed with eligible municipalities under the MSIP component of Municipal Investments (loan component), out of which 33 sub-projects were completed and 11 are under implementation, while others are either at the tendering stage or about to start the tendering process. Furthermore, 22 sub-projects are currently under preparation by the respective municipalities with support from the Project Management Unit (PMU). In addition, 19 municipalities submitted applications to access funds under the MSIP component of Performance-based Investment Grants, with six performance grants agreements signed, and four grant activities already successfully completed. Some of the MSIP accomplishments to date include: more than 11,000 households with new water connections; about 240,000 people with access to regular solid waste collection; and all participating municipalities/utilities publish their budget information on their websites.

The original IBRD Loan for MSIP (approved on March 26, 2009) was in the amount of US$25 million equivalent. It was followed by Additional Financing loan of US$50 million equivalent approved by the Board on May 10, 2012. More recently, a new Component introducing the EU IPA-financed Rural Investment Window of EUR15.5 million, Recipient Executed Trust Fund (RETF), was added on December 22, 2014 to provide grants for priority rural infrastructure investments in eligible municipalities through the existing MSIP implementation mechanism.

To date, more than 40 percent of MSIP total loan amount (including both original loan and AF funds) has been disbursed. In addition, about EUR47.2 million have already been committed for municipal investments under the existing sub-projects pipeline. This represents 98 percent of all available MSIP investment funds, excluding the IPA-financed window. Thus, the MSIP funds are now fully committed and the project cannot respond to new applications from the municipalities. At the same time, municipalities continue to express growing interest and demand in using MSIP financing.

Given a persisting needs for improving municipal infrastructure and based on the positive experience in implementation of MSIP, the Government of FYR Macedonia requested the Bank for a new project or additional financing to MSIP in the amount of EUR25 million. Since the on-going MSIP already has two additional financings, including the recently approved IPA window, it was decided to proceed with preparation of a new operation that would present the second phase of MSIP. This is also a good opportunity to take stock of implementation experience under MSIP and bring in the needed adjustments if any.

MSIP2 will continue to focus on improving the transparency, financial sustainability, and delivery of targeted services under the responsibility of participating municipalities and their CSEs, such as water supply, sanitation, and solid waste management, as well as energy efficiency, urban transport, and other services delivered by municipalities. It will adopt the implementation arrangements and mechanisms that proved to be effective under the MSIP with some adjustments introduced based on the MSIP experience and lessons learned. In addition, MSIP2 aims to enhance inclusive service delivery by targeting poorer and marginalized communities for infrastructure improvements through the grant component. The positive aspects of MSIP experience, which the new project will adopt, include the access to loans affordable to municipalities (sub-loans), demand-driven process with participating municipalities selecting priority investments out of the wide variety of municipal investments, support for municipalities throughout sub-project cycle contributing to capacity building, and increased transparency and disclosure of information by participating municipalities as an eligibility condition. The lessons learned include the need to improve construction supervision and quality of technical documentation prepared by the municipalities.

While MSIP2 is expected to largely employ the institutional arrangements and implementation mechanism developed under the existing MSIP operation, an idea to establish a more sustainable and institutionalized financing mechanism for municipal infrastructure development, going beyond the current project-based Project Management Unit (PMU) approach, has been discussed with the Borrower. The MoF has informed the Bank of its plans to transfer the municipal infrastructure financing mechanism to the government-owned Macedonian Bank for Development Promotion (MBDP) in the future, whose current roles are to provide finances to small and medium-sized enterprises and export oriented companies. An option of creating a new institution such as a municipal development fund has been referred as too excessive for a relatively small country.

Through its TA component, MSIP2 could support a transition to MBDP or identify alternative options to ensure sustainability of the municipal financing instrument.

MSIP2 will likely have a composition of the components similar to MSIP, with the several adjustments, as follows:

Component A - Municipal Investments (tentative allocation – Euro 18.5 million): will provide sub-loans to municipalities for investments in (i) revenue-generating public services, and (ii) other projects of high priority for the municipalities and with cost-saving potential.

Component B - Poverty/Social Inclusion Investment Grants (tentative allocation – Euro 5 million): will provide investment grants to municipalities as an incentive for them to invest in infrastructure improvements in poorer and marginalized communities within their jurisdictions. A set of new performance criteria including the poverty/social inclusion criteria will be designed and agreed upon with the MoF during the project preparation.

Component C - Project Management, Monitoring and Evaluation, and Capacity Building TA (tentative allocation – Euro 1.5 million): supports operational costs of the PMU and assists with project implementation and monitoring, as well as finance consultancy services and technical assistance for (i) sub-project preparation/implementation and local capacity building for municipalities and CSEs to improve service delivery, and (ii) national level institutional strengthening.

Distribution of funds between the components will be confirmed during the project preparation.

IV. Safeguard Policies that might apply

Safeguard Policies Triggered by the Project	Yes	No	TBD
Environmental Assessment OP/BP 4.01	X		
Natural Habitats OP/BP 4.04		X	
Forests OP/BP 4.36		X	
Pest Management OP 4.09		X	
Physical Cultural Resources OP/BP 4.11		X	
Indigenous Peoples OP/BP 4.10		X	
Involuntary Resettlement OP/BP 4.12	X		
Safety of Dams OP/BP 4.37		X	
Projects on International Waterways OP/BP 7.50	X		
Projects in Disputed Areas OP/BP 7.60		X	

V. Financing (in USD Million)

Total Project Cost:	28.97	Total Bank Financing:	28.97
Financing Gap:	0.00		

Financing Source	Amount
Borrower	0.00

International Bank for Reconstruction and Development	28.97
Total	28.97

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