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Report No: 43727-IN

PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED CREDIT

IN THE AMOUNT OF SDR 128.1 MILLION
(US$ 200.0 MILLION EQUIVALENT)

TO THE

REPUBLIC OF INDIA

FOR A

KERALA LOCAL GOVERNMENT AND SERVICE DELIVERY PROJECT

February 24, 2011

Sustainable Development Department
Urban and Water Unit
South Asia Region

CURRENCY EQUIVALENTS
(Exchange Rate Effective – November 15, 2010)

Currency Unit	=	Rupee
US$1.00	=	R46.00
Rupee 1	=	US$0.02
1SDR	=	1.56194USD

FISCAL YEAR
April 1 – March 31

ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
AFS	Annual Financial Statement
CAG	Comptroller and Auditor General
CRRI	Central Road Research Institute
DAC	Decentralization Analysis Cell
DOF	Department of Finance
DPC	District Planning Committee
DPR	Detailed Project Report
EA	Environmental Assessment
EGs	Environmental Guidelines
FMRs	Financial Monitoring Reports
EMF	Environmental Management Framework
ESMF	Environment and Social Management Framework
GAAP	Governance and Anti-Corruption Action Plan
GIFT	Gulati Institute of Finance and Taxation
GoK	Government of Kerala
GP	Gram Panchayat
HDI	Human Development Index
ICR	Implementation Completion Report
IDA	International Development Association
IKM	Information Kerala Mission
IUFR	Interim Unaudited Financial Report
KILA	Kerala Institute of Local Administration
LEA	Limited Environmental Assessment
LFA	Local Fund Auditor
LSG	Local Self Government
LG	Local Government
M/I	Medium/Impact
MTFF	Medium Term Fiscal Framework
MoU	Memorandum of Understanding
NABARD	National Bank for Agriculture and Rural Development
NCB	National Competitive Bidding

NSSO	National Sample Survey Organization
ORAF	Operational Risk Assessment Framework
PG	Performance Grant
PFS	Project Financial Statements
PMU	Project Management Unit
SCP	Special Component Plan
SFC	State Finance Commission
SIL	Specific Investment Loan
SIRD	State Institute for Rural Development
SPAO	State Performance Audit Officer
TSB	Treasury Savings Bank
TSP	Tribal Sub Plan
VGDF	Vulnerable Group's Development Framework

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Country Director:	N. Roberto Zagha
Sector Director:	John Henry Stein
Sector Manager:	Ming Zhang
Task Team Leader:	Roland White

INDIA

KERALA LOCAL GOVERNMENT AND SERVICE DELIVERY PROJECT

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INDIA

KERALA LOCAL GOVERNMENT AND SERVICE DELIVERY PROJECT

PROJECT APPRAISAL DOCUMENT

South Asia
SASDU

Date: February 24, 2011 Country Director: N. Roberto Zagha Sector Director: John H. Stein Sector Manager: Ming Zhang Team Leader(s): Roland White Project ID: P102624 Lending Instrument: Specific Investment Loan	Sector(s): Sub-national Government Administration (90%); Other Social Services (10%) Theme(s): EA Category: B-Partial Assessment

Project Financing Data

Proposed terms:

[ ] Loan [X] Credit [ ] Grant [ ] Guarantee [ ] Other:

Source		Total Amount (US$M)
Total Project Cost:		260.0
Cofinancing:		
Government of Kerala (GoK)		60.0
Total Bank Financing:		200.0
IBRD		
IDA		200.0
New		200.0
Recommitted		-

Borrower: Government of India, New Delhi, India

Responsible Agency: Local Self Government Department (LSGD), Government of Kerala, India

Contact Person: Mr. S.M.Vijayanand, Additional Chief Secretary
Telephone No and Fax No.: +91-471-2333174, +91-471-2327395
Email: prlsecy@lsg.kerala.gov.in

Estimated Disbursements (Bank FY/US$ m)

FY	*2012*	*2013*	*2014*	*2015*	*2016*
Annual	40.0	57.0	53.0	49.0	1.0
Cumulative	40.0	97.0	150.0	199.0	200.0

Project Implementation Period: July 1, 2011 End: December 31, 2015 Expected effectiveness date: June 30, 2011 Expected closing date: December 31, 2015	
Does the project depart from the CAS in content or other significant respects?	○ Yes X No
If yes, please explain:	
Does the project require any exceptions from Bank policies? Have these been approved/endorsed (as appropriate by Bank management? Is approval for any policy exception sought from the Board?	○ Yes X No ○ Yes ○ No ○ Yes X No
If yes, please explain:	
Does the project meet the Regional criteria for readiness for implementation?	X Yes ○ No
If no, please explain:	
Project Development objective: To enhance and strengthen the institutional capacity of the local government system in Kerala to deliver services and undertake basic administrative and governance functions more effectively and in a sustainable manner	
Project description: The project will have four components. Component 1 will provide Gram Panchayats (GPs) and Municipalities with additional discretionary funds to provide increased resources for expanded local investment for the creation, maintenance and operation of capital assets in a manner which incentivizes the strengthening of their institutional capacity. Component 2 will provide capacity-building inputs to strengthen and supplement the existing systems and human resource of Municipalities and GPs to enhance their institutional performance. Component 3 will strengthen the system of performance monitoring of GPs and Municipalities in Kerala. Component 4 will support project management.	
Safeguard policies triggered? Environmental Assessment (OP/BP 4.01) Natural Habitats (OP/BP 4.04) Forests (OP/BP 4.36) Pest Management (OP 4.09) Physical Cultural Resources (OP/BP 4.11) Indigenous Peoples (OP/BP 4.10) Involuntary Resettlement (OP/BP 4.12) Safety of Dams (OP/BP 4.37) Projects on International Waters (OP/BP 7.50) Projects in Disputed Areas (OP/BP 7.60)	 X Yes ○ No X Yes ○ No X Yes ○ No ○ Yes X No X Yes ○ No X Yes ○ No ○ Yes X No ○ Yes X No ○ Yes X No ○ Yes XNo

Conditions and Legal Covenants			
Financing Agreement Reference		Description of Condition/Covenant	Date Due
		GoK shall, no later than six months after project effectiveness, appoint the LSG support engineers (1 per block) to the LSGD.	Within six months of Effective date
		GoK shall, within 30 months of the Effective date, carry out jointly with the Association, a Mid-term Review of the progress made in carrying out the project.	Within 30 months of Effective date
		GoK shall ensure that, throughout the duration of the Project, the total annual budgeted State Finance Commission award amount for LSGs shall not decrease in real terms, as measured using the national inflation rate as deflator and using 2010/2011 as the base year.	Ongoing

I. STRATEGIC CONTEXT AND RATIONALE

A. Country Context

1. India's consistency in pursuing economic reforms over the last two decades has contributed to the country's fast economic growth.[1] Between 2004 and 2008, India registered an average real GDP growth of about 8.5 percent.[2] The country's high growth has been accompanied by parallel increases in spending on health, education, drinking water and sanitation, rural and urban infrastructure, and employment programs. Over fiscal years 2003-2007, average government expenditure as a percentage of GDP was about 15.35 percent, which has contributed to improvements in literacy rates,[3] life expectancy,[4] and child mortality rates.[5] Likewise, improvements in other health indicators and in access to and quality of basic social services have followed. However, India has made less progress than other countries with respect to service delivery in both rural and urban areas. With a Human Development Index (HDI) of 0.609, India ranks poorly at 132nd out of 179 countries,[6] and considerable geographic variation exists with regards to the progress that has been achieved. Rural areas especially continue to lag in social and economic indicators, and regional disparities are increasing both between as well as within states. In urban areas, "India's cities fall well short of not only the levels of service to which international cities aspire but even a 'basic' standard of living for their residents"[7] In sum, improvements in service delivery have not been commensurate with the magnitude of Government of India (GoI) expenditures.

2. The core challenge has been a set of policy and institutional obstacles which impede effective service delivery and the implementation of government programs. Traditional, centralized mechanisms[8] have proven incapable of delivering effective services and governance at the local level as India has developed socio-economically and its human settlement patterns have evolved. As a broad response to this, in 1994 India adopted the 73rd and 74th Constitutional Amendments which mandated the creation of local governments in both urban and rural areas. However, implementation of these Amendments – which falls to the States as the constitutional entities which have legal jurisdiction over local government matters – has been uneven and slow. There is need for greater clarity in the allocation of functions and expenditure assignments between different levels of government, clearer accountability, greater predictability in intergovernmental fiscal flow, as well as support incentives for local governments to perform effectively.

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[1] From 1951 to 1980, real GDP growth averaged around 3.5 percent; this increased to 5.7percent from 1980 to 1990. Bhagwati, Jagadish and Charles W. Calomiris 2008. *Sustaining India's Growth Miracle*. Columbia University Press.
[2] Economist Intelligence Unit Country ViewsWire (2009).
[3] Literacy rates among the population aged 7 rose considerably from 52.2 percent in 1991 to 65.2 percent in 2001. Government of India, 2001 Census.
[4] Life expectancy increased from just 42 years in 1960 to 65 years in 2007. World Bank, HNP Stats.
[5] Child mortality rates decreased from 234 per 1,000 in 1960 to 72 per 1,000 in 2007. World Bank, HNP Stats.
[6] As evaluated in the 2008 Statistical Update of the Human Development Report (HDR).
[7] McKinsey Global Institute, *India's urban awakening: Building Inclusive cities, sustaining economic growth*, April 2010.
[8] Predominantly state departments and agencies

B. Sectoral and Institutional Context

3. Against this broad backdrop it should also be recognized that India is very heterogeneous and, with respect to decentralization, Kerala is a notable outlier within the country. Since the late 1990s, in what is generally referred to as a "big bang" reform, Kerala has devolved more responsibilities and resources ("funds, functions and functionaries") to local governments – and, within the local government system, to the lowest levels of local government – than any other Indian states. More particularly, in addition to their responsibilities for typical local services such as water, roads and sanitation, local governments in Kerala have been given (limited) functions in respect to health and education which are found in few if any other states. On the fiscal side, the State has implemented the recommendations of successive State Finance Commissions (SFC), the most recent of which proposed that local government transfers constitute 25 percent of state tax revenue in 2003/04, with an increase of 10 percent a year thereafter. Consequently, total SFC allocations have risen to Rs 2,889 crores for 2010/11. In 2007/08 average Gram Panchayat (GP) revenues per capita in Kerala were approximately Rs 644 compared with Rs 342 in West Bengal, which is also regarded as one of India's "decentralization" leaders.[9] Moreover, again in line with SFC recommendations, Kerala has introduced an objective, formula-based approach to the horizontal distribution of SFC transfers between local governments, which other Indian states have yet to do. On the human resource side, the average full-time staff complement of a GP in Kerala (excluding contract staff) is 9; in West Bengal it is 5.[10]

4. Despite this impressive progress, a number of core challenges remain. In the short to medium term, three stand out:

a. Expenditure autonomy. While GPs and Municipalities in Kerala have benefitted greatly from both the increased quantum of fiscal resources flowing to them, and the predictable nature of the SFC transfers which are allocated by formula, usage of these funds is not fully discretionary. The extent to which these entities are able to respond effectively to locally determined investment and service priorities would improve with greater discretion.

b. Institutional capacities. While GPs and Municipalities in Kerala generally have larger staff complements than in other Indian states, institutional capacity remains limited and insufficient – particularly in an environment where the mandates (as in numbers of programs to be implemented) and resources flowing to these Local Self Governments (LSGs) are increasing very rapidly. Among other things, as with other states, funding for "centrally-funded schemes" such as the Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS) has increased substantially over the past five years. In Kerala's case, these almost doubled between FY 06/07 and FY 07/08, with further very substantial increases in following years.[11] Two specific weaknesses may be identified. First, the organizational and operating systems for local governments – in areas such as budgeting and planning, financial management and asset management – have yet to be coherently integrated, updated and modernized. Second, while

[9] ODI, *Fiscal Analysis of Local Self Governments in Kerala*, September 2010. This excludes funding from a number of GoI funded "centrally.funded schemes" such as NREGS.
[10] Ibid.
[11] Ibid.

assessments undertaken for the preparation of the project indicate that the skills levels of local officials are reasonably robust in some areas, there is a great deal of unevenness. If this is to be addressed and skills levels are to be upgraded in line with systems modernization, the local government training infrastructure of Government of Kerala (GoK) needs to be updated and improved.

c. State management and oversight of local government system. Finally, for developmental as well as fiduciary reasons, the capacity of GoK to manage and oversee the local government system as a whole needs to be improved.

5. In sum, as LSGs in Kerala – like local governments elsewhere in India, but to a unique degree – take on additional responsibilities and absorb resources at accelerated rates, GoK is poised to undertake a second generation of decentralization reforms which focus, in a practical and incremental manner, on expanding local expenditure autonomy, strengthening LSG institutional capacity and enhancing the state government's ability to manage and oversee the system overall. The proposed project has been developed as a key vehicle through which to pursue this objective and, as such, seeks both to have direct results within its life as well as long-term, systemic impacts. Given its established dialogues on local government and decentralization with both Indian Central Government Ministries and State Governments, and the valuable experience it has gained from its extensive global portfolio of analytic and lending activities in the sector in South Asia and internationally, the World Bank is well-placed to support GoK in this regard. Moreover, at the country level, this project would constitute one of four Bank-supported local government projects (two are under implementation in Karnataka and West Bengal; a third is under preparation in Bihar) in fairly diverse state environments which will generate lessons for one another and for the respective states' approaches to decentralization.

C. Higher Level Objectives to which the Project Contributes

6. The higher level objectives to which the project will contribute are improved local service delivery and governance in Kerala. At the national level, the project will also support the overall process of decentralization as mandated under the 73rd and 74th Constitutional Amendments.

7. The project will contribute directly to pillar three of the World Bank's India Country Strategy – "Increasing the effectiveness of public service delivery". It will fund local infrastructure and service-delivery improvements and also support "institutional arrangements that promote an enabling environment for results."

II. PROJECT DEVELOPMENT OBJECTIVES

A. Project Development Objective

8. The project development objective is to enhance and strengthen the institutional capacity of the local government system in Kerala to deliver services and undertake basic administrative and governance functions more effectively and in a sustainable manner.

B. Project Beneficiaries

9. Direct beneficiaries of the project will be the 978 GPs and 60 Municipalities in the State of Kerala. Investments made by the GPs and Municipalities will indirectly benefit the entire population of the State of Kerala outside of the five City Corporation areas.

C. PDO Level Results Indicators

10. Achievement of the PDO will be measured by: (a) 70 percent GPs and Municipalities will have passed the performance assessments for well-functioning fiduciary, planning and service delivery systems [12] (total = 1038); (b) A well-established performance-based grant system is increasingly financed by GoK; and (c) the number of direct project beneficiaries of which a certain percentage are female.

III. PROJECT DESCRIPTION

A. Project Components

11. The project will have four components with an estimated cost of US$260.0 million. A brief description of the project components is described below. A detailed description of the components is provided in Annex 2.

12. *Component 1: Performance Grants (US$238.6 million - IDA and GoK)*. This component will phase in an annual, performance-based grant to all 978 GPs and 60 Municipalities in Kerala.[13] It will provide GPs and Municipalities with additional discretionary funds for expanded local investment in a manner which incentivizes the strengthening of their institutional capacity (which is supported, on the supply side, under Component 2). The performance grant (PG) will be spent on both the creation and maintenance and operation of capital assets used in service delivery. The overall goal is to improve GP and municipal performance in local governance and public service delivery.

13. In order to provide a realistic and feasible mechanism for incrementally strengthening the institutional capacities of the GPs and Municipalities, the PG will be introduced in two phases. The administrative and institutional systems necessary for the introduction of a full performance grant will be established over the first two years of the project (Phase 1). During this time all GPs and Municipalities will receive grant funding, the use of which will be subject to basic fiduciary requirements. From year three onwards, the performance dimension of the grant, where qualification to receive a grant is based on an annual performance assessment, will be applied (Phase 2).

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[12] The quality of GPs' fiduciary and planning systems will be measured through the Project's annual performance assessment system, along with separate third party validation. (See Component 1 description). GPs will be assessed according to specific criteria in areas of: (i) planning and budgeting; (ii) project execution and service delivery; (iii) accounting, reporting and audit; and (iv) transparency and accountability. The full performance assessment will occur in the second year.

[13] These are the numbers which will be in place following the LSG (Local Self Government) elections in October 2010.

14. Component 1 intends to introduce the Performance Grant (PG) system as an integral part of the Kerala Local Self Government fiscal framework which will continue beyond the life of the project. To this end, GoK will provide a rising counterpart contribution to the PG as follows:

.Project Year	Year 1 (2011-12)	Year 2 (2012-13)	Year 3 (2013-14)	Year 4 (2014-15)	Total
IDA	*35.0*	*51.0*	*47.6*	*45.0*	***178.6***
State	-	*10.0*	*20.0*	*30.0*	***60.0***
Total	**35.0**	**61.0**	**67.6**	**75.0**	**238.6**

15. *Component 2: Capacity Building (US$11.2 million – IDA).* This component will provide capacity building inputs to strengthen and supplement the existing systems and human resources of LSGs to enhance their institutional performance. The focus will be in four core areas: (i) the development and improvement of administrative systems used by LSGs; (ii) formal training to strengthen the human resource capacities of LSGs using these systems; (iii) mentoring directed at human resource capacity improvement and supplementation; and (iv) strengthening of the overall institutional capacities of the key organizations responsible for delivering LSG training in Kerala. In the longer term, the component will support the formulation of a State-wide capacity building strategy for LSGs.

16. *Component 3: Enhancing State Monitoring of the Local Government System (US$3.4 million - IDA).* This component will provide support to strengthen the system of performance monitoring of LSGs in Kerala. This component will comprise four sub-components:

a. Database of GP and municipal information. The project will establish a database of GP and municipal level information which will store basic information regarding GP and municipal profiles: population, vital statistics, livelihoods, employment, education, water and sanitation, budget expenditures and physical assets.

b. LSG Service Delivery Survey. The second sub-component is a survey to gauge trends on LSG service delivery performance and citizen satisfaction throughout the state. The survey will examine delivery trends state-wide in sectors where GPs and Municipalities have some responsibility, explore citizen satisfaction and usage of basic services as well as awareness of GP planning and budget processes.

c. Project Evaluations. In addition, the project is planning two evaluations to evaluate the quality of the capacity building efforts (Component 2) and service delivery technical evaluation for the Performance Grant investments (Component 1). The latter will include an assessment of improved access to services as a result of the block grant investments; coverage/distribution of service provision; technical quality, operations and maintenance arrangements, cost effectiveness (value-for-money) and safeguards issues.

d. Decentralization Analysis Cell (DAC). The DAC will play two key functions: (i) it will collect, store, compile and report GP/Municipality level and service delivery data; (ii) the DAC will also carry out a policy advisory function providing independent analysis on the performance of the State's intergovernmental fiscal system and service delivery system and provide ongoing policy advice to GoK and the SFC on local and intergovernmental fiscal and institutional issues.

The key clients of the DAC's outputs will include the Department of Local Self Government (LSGD), Department of Finance (DoF), State Finance Commission (SFC), LSGs, and citizens.

17. *Component 4: Project Management (US$6.8 million - IDA).* This component will provide support to the Project Management Unit (PMU) within the LSGD in overall coordination, implementation, monitoring and evaluation of the project.

B. Project Costs and Financing

(i) Lending Instrument

18. The lending instrument chosen for Bank support is a Specific Investment Loan (SIL). The SIL is considered the most appropriate instrument to support the institutionalization of decentralization in Kerala, including the introduction of a grant system, and the consolidation and expansion of the LSGs' capacity building in the areas such as financial management, procurement, planning and environmental and social safeguards.

(ii) Project Financing Table

19. The total project financing requirements are estimated at US$260.0 million, inclusive of price and physical contingencies, and taxes. The Government of Kerala will finance US$60.0 million for the Performance Grants. The remaining costs of US$200.0 million for Performance Grants, goods, consultant services, and operating costs will be funded under the IDA credit. Detailed information on costs and sources of financing are provided in Tables 1 & 2 below:

Table 1: Project Costs by Component

	Local	**Foreign**	**Total**
Program Cost By Component	**US $million**	**US $million**	**US $million**
Performance Grant	238.6	0.0	238.6
Capacity Building	9.9	0.7	10.6
Enhancing State Monitoring of the Local Government System	2.0	1.3	3.3
Project Management	4.8	1.5	6.3
Total Baseline Cost	255.3	3.5	258.8
Physical Contingencies	0.0	0.2	0.2
Price Contingencies	0.8	0.2	1.0
Total Project Costs	256.1	3.9	260.0

Table 2: Project Costs by Component and Sources of Financing

Component and/or Activity	**GOK US$ million**	**IDA US$ million**	**Total US$ million**
1. Performance Grant	60.0	178.6	238.6
2. Capacity Building	0.0	11.2	11.2
3. Enhancing State Monitoring of the Local Government System	0.0	3.4	3.4
4. Project Management	0.0	6.8	6.8
Total Project Costs	**60.0**	**200.0**	**260.0**

IV. IMPLEMENTATION

A. Institutional and Implementation Arrangements

20. *Project Oversight*. The Local Self Government Department of Kerala (LSGD) will have the primary responsibility for project implementation and ensuring that the project development objectives are met. The LSGD will execute the project through a Project Management Unit (PMU) with overall responsibility for project execution, ensuring that the project resources are budgeted and disbursed, and that project accounts are audited.

21. *Project Management*. The PMU, within LGSD, will assume direct responsibility for day to day project management, coordination and implementation. The PMU will take the lead role in planning, coordination and monitoring of the project performance in line with the project implementation schedule and facilitate day to day decisions for implementation of various components of the project and will be responsible for inter-institutional coordination. The PMU will undertake the annual performance assessments of the GPs and Municipalities, quality assurance of the assessment, prepare annual work programs, budgets, annual procurement plans, will disburse funds, review fund execution and accountability, oversee quarterly review meetings and contract and supervise project staff and consultancy assignments, prepare reports and other documents and provide quality control. The PMU will be headed by a Project Director assigned from the state government, reporting to the Principal Secretary, LSGD, and will be supported by a Deputy Project Director for this specific role. The PMU will be staffed by (i) Financial Manager; (ii) Finance Assistant, (iii) Procurement Specialist; (iv) Environmental and Social Safeguards Specialist; (v) Grant Management Specialist; (vi) Capacity Building Specialist; (vii) Monitoring and Evaluation Specialist; (viii) Communications Specialist; (ix) IT Specialist; and (x) Support Staff.

22. Information Kerala Mission (IKM) is an e-governance project of the GoK under the LSGD, aiming at strengthening local self-governance through ICT (Information Communication Technologies) applications. IKM will support the process of updating legacy data of GPs and Municipalities relating to inventory of assets, infrastructure, taxation, and other revenue related information in to the financial management e-system at LSG level.

23. *Implementation Support*. Three execution support agencies will implement specific project components and sub-components under the overall direction of the LSGD. These are: (i) Kerala Institute of Local Administration (KILA), an autonomous institution registered under the Societies Act, 1955, established under the LSGD which will be responsible for the execution of the various activities under Component 2; (ii) State Institute for Rural Development (SIRD), an autonomous body under the auspices of the GoK which will be responsible for various activities under Component 2; and (iii) Gulati Institute of Finance and Taxation (GIFT), an autonomous institution under the Department of Finance, which will house the Decentralization Analysis Cell. A Memoranda of Understanding (MoU) will establish the nature of the relationship between the PMU and these institutions.

24. *Funds Flow and Financial Accountability Reporting; Implementing Agency Risks.* Arrangements for funds flow and financial reporting are outlined in the Financial Management Assessment section of the PAD. Implementing Agency Risks are dealt with in the Financial and

Procurement Assessments, the Operational Risk Assessment Framework (ORAF) and the Governance and Accountability Action Plan (GAAP).

25. *Relationship to Jalanidhi II*. The World Bank is currently preparing a water supply and sanitation project in Kerala – Jalanidhi-II – in which Gram Panchayats will play a central role.[14] Building on the demand responsive approach established in 112 GPs under the successful Jalanidhi I predecessor project, Jalanidhi II intends to assist GoK in increasing the access of rural communities to improved and sustainable water supply and sanitation services in Kerala. Jalanidhi II will focus on another 200 GPs across the state, providing them with grant funding to support the development of their water and sanitation systems. GPs will play a central role in planning, funds management and project activity management, while Beneficiary Groups (BGs), operating under the overall oversight of GPs, will play critical project implementation and maintenance and operation (including cost recovery) roles. In addition, under Jalanidhi-II the GPs will be responsible for directly managing large water supply schemes and environmental management interventions and for developing and protecting GP-wide water resources, as well as playing an important role in ensuring the transfer of ownership and the management of existing single village water supply schemes currently owned and managed by the Kerala Water Authority (KWA) – all in line with GoI sector guidelines. The project will also provide sector-specific capacity enhancement and strengthening to both GPs and BGs in order to enhance their abilities to play their respective roles in water supply and sanitation sector activities. The complementary nature of KLGP and Jalanidhi II offers significant opportunities for developing synergies. The nature of these synergies is discussed in greater detail in Annex 2.

B. Results Monitoring and Evaluation

26. Annex 1 provides the results framework including outcome indicators and intermediate outcome indicators for each project component. The PMU has overall responsibility for project implementation and the overall monitoring and evaluation system in coordination with KILA, SIRD, and GIFT.

27. The PMU is responsible for undertaking the annual performance assessments under Component 1 which will provide information regarding the institution-strengthening efforts of the GPs and Municipalities. KILA and SIRD will provide the project with annual reports of the training activities. A project evaluation will also be commissioned twice during the life of the project to examine improved access and the technical quality of service delivery outputs and the capacity building components. All the reports and studies will feed into the formal mid-term and final evaluations.

28. Also in respect of Component 1, and to enhance transparency, accountability and results measurement, two additional reporting will be introduced:

[14]Pursuant to the initiation of decentralization reform in Kerala in 1997, GPs have functional responsibility for water supply and sanitation. In practice, this is being incrementally achieved as water systems and funding for these are transferred from KWA and the state to the GPs.

- For “upward” accountability, a system of semi-annual administrative reporting to the State Government on physical progress and asset creation funded from the PG. This will expand to include other expenditures over the life of the project
- For “downwards accountability”, (a) a simple local annual budget report; (b) a simple local plan execution and project report will be disseminated to the public.

29. For standard reporting to the Bank, the GoK will prepare the required semi-annual narrative progress reports and quarterly Interim Unaudited Financial Reports (IUFRs). A mid-term review will be conducted within 30 months of project implementation to evaluate progress of the project.

C. Sustainability

30. The Bank and GoK are proposing to provide $238.6 million to the Kerala Local Government Project over four years to fund performance grants from 2011/12 to 2014/15. Performance Grants will be fully funded by the Bank for the year, with the GoK phasing its contribution over the following three years. In order to assess the fiscal sustainability of the project, the potential impact of this funding on SFC transfers over the project timeframe was simulated under two scenarios.[15] Scenario 1 was based on the GoK’s own Medium-Term Fiscal Framework (MTFF), which has been extended by three years with a growth projection of 14 percent for SFC and state revenues for those later years; Scenario 2 was more conservative, projecting 10 percent growth of SFC transfers and state revenues over the five year project lifecycle.

31. Under both scenarios, additional performance grant funding represents an additional allocation of nearly seven percent of SFC allocations or one percent of total state own revenues. In the case of Scenario 1 these shares decline over time as growth in SFC and own source revenues outstrip the 10 percent increase in performance grant funding, whilst in scenario 2 they remain constant. Over time state transfers are maintained at around 13% of state own revenues under scenario 1 and 15 percent under Scenario 2. Under scenario 1 there is more fiscal space for GoK to take over the additional funding commitment. However, even under the more conservative Scenario 2, this should be fiscally sustainable beyond the lifetime of this project.

32. So far as service delivery and physical asset sustainability is concerned, the project will provide funding to LSGs for expenditure either on investment and/or on maintenance and operations of capital assets used in service delivery. The capacity building activities supported by the project will include the development of an asset management system and training of LSG officials and staff on the importance of maintenance and operations functions.

V. KEY RISKS

33. The potential risks are summarized in the Operational Risk Assessment Framework (Annex IV). The overall risk rating for project implementation is Medium/Impact (M/I). This

[15] See ODI, *Fiscal Analysis of Local Self Governments in Kerala*, September 2010. The allocations here refer to SFC transfers, and do not include state and centrally sponsored schemes or the salaries of staff from transferred institutions.

rating reflects the view that a number of key decisions regarding the basic scope and design of the project are vital. While the chances of positive outcomes are reasonably good, the impact of poor decision-making on these issues would be deleterious to the realization of the PDOs. There is a fairly wide range of risks to the project during implementation, so the likelihood of at least some of these materializing is quite high, but their overall impact is likely to be manageable during the life of the project.

34. The project will strengthen existing governance arrangements at the State level as well as the LSGs with the objective of mitigating potential governance risks that may impede the project from achieving its objectives. The key tool for this is a Governance and Accountability Action Plan which has been developed through an analysis of the key transactions which are intrinsic to the project. At every stage in this "transaction chain", potential risks are identified and corresponding mitigation measures have been developed.

VI. APPRAISAL SUMMARY

A. Economic and Financial Analysis

35. Annex 7 examines the economic and financial benefits, costs and risks of the project as well its likely impacts. It indicates that the performance of the GPs and Municipalities in terms of service delivery and governance should be enhanced through increased discretionary financial resources and strengthened institutions. The reforms implemented under this project will help strengthen the systems and processes, including financial management, procurement, e-governance, performance monitoring and local planning and budgeting. The interventions under the project will improve efficiency in service delivery at the GP and municipality level. The social benefits of the chosen interventions under this project are likely to outweigh their costs.

36. In terms of rate of return, the types of public infrastructure to be created under Component 1 are likely to yield a higher rate of return than those under alternative arrangements. The decisions taken by local self governments will likely reflect the local preferences identified through a local planning process, thus generating allocative efficiencies. The resulting choices of local public investments paid for using discretionary Performance Grants provided by the project are likely to yield higher rates of return over time. A priori, it is difficult to determine the exact type of public investments undertaken in a particular GP or municipality. However, the overall menu of public investments that GPs and Municipalities may select is known. Typically, such investments may include small roads, bridges, water supply and sanitation i.e. investments within the devolved mandates of GPs and Municipalities in Kerala. Evaluations of projects or programs in India that established similar public investments have found positive rates of return.

B. Technical

37. The project will use existing GoK procedures for the technical design, costing and procurement of GP and municipal investment projects. The technical support for GP and municipal project planning, design and execution will be provided by the capacity building activities supported under Component 2.

38. The project will also strengthen local government performance monitoring in the three areas: (i) institutional performance of local governments; (ii) service delivery performance; and (iii) resource inputs to local governments. Community involvement in the project planning and procurement management, together with improved reporting by GPs on their expenditure activities upwards (supported under Component 3), is expected to lead to improved technical project quality. There is also extensive international evidence to show that when investments are identified through community participation processes, there are strong incentives for improved operation and maintenance.

C. Financial Management

39. A financial management assessment of the LSGD, GPs and Municipalities was undertaken in August 2010. The LSG level assessment focused on the capacity of the GPs in the areas of budgeting, fund flow, accounting and financial reporting, internal controls and auditing. The key finding of the assessment was that as long as the GPs and Municipalities continue to use their current state systems of financial management and oversight, and adhere to all the relevant state rules and guidelines, they are capable of handling Component 1 funds and maintaining reasonable fiduciary oversight and control over these. A financial capacity assessment of the other proposed executing agencies for the project (KILA, SIRD GIFT) was also undertaken by the Bank. On the basis of this assessment, it was decided that these agencies should play the role of Executing Support Agencies. Details on the financial management arrangements are outlined in Annex 3.

40. *GoK budget*. The GoK budgeting and accounting system will be used to transfer performance grants and to make funds available to GPs and municipalities under Component 1 and for making funds available to the PMU for implementing Components 2, 3 and 4 of the Bank project.

41. *Fund Flows, Expenditures and Payments: Component I.* Performance Grants under Component 1 will form one of the disbursement categories for the project. The Kerala State treasury system and existing local government financial management systems will be used for releasing PG funds to the local bodies, expenditure authorization, raising bills, making payments and accounting for funds usage in the same way as for the existing grants. At the Local Government (LG) level, the PG funds will be separately identifiable in the LG budget and will be used for sub-projects and activities at the local level as per the grant rules (which include a negative list). LGs will maintain appropriate records and documentation of the work done and the expenditure incurred. The control and use of PG funding by GPs and Municipalities will be subject to the overall fiduciary and reporting arrangements of the state pertaining to local government, as well as a range of specific arrangements established for the functioning of the PG system and administered by the LSGD (PMU). These include the annual statutory audit undertaken by the LFA (which covers all LG expenditures, including those related to the PG), the six monthly financial and physical progress reports, and the annual performance assessment which includes an assessment of local government performance in areas such as financial management (drawing on the LFA audit), procurement, safeguards, and so on. During project implementation, Bank supervision will focus on the overall functioning and adequacy of these arrangements and the operation of the PG system at all levels. Disbursement of PG funds from

GoK to LGs and the project execution support agencies will be documented in accounting records and reported through quarterly IUFRs, taking into consideration Government's fiduciary arrangements at the local level and the Bank's oversight of such arrangements. Periodically, differences between aggregate PG disbursements to LGs and aggregate PG expenditures by LGs will be reported by the PMU to the Bank.

42. The PG release will be made to the GPs/ Municipalities through annual budgetary allocations in a single annual tranche (in April every year except for the first year when the release will be in August) in line with the receipt of advances from the Bank based on the annual cash forecast of the PG requirement which, in turn, is based on the annual performance assessment. As with existing grants, "release" will not mean the actual flow of cash but will constitute an authorization limit for the local body to incur expenditure to that (accumulated) limit over a particular period.[16] Funds will be transferred from the Kerala state consolidated fund to the common state public account and thereon to the project specific treasury based accounts of the individual GPs/ municipalities. Each LG will maintain a project specific dedicated Treasury based account for the PG with the State treasury/sub-treasury, and the funds to the GP/municipality for the PG will be allotted to this account. The transaction will be treated as expenditure in the state accounts once the amount is transferred from the state consolidated fund to the state public account. Unspent balances in the local government accounts at the end of the year will be carried over to the next financial year. Every six months, the PMU will compile a report on the PG expenditure performance of LGs which will include details of the receipt, utilization and unspent balances in the individual LG Treasury based accounts. This will be reported to the Bank as an Annex to the IUFR. The project has an in-built mechanism to ensure that the difference between PG funds disbursed to LGs and the actual expenditure of these funds does not become too great;[17] however, this situation will be monitored and if, for any reason, significant unspent balances accumulate in aggregate, appropriate remedies will be worked out in consultation with the GoK Finance Department and LSGD to ensure that PG funds are spent by LSGs on a timely basis in accordance with grant rules. Any PG funds provided by the Bank which are not utilized by LGs by the closing date of the project will be refunded to the Bank.

43. *Fund Flows, Expenditures and Payments: Component 2, 3 and 4.* Funds for components 2, 3 and 4 will be made available to the PMU in a Treasury Savings Bank (TSB) Account. Funds for components 2 and 3 will be released from the PMU every quarter to the respective support entities (KILA, GIFT, SIRD) in their Bank accounts, for incurring expenditure on various agreed activities. These entities will keep an account of the funds released and report to the PMU on the actual expenditure incurred under components 2 and 3. Expenditure on activities implemented by the PMU (component 4) will be expended from the TSB Account. The PMU will collate the expenditure details for all the project components and will prepare the six-monthly financial monitoring reports.

44. ***Internal audit arrangements.*** The State Performance Audit Officer (SPAO) who reports to the Principal Secretary, LSGD, is the designated internal auditor for the GPs and

[16] The "accumulated limit" means the annual grant amount plus any rolled over balance from previous financial years.

[17] In Phase 2, no local government which has not spent at least 80 percent of its PG fund allocation for the previous year will qualify for a PG fund allocation for the next year.

municipalities. It was agreed that that the SPAO will be the internal auditor of the project and will conduct the audit as per TORs agreed with the Bank. The internal audit will be six-monthly and will cover the performance grants being received by the GPs and the municipalities and provide assurance that the funds are being used for intended purposes. The SPAO will also audit expenditure incurred under Components 2, 3 and 4. In case the SPAO is unable to undertake this task, the project will engage a firm of chartered accountants to do this work.

45. *Project Financial Statement Audit and external audit of LSGs under Component 1.* Project Financial Statements (PFS) of the World Bank project will be audited by the Comptroller and Auditor General (CAG) of India through the Office of the Accountant General in Kerala. The CAG audit of the PFS will be in line with the standard ToR for Bank financed projects. The PFS (which is actually the Interim Unaudited Financial Report for the second half of the year and captures the financial information for the entire year) will include the expenditures incurred under all the components of the project, including PGs to the GPs and Municipalities, expenditures incurred under components 2 and 3 by other entities like KILA, SIRD, GIFT, and the expenditure incurred by the PMU for component 4. The State Local Fund Auditor (LFA) is the designated external auditor for the GPs and the Municipalities and is responsible for issuing the annual audit certificate on the financial statements of the LSGIs. Every year, a summary of the LFA LG audit findings will be prepared by the PMU on the basis of a review of the LG audit reports (undertaken as part of the annual assessment) and made available to the project auditor.

D. Procurement

46. *Component 1. Under this component, where the Bank will be supporting* a grant from the state to local governments, the procurement assessment focused on the procurement arrangements used by LGs across the state, and the formulation of measures to ensure that the arrangements for procurement in respect of PG funding are in line with acceptable standards. A procurement assessment carried out in 16 GPs/Municipalities in 2 districts Thiruvananthapuram and Thrissur and the LSGD found that The Kerala Panchayati Raj Act 1994, the Kerala Municipality Act 1994, Kerala Stores Purchase Rules and Kerala Panchayati Raj (execution of Public Works) Rules 1997 provide the legal foundation for the local government system and procurement management in Kerala. The review of procurement practices around various stages in a procurement cycle indicated overall high levels of compliance with the suggested procedures. In order to ensure consistent application of the processes and procedures across all LSGs, it was agreed with LGSD that a Procurement Manual for Goods and Services for LSGs detailing the Procurement rules, regulations, clear definitions of roles and responsibilities and functional process flows, standard bidding documents, various formats for tendering, evaluation, grievance handling mechanism and a monitoring and evaluation framework has been developed and issued through a Government Order (GO). Similarly, for public works, consolidating and issuing original and subsequent amendments to the Kerala Municipality and Panchayati Raj (execution of Public Works) Rules 1997 was identified as the requirement. The Government issued the Procurement Manual on November 8, 2010, which was reviewed and found to be acceptable subject to few safeguards as detailed in Procurement section of Annex 3. For project purposes, the government Procurement Manual for Goods and Services and Public Works Rules subject to the safeguards suggested will constitute the procurement arrangements for GPs and Municipalities under Component 1. In addition, all goods, works; and services required for the

Project shall be procured in accordance with the requirements set forth or referred to in Section I of the Procurement Guidelines. For supervision, as per the arrangements defined in the OPCS Guidelines for Management of Procurement in CDD projects (December 2009), the Bank will rely on the third party Annual Performance Assessment and the internal audit carried out by State Performance Audit Wing of the LSGD.

47. In addition, a series of capacity building measures including training implementing officers in the LSGs on the new Procurement manual, strengthening the Performance Audit Wing (PAW) through developing tools for procurement post review and training programs for skill development of PAW staff will also be undertaken under other components of the project.

48. *Components 2, 3, and 4.* A brief summary of the procurement capacity assessment and project arrangements is provided in Annex 3. Based on the capacity assessment of implementing agencies KILA, SIRD and GIFT and the absence of dedicated procurement capacity in these institutions, it was agreed that PMU would provide procurement support to these institutions for implementing the project. It was agreed that, the maximum value of a single contract that can be procured by KILA, SIRD and GIFT as US$50,000 under the categories of non-consulting services, individual consultants; goods and equipment and works. For all consultants firms irrespective of value following the methods of QCBS, QBS, CQS, LCS or SSS and all other contracts valued above US$50,000, PMU will be responsible for procurement and placing the items services for the respective agencies.

49. Procurement for components 2, 3 and 4 will be carried out in accordance with the World Bank's "Guidelines: Procurement under IBRD Loans and IDA Credits" dated May 2004, revised in October 2006 and May 2010, and "Guidelines: Selection and Employment of Consultants by World Bank Borrowers" dated May 2004, revised in October 2006 and May 2010. The Procurement plan for components 2, 3 and 4 for the first 18 months has been prepared and accepted by the Bank. It will be updated at least annually to reflect implementation needs.

E. Social

50. *Involuntary Resettlement (OP 4.12)*. The project will not use involuntary land acquisition in sub-projects using the Project Funds and hence OP 4.12 is not triggered. Land requirements are expected to be small for GP/municipal sub-projects. A Social Development Framework relating to land acquisition has been developed and integrated as part of the ESMF for GP and Municipality usage of PG funds under Component 1. The project will follow due procedures and documentation processes for all land acquisitions. The details of the land acquisition should be discussed in an open forum and compensatory measures if any shared with the local community. Due diligence, as part of the ESMF, will be exercised to avoid economic displacement as a result of sub-project activities. The project will discourage land donation by poor families and vulnerable groups. Where lands are purchased from open market on a willing seller- willing buyer- principle, the seller will have right to say no.

51. *Indigenous Peoples Policy (OP 4.10).* If there are tribal populations resident in the project areas, the Bank's Indigenous Peoples policy on such populations becomes applicable to these groups. In the case of Kerala, the tribal population constitutes only 1.1 percent of the total

population. While the tribal population is spread over the State across districts, a large proportion of tribals (60 percent) live in the border districts of Wyanad, Idukki and Palakkad. In general, it appears that they may not form majority populations and maybe largely confined to compact administrative units in most districts.

52. A robust process/institutional framework for addressing issues of Tribals and other vulnerable groups has been developed by GoK as part of their decentralized planning process after extensive stakeholder consultations. Moreover, unlike in other States, a substantial part the budget under Tribal Sub Plan (TSP) and Special Component Plan (SCP) flows through the LSG system in Kerala. In this context, the potential to adopt country systems in the form of a Vulnerable Groups' Development Framework (VGDF) which incorporates the requirements of tribal groups has been recognized. The VGDF has been developed based on detailed consultations with key stakeholders and has been integrated with the ESMF and disclosed. The implementation of VGDF will be supported through capacity building programs of KILA. The performance under VGDF will be measured through the annual independent performance assessment system and will be an integral part of the performance grant award process.

F. Environment

53. The LGSDP falls in the environmental screening category B as per the Bank's OP 4.01. An Environmental Assessment (EA) was undertaken by the GoK. The EA identified the following key environmental issues concerning the activities of LSGs: (i) depletion of natural resources, (ii) changes in land use and topography, (iii) non-permissible activities in forests, (iv) natural habitats or areas of historical significance, (v) soil erosion, (vi) inadequate waste disposal, (vii) usage of banned pesticides, and (viii) insufficient fodder resources. Accordingly, the Project triggers the following safeguard policies of the World Bank: Environmental Assessment (OP 4.01), Forests (OP 4.36), Natural Habitats (OP 4.04) and Physical Cultural Resources (OP 4.11).

54. An ESMF has been developed for the project to ensure compliance with the applicable regulations and triggered safeguards policies. The ESMF will be applied to sub-projects to be taken up by LGs making use of the PGs provided to them under Component 1 of the Project. The ESMF comprises a detailed strategy and procedures for environmental and social appraisal (ESA) of sub-projects taken up by the LSGs. Potential adverse impacts to the environment are identified through a regulatory list and screening tool and can either be prevented or reduced by incorporation of appropriate mitigation measures, provided via Environmental Guidelines (EGs) in the ESMF. The ESMF also has a provision for carrying out Limited Environmental Assessment (LEA) for cases where medium level impacts on the environment are expected. The ESMF contains institutional arrangements, capacity building plans and monitoring mechanisms to enable effective implementation of safeguard measures. Monitoring and evaluation of the ESMF will take place through the Annual Performance Assessment that has safeguards incorporated as assessment parameters through the Local Service Delivery Technical Evaluation, which will be undertaken by independent specialized agencies. In the future, the LSDG could consider the option to apply the ESMF to all activities taken up by the LSGs irrespective of the source of funds.

Annex 1: Results Framework and Monitoring

INDIA: KERALA LOCAL GOVERNMENT AND SERVICE DELIVERY PROJECT

Project Development Objective (PDO): To enhance and strengthen the institutional capacity of the local government system in Kerala to deliver services and undertake its basic administrative and governance more effectively and in a sustainable manner.

PDO Level Results Indicators*	Core	Unit of Measure	Baseline 2011	Cumulative Target Values**				Frequency	Data Source/ Methodology	Responsibility for Data Collection	Description (indicator definition etc.)
				2012	2013	2014	2015				
Indicator One: By end of project, 70% GPs and Municipalities will have passed the performance assessments for well-functioning fiduciary, planning and service delivery systems [18] (total = 1030)	☐	%	0	0	50%	60%	70%	Annual performance assessments (PAs), bi-annual WB supervision missions	PAs, supervision missions	LSGD, WB	% of GPs and Municipalities meeting performance assessment criteria
Indicator Two: A well-established performance-based grant system is increasingly financed by GoK	☐	USD (mil.)	0	0	10	20	30	Annual PAs, bi-annual supervision missions,	PAs, supervision missions, project reports	LSGD, WB	Increasing financial contribution by state govt.

[18] The quality of GPs' fiduciary and planning systems will be measured through the Project's annual performance assessment system, along with separate third party validation. (See Component 1 description). GPs will be assessed according to specific criteria in areas of: (i) planning and budgeting; (ii) project execution and service delivery; (iii) accounting, reporting and audit; and (iv) transparency and accountability. The full performance assessment will occur in the second year.

Indicator Three: The number of direct project beneficiaries of which a certain percentage are female.	☒	Total popula-tion (less MCs)	0				29.5m 51%	Annual	Progress reports	GPs	Core indicator, total state population

INTERMEDIATE RESULTS

Intermediate Result (Component One): Block Grants
Grants provided to GPs and Municipalities to execute mandated functions and incentivize institutional strengthening

PDO Level Results Indicators*	Core	Unit of Measure	Baseline 2011	2012	2013	2014	2015	Frequency	Data Source/ Methodology	Responsibility for Data Collection	Description (indicator definition etc.)
Intermediate Result indicator One: By EOP, #/types of subprojects built by GPs and Municipalities through block grants	☐	#/type	#/type of subprojects from block grants are not predetermined. However, the project will be reporting upon the #/type of outputs through semi-annual reports.					Annual PAs, semi-annual progress reports, bi-annual supervision missions	PAs, supervision missions	LSGD, WB	#/type of subpro-jects
Intermediate Result indicator Two: Performance of all GPs and Municipalities is assessed each year.	☐	%	0	0	0	100%	100%	Annual PAs	PAs	LSGD	% of GPs assessed

Intermediate Result (Component Two): Capacity Building Improved capacity within LSGs to perform their key functions related to: planning and budgeting; project execution and service delivery; financial management, and transparency and accountability												
Intermediate Results Indicators*	**Core**	**Unit of Measure**	**Baseline 2011**	**2012**	**2013**	**2014**	**2015**	**Frequency**	**Data Source/ Methodology**	**Responsibility for Data Collection**	**Description (indicator definition etc.)**
Intermediate Result indicator One: LSGs received training over life of project in areas mentioned under component 2.	☐	GPs & munici-palities	0 (from the project)	213	510	765	1028	Annual training reports	Training reports	KILA SIRD	# of LSGs
Intermediate Result indicator Two: KILA's capacity developed to provide enhanced training to GPs and Municipalities	☐	Quality as assessed by independent evalua-tion			Quality based upon baseline on quality of training		Quality improved as assessed during final evalua-tion	Yr 2 and Yr 4 of project	Contracted external evaluators	Contracted external firm	Qualitative assessment of capacity
Intermediate Result indicator Three: Production of draft manuals in	☐	Draft manuals	0 (from the project)	1		Min. 2 (cum)	Min. 4 (cum)	Annual project reports	Project reports	LGSP	Number of draft manuals

the areas of budget, planning, financial mgmt, public works/procurement, institutional mgmt.											

Intermediate Result (Component Three): Monitoring Performance of Local Government State systems for monitoring of LSGs are strengthened											
Intermediate Results Indicators*	**Core**	**Unit of Measure**	**Baseline 2011**	**2012**	**2013**	**2014**	**2015**	**Frequency**	Data Source/ Methodology	Responsibility for Data Collection	**Description (indicator definition etc.)**
Intermediate Results indicator One: GP database established and operating with annual reports produced	☐	Data-base	0	0	0	1	1	Annual reports	Database	DAC	1 database established
Intermediate Results indicator Two: Decentralization Analysis Cell (DAC) providing annual fiscal reports		DAC fiscal reports	0 (DAC recently formed)	0	1 DAC annual fiscal report	2 (cum)	3 (cum)	Annual fiscal reports, project reports	Fiscal reports, project reports	DAC, PMU	# of reports provided by DAC
Intermediate	☐	Studies/survey	0	0	0	3	4	Yrs 3 and 4	Studies,	LSGD	# studies/

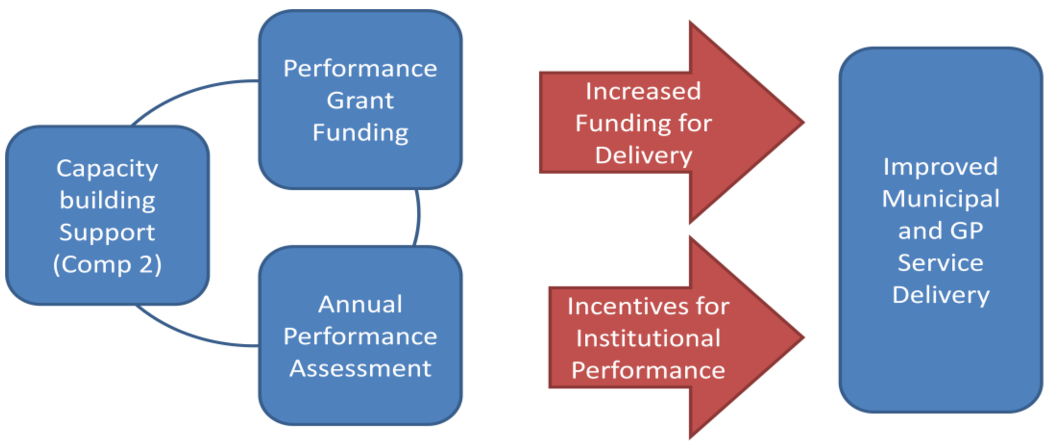
Result indicator Three: Project studies/surveys completed		s				(cum)	(cum)		surveys		Surveys
Intermediate Result (Component Four): Project implementation and management Technical and management support provided to LSGD to implement project.											
Intermediate Result indicator One: LSGD PMU fully staffed and functioning to provide project support and oversight to GPs & Municipalities	☐	PMU prof key staff	6 key positions filled prior to negotia-tions.	1PMU (min.8 full-time prof staff)	1PMU (min. 10 full-time prof staff)	1PMU (min. 10 full-time prof staff)	1PMU (min. 10 full-time prof staff)	Annual report	Project reports, supervision missions	LSGD	# of key profession al staff in PMU.

Annex 2: Detailed Project Description

INDIA: KERALA LOCAL GOVERNMENT AND SERVICE DELIVERY PROJECT

<u>Component 1: Performance Grants (US$238.6 million- IDA and GoK)</u>

1. *Objective*. This component will phase in an annual, performance-based grant to all 978 GPs and 60 Municipalities in Kerala.[19] The main objective is to provide GPs and Municipalities with additional discretionary funds for expanded local investment for the creation, maintenance and operation of capital assets in a manner which incentivizes the strengthening of their institutional capacity (which is supported under Component 2). The overall goal is to improve GP and Municipal performance in local governance and public service delivery.



2. *Establishment of Grant.* Component 1 will introduce the performance grant in two phases. The administrative and institutional systems necessary for the introduction of a full performance grant will be established over the first two years of the project (Phase 1). During this time all GPs and Municipalities will receive grant funding, the use of which will be subject to basic fiduciary requirements. From year three onwards the performance dimension of the grant, where qualification to receive the grant is based on an annual performance assessment, will be applied (Phase 2).

3. *Allocation formula and funding levels*. The performance grant will amount to the equivalent of $238.6 million over four years from IDA and GoK. The allocation of funds will be based on the prevailing State Finance Commission (SFC) recommended approach: the (currently ad hoc) proportional division between GPs and Municipalities overall; and the (formula-based) horizontal allocations among GPs and Municipalities respectively. Initial estimates of allocations are as follows:

[19] These are the numbers which will be in place following the LSG (Local Self Government) elections in October 2010.

Project Year		Year 1 (2011-12)	Year 2 (2012-13)	Year 3 (2013-14)	Year 4 (2014-15)	Total
Total to LSGs ($m)	**Total**	**35.0**	**61.0**	**67.6**	**75.0**	**238.6**
	GP	30.5	53.1	58.8	65.3	**207.7**
	Munic.	4.5	7.9	8.8	9.7	**30.9**
Average per LG ($)	GP	31,152	54,293	60,168	66,754	***212,368***
	Munic.	75,556	131,683	145,931	161,905	***515,075***
Average Per Capita ($)	GP	0.8	1.4	1.6	1.7	***5.6***
	Munic.	1.3	2.2	2.4	2.6	***8.4***
Source of Funds ($m)	*IDA*	*35.0*	*51.0*	*47.6*	*45.0*	***178.6***
	State	-	*10.0*	*20.0*	*30.0*	***60.0***

4. *Use of Grant Funds.* The performance grant will be utilized for the acquisition of capital assets; capital works; and maintenance and operation of these assets in line with the functional mandates of local bodies. The grant will be fully discretionary within these parameters, subject to a clear negative list which will refer to activities proscribed for environmental and other reasons. Although the grant will amount to less than 10 percent of a typical GP's and Municipality's overall revenue, it will increase the discretionary funding available for capital expenditures significantly by approximately 50 percent in GPs and 80 percent for Municipalities. It will also significantly increase discretionary funding available for maintenance of capital assets by 60 percent in GPs and 20 percent for Municipalities.

5. *Budgeting, Planning and Execution.* Funds will be programmed and projects prepared and executed using existing budgeting, planning, DPR (Detailed Project Report) and implementation procedures at GPs and Municipalities. In addition, an Environmental and Social Management Framework (ESMF) will be introduced to establish simple social safeguards; mitigate adverse environmental effects; and cater for Vulnerable Groups. Procurement by LSGs will be as per an updated new procurement manual for Goods and Services and consolidated rules for Works, subject to a small number of special conditions which will be outlined in the Grant Operations Manual. GPs and Municipalities will use their existing financial management systems to budget, manage and account for the use of PG funds. External annual audit of these entities will be undertaken by the LFA (Local Fund Auditor) on a certification basis.

6. *Reporting.* Two types of reporting will be introduced in the context of the grant. First, for "upward" accountability, a system of half yearly administrative reporting to the State Government on physical progress and asset creation funded from the PG will be introduced; this will expand to include other expenditures over the life of the project. Secondly, for "downwards accountability" and to enhance local transparency, a simple local budget and plan execution report will be produced and issued to the public.

7. *Phasing in of Grant.* As indicated above, the grant will be introduced over two phases. During phase 1 – year 1 to 2 of the project - the performance grant systems will be established and capacity building for GPs and Municipalities will start. Over this time all GPs and Municipalities will receive grant funds subject to certain basic fiduciary and procedural

requirements. During phase 2, the local self governments will only receive grant funds on the basis of demonstrated institutional performance as measured through an annual performance assessment and procedural requirements. In order to access the grant in any year, all participating local bodies will be required to have passed a resolution with respect to participation in the performance grant programme at its commencement.

8. *Phase 1* will function as follows:

- Access criteria. In order to be allocated the grant during the first two years, participating local bodies will be required to meet a set of basic fiduciary requirements in the table below. For the first year, the PMU, supported by the necessary technical expertise, will verify whether local governments have met these fiduciary requirements. For the second year, an independent firm will be contracted by the PMU to verify that the requirements are met.

Phase 1 - Basic Fiduciary Access Criteria	
for access to grant in 2011/12	**for access to grant in 2012/13**
- "Clean" external audit (not adverse or disclaimed) for 2008/09 - External audit for 2008/09 does not include observations pertaining to significant financial management weaknesses[20] -Annual Budget for the forthcoming year passed by March 31 and a copy availed to LSGD by April 30, 2012	- "Clean" external audit (not adverse or disclaimed) for 2009/10 and 2010/11 - External audit for 2009/10 and 2010/11 does not include observations pertaining to significant financial management weaknesses- - Annual Plan for FY 2011/2012 approved by both the GP or Municipal Council and a copy availed to LSGD - Annual Budget for the forthcoming year passed by March 31 and a copy availed to LSGD by April 30

- Grant Allocation Announcement. Using a simple grant allocation model based on the prevailing SFC allocation formula, the PMU will then calculate the share of the grant allocation for each qualifying local body. A grant allocation announcement will be made alongside the State Budget during February of each year. This will include a list of the local bodies to which the grant has been allocated and the indicative allocation amounts for the performance grant for the forthcoming year.

- Grant release and receipt. In order to actually receive the grant in both years all LSGs to which the grant has been allocated will need to pass an annual budget for the forthcoming year in the approved format by end March and to submit this budget to the LSGD by end April.

- Grant Cycle. In the first year of the project, the grant cycle will be as follows:

[20] These significant financial management weaknesses will be pre-specified in the Project Implementation Manual. A more detailed discussion of this may be found in the Financial Management and Disbursement section of this Annex.

- An audit for the 2008/09 financial year will be completed for all GPs and Municipalities by 1st January, 2011;
- The audit opinions reviewed and grant allocation decision made by March 15, 2011;
- In March 2011, the grant allocation decision will be communicated to Local Bodies for financial year 2011/12 alongside the State Budget.
- Between January and July of 2011, the Local bodies will prepare their annual plans and budgets.
- By the end of July GPs and Municipalities must have passed resolution agreeing to participate in the grant scheme, including both phase 1 and phase 2.
- The grant will be disbursed to qualifying local governments in one instalment in August 2011.

* In the second year of the project the grant cycle will be as follows:

  - An audit for the 2009/10 and 2010/11 financial year will be completed for all GPs and Municipalities by the end of October 2011. Following this the eligibility criteria will be assessed by the end of December 2011.
  - In February 2012, the grant allocation decision will be communicated to Local Bodies for financial year 2012/13 alongside the State Budget using the grant allocation model.
  - Between January and July 2012 local bodies will prepare their budgets and annual plans.
  - The grant will be disbursed to qualifying local governments in a single tranche in April.

9. *Phase 2* will function as follows:

* Access criteria and performance measures. In order to access the grant all participating local bodies will be required to a) meet a set of mandatory minimum conditions in full; and b) achieve a certain score against a set of performance criteria. An Annual Performance Assessment will be carried out between September and December each year during which performance against mandatory minimum conditions and performance criteria will be measured. This will be conducted by an independent organization contracted by the PMU. The results of each assessment will be independently validated on a sample basis. The assessment will be phased in, as described below. The table which follows sets out the proposed Mandatory Minimum Conditions and Performance Criteria. A draft of the detailed Assessment Manual that will provide the basis for the annual performance assessment is being produced as part of project preparation and will need to be finalized before the beginning of the 2011/12 financial year. The manual will need to strike an appropriate balance between setting performance targets high enough to leverage meaningful institutional strengthening, and setting them so high that local governments – particularly weaker local governments – find them impossible to achieve and are thus discouraged from participating in the grant program.

Phase 2 – Annual Performance Assessment		
PERFORMANCE AREA	**MANDATORY MINIMUM CONDITIONS**[21]	**PERFORMANCE CRITERIA**
1. Planning & Budgeting	- Annual Plan for preceding year approved by both the council and DPC and a copy availed to LSGD	N/A
2. Project Execution and Service Delivery	- Minimum of 80% of performance grant funds spent for those LSGs which received the grant in the preceding year. - Compliance with the regulatory list from the ESMF in DPR process during preparation and execution (only for performance grant projects) - Physical assets funded from performance grant verified.	- Compliance with ESMF safeguards during execution (only for performance grant projects) - Transparent and appropriate methods of procurement are followed and properly documented. - More than 90% of performance grant funds spent for those LSGs which received the grant in the preceding year. - Functional IT infrastructure connected to the internet
3. Accounting, reporting & audit	- "Clean" LFA audit (not adverse or disclaimed) for the year preceding assessment. - Audit report for the year preceding assessment does not include observations pertaining to significant financial management weaknesses.	- Semi-annual reports prepared and submitted to the State Government - Unqualified external audit opinion for the year preceding assessment - Follow up actions taken to address significant financial management weaknesses observed in the audit for the preceding year but one to assessment.
4. Transparency and accountability	- Preparation and distribution of a public report on the annual budget and plan	- Availability of public reports at the ward level - Vulnerable groups participate in and benefit from planning and execution - Citizen charter developed and displayed

- Grant Allocation Announcement. Based on the results of the Annual Performance Assessment the LSGD will make a grant allocation announcement by February of each financial year alongside the State Budget, and in time to be factored into the budget process of local bodies. The aforementioned grant allocation model will be used to calculate each LSGs share of the Performance Grant for that year.

- Grant release and receipt. In order to actually receive the grant in all years all LSGs to which the grant has been allocated will need to pass an annual budget for the forthcoming year in the approved format by end March and to submit this budget to the LSGD by end April.

[21] Note that in all cases "preceding year" refers to the Fiscal Year prior to the one in which the assessment is actually taking place i.e. the year in which the performance of the LSGs is being examined by the annual assessment.

- Grant Cycle. The full allocation and disbursement cycle for the performance grant will come into effect in the second year of the project (the Indian financial year 2012/13) and continue thereafter. This cycle will be as follows:

  - In August, the annual assessment process will start and be completed by the beginning of December. The audit conducted for the previous financial year will feed into the assessment.
  - The grant allocation decision will be communicated to local bodies alongside the State Budget in February. This will include a list of the qualifying local bodies and allocations for the performance grant for the forthcoming year computed using the grant allocation model.
  - Between January and July local bodies will prepare their budgets and annual plans.
  - The grant will be disbursed to qualifying local governments in a single tranche in April.

<u>Component 2: Capacity Building (US$11.2 million - IDA)</u>

10. *Objective*. This component will provide capacity-building inputs to strengthen and supplement the existing systems and human resource of LSGs to enhance their institutional performance. The project will follow a two track approach. In the short and medium term, it will support immediate capacity development efforts to address critical capacity gaps in local governments. These will be focused in four core areas: the development and improvement of administrative systems used by LSGs; formal training to strengthen the human resource capacities of LSGs using these systems; mentoring directed at human resource capacity improvement and supplementation; and strengthening of the overall institutional capacities of the key organizations responsible for delivering LSG training in Kerala. In the longer term, the component will support the formulation of a State-wide capacity building strategy for LSGs.

11. ***Sub-components and activities***

a. Systems Improvements. This sub-component will support activities to develop and improve the systems that enable local self governments in Kerala to function efficiently, effectively, and accountably. It will provide support to the development of key aspects of systems which are currently in place as well as the development of new systems. For example, although the GoK have issued orders for the key LG functional areas (i.e., budget, planning, FM, procurement, etc) most of these orders have not been codified into operational manuals and the project can usefully support the development of these. Similarly, the existing process for statutory auditing of local government needs further improvements. So far as new systems go, the project intends to introduce a new, simple system of local reporting on budget and plan implementation performance and the development of this need to be supported. In summary, this component will provide support to the development of operational manuals of key function areas based on existing policies, entering legacy data into newly developed e-systems, and incorporating specific Bank procedures into budgeting, planning, and FM. The table below summarizes the scope of activities under this component, and the main agency responsible for the implementation.

Systems	*Scope of Activities*	*Responsibility*
Budget, Planning, FM, and Asset Management	• Support for preparation of Public Report, Budget, Plan, FM, Asset Management, Public Works & Maintenance Manuals	• KILA
Auditing	• Support for preparation of Statutory Auditing Manual	• KILA
Finance Management	• Support for entering legacy data in FM system	• IKM
Administrative Management	• Support to develop the toolkits (PRA, Social Audits, ESMF, DPR)	• KILA/ SIRD
	• Support for the development of a Grievance Redressed Mechanism only for the Bank funded projects (future expansion)	• KILA
	• Support for the development of Office Management Manual	• KILA
	• Support for the develop of manual for the management of transferred institutions and local service delivery	• KILA

b. Formal Institutional Training. GoK has established a decentralized training network through which KILA plays a nodal role in developing training programs and coordinating the delivery of course in all key areas of local self governance including budgeting, planning, financial management, procurement, public works implementation. Therefore, there is no significant need to expand the scope of formal institutional training, with the exception of specific areas which new systems have been recently developed and areas specific to the Bank project (e.g. ESMF/VGDF). In these areas, KILA and SIRD will require support for improved development of course content, and training of master trainers, since these new issues could be incorporated into the existing courses and delivered according to their training calendars. In addition, local government project orientation will be developed and roll-out by KILA targeting the key officials of all LSGs. The table below summarizes the scope of activities under this component.

Training Support Areas	*Training Activities*	*Responsibility*
Budgeting, Planning, FM, Procurement, and Asset Management	• Support for the course design and master training on ESMF/VGDF • Support for course design and master training on annual budget and planning public reports • Support for course design and master training on the new procurement manual (amended) for LSGs	• KILA • KILA • KILA
Statutory Auditing	• Support for course design and master training on the new statutory auditing manual	• KILA
Social Audits	• Support for course design and master training on the new social audit manual	• SIRD
Project Orientation	• Support for development and roll-out of local government project orientation training	• KILA

c. Mentoring. Local governments in Kerala have increased their responsibilities and resources in the past years without similar increase of staff. As result, some key functions are clearly understaffed to undertake basic functions. This is particularly critical in the area of engineering, which is required for the preparation of DPRs and monitoring of public works. The introduction of e-governance systems have also posed an additional challenge for local staff who are not used to computer based systems. While IKM have some capacity to provide mentoring support, the demand is growing much faster than its capacity to respond. Handholding support will be also important in few areas introduced by the Bank project, particularly EMF. Therefore, the project will focus mentoring support to GPs and municipality on clearly indentified area as follows:

- Sub-project technical support: the project will cover the operational costs (travel, etc) of engineers (1 per block) working for the Department of Self Local Government to provide technical assistance (engineering design, EMF, procurement, contract supervision, quality assurance) to individual GPs and Municipalities during preparation of DPRs and supervision of works funded by Project;

- LSG technical support – KILA: The project will provide support to the expansion of the Help-Desk functions located at KILA to incorporate the new areas of ESMF and procurement and to supplement existing general capacities; and,

- LSG technical support - IKM: The project will provide support to the expansion of IKM capabilities to provide technical support (on-line and mentoring) to LSGs for the implementation of e-governance systems, and accounting systems.

d. Institutional Strengthening of KILA and SIRD. Although KILA and SIRD training covers a wide range of topics, which are delivered to a large number of participants every year based on a cascade training approach, both institutions still apply traditional training techniques which undermines effectiveness. KILA and SIRD courses use mainly traditional face-to-face lecturing mode, simple text books, and traditional pedagogy. Both institutions have also a very small number of core staff, who are mainly course management and not experts in specific fields, and do not have many opportunity to update their knowledge. The methods and techniques used for evaluation of training are also not very advanced; this will undermine the potential of gathering this information for continuous improvement of their learning programs. KILA and SIRD have not incorporated the modern course management software, which are particularly important for training institutions with large number of courses and participants. To address these institutional constraints, the project will focus on these specific areas and activities:

Areas	*Scope of Activities*
Pedagogy and learning design	• Support the services of external experts on effective adult learning pedagogy to re-train KILA and SIRD faculty and trainers on how to design and delivered effective learning programs and support for preparation of course modules
Enhance specialization of KILA and SIRD	• Support a series of efforts to enhance institutional expertise, including additional faculty member, study visits, mid-career courses, and faculty exchange initiatives
M&E for Capacity Building	• Support the service of external experts to strengthen M&E system for both KILA and SIRD (guidelines, manuals, templates and software)
Upgrade Training Facilities	• Equip KILA and SIRD classrooms with modern and adequate furniture and training equipment
Administrative Management	• Support the implementation (software and technical assistance) of a course management system for KILA and SIRD • Support the implementation of office automation (software) for KILA and SIRD

e. Medium and Long-Term Strategic Capacity Development Support. There is also a growing consensus among the key stakeholders that the institutionalization of capacities at local level in Kerala needs to be guided by a sound capacity development strategy for local self governance. At a policy level, the State-wide efforts need an overall strategy for capacity development which could ensure better coordination among the different resource institutions, leverage the resources, and foster complementarity of training programs. Similarly, the resource institutions are not fully applying technically sound needs assessment to design their training programs, but only semi-structured roundtables discussions with representative institutions. Both the needs assessment and the strategy are very important for providing long term directions for the multiple capacity development initiatives that take place every year, including system development, mentoring, and intuitional training. A two-track approach (long term strategy and short-medium term capacity support) will ensure that the vast resources invested in capacity development of local governments in Kerala achieve greater results. The project will, therefore, support two main activities under this sub-component: (i) state-wide Capacity Needs Assessment of Local Governments; and (ii) state-wide Capacity Development Strategy.

Component 3: Enhancing State Monitoring of the Local Government System (US$3.4 million - IDA)

12. *Objective* This component will strengthen the system of performance monitoring of LSGs in Kerala.

Sub-components and activities

13. This component will comprise four sub-components: (a) a database of basic GP and municipal level information; (b) service delivery survey; (c) evaluations and studies for Project: and (d) the Decentralization Analysis Cell (DAC) which, among other things, will be responsible for (a) and (b).

a. Database of GP and municipal information. The project will establish a database of GP and municipal level information which will store basic information regarding GP and municipal profiles: population, vital statistics, livelihoods, employment, education, water and sanitation, budget expenditures and physical assets. The data will be collected from existing datasets such as the 2001 and 2010 census, administrative records, state audits, and line department routine data. As more information becomes available through the project and other surveys, relevant GP level data can be added to the system. The database will be web-based and available to the general public. DAC will be responsible for operating and updating the system, including generating reports on GP profiles and aggregating data annually.

b. LSG Service Delivery Survey. The second sub-component is a survey to gauge trends on LSG service delivery performance and citizen satisfaction throughout the state. The survey, to be contracted to an external survey firm/s, will examine delivery trends state-wide in sectors where GPs and Municipalities have some responsibility, explore citizen satisfaction and usage of basic services as well as awareness of GP planning and budget processes. The survey will use a stratified sample of GPs and Municipalities. It will take place twice during the life of the project, at the beginning and final year. The DAC will produce a report of findings after each round, and will disseminate the findings on the web and through the media.

c. Project Evaluations. In addition, the project is planning two evaluations to evaluate the quality of the capacity building efforts (Component 2) and Performance Grant investments (Component 1):

1. Capacity Building Evaluation. Given the importance of the capacity building component, the project will want to monitor, evaluate and document the training activities carefully. Aspects for review are: the number and types of persons undergoing training; the appropriateness of delivery methodologies such as formal institutional training and mentoring; suitability and effectiveness of the curriculum; duration of capacity building interventions; levels of effort by the training institutions

and trainers, and feedback from participants. These evaluations will be done in Years 2 and 4.

2. Service Delivery Technical Evaluation. This study will examine a random sample of ten percent of GPs and review their service delivery outputs related to physical assets issues. The evaluation will examine in depth: improved access and coverage; the technical quality of public goods financed by the project; cost effectiveness (value-for-money); use of goods; operations and maintenance, and safeguard issues. This evaluation will be completed in Years 2 and 4.

d. *Decentralization Analysis Cell (DAC).* The DAC will play two key functions: (i) as mentioned above, it will collect, store, compile and report GP/Municipality level and service delivery data; (ii) DAC will also carry out a policy advisory function providing independent analysis on the performance of the State's intergovernmental fiscal system and service delivery system and provide ongoing policy advice to GoK and the SFC on local and intergovernmental fiscal and institutional issues. The core activities of the policy advisory function will be preparation of annual fiscal report, just-in-time policy advice to the GoK and policy studies on key policy issues (e.g. property taxation, municipal borrowing, analysis of intergovernmental transfers, etc.). The key clients of DAC's outputs will include the Department of Local Self Government (LSGD), Department of Finance (DoF), State Finance Commission (SFC), LSGs, and citizens.

The DAC has been established in the Gulati Institute of Finance and Taxation (GIFT), formally the Centre of Taxation Studies. GIFT is an autonomous entity directly accountable to a governing body comprising of appointed academicians, and Government officials. DAC funding will come directly from the Department of Local Self Governments (LSGD), through the PMU to GIFT. The DAC will fall under the overall governance structure of GIFT; however a Steering Committee headed by LSGD and comprising DoF, GIFT (Director), PMU and DAC (Director) will provide overall strategic oversight for the DAC and will approve its annual work plan. The DAC will submit a report on its annual work plan to the PMU which report to the LSGD and the World Bank on DAC activities. DAC senior staff, which has yet to be recruited, will comprise a full time Head, a Deputy-Head: Data and Deputy-Head: Policy Advisor. Other staff could include computer programmer, service delivery specialist, financial management /procurement specialist, administrative assistant, research analyst, and two data analysts. All DAC positions will be subject to competitive selection of interested, eligible and qualified candidates. The DAC positions will be advertised in the local media to attract a pool of qualified applicants.

<u>Component 4: Project Management (US$6.8 million - IDA)</u>

14. This component will provide support to the Project Management Unit (PMU) within the LSGD in overall coordination, implementation, monitoring and evaluation of the project. The three main activities envisaged under this component are:

a. Support to Project Management. The project will provide financing towards office and administrative expenses for the PMU within the LSGD. The project will also provide resources for technical assistance, training of the project team, goods and equipment to augment the

LSGD's capacity in the areas of monitoring and evaluation, contract management, and communication and funding for the annual Performance Assessment and Quality Assessment of the PA.

b. *Project Reporting*. This sub-component will provide resources to support the Project M&E, including monitoring of the project outcome indicators; preparation of annual project audited financial reports and semi-annual progress reports, Interim Unaudited Financial Reports, consulting services for preparation and review of documents for the Mid Term Review and project completion reports and workshops for final evaluation of the project. Preparation of a follow on support prior to closure of the project is also envisaged under the project.

c. Project Information, Education and Communications. This sub-component will finance the following activities: (i) broad communications about the project including its objectives and expected outcomes, roles and responsibilities of the Gram Panchayats and Municipalities, and (ii) focused IEC to the targeted GPs and Municipalities on eligibility, allocation, rules and procedures of the Performance Grants (brochures, pamphlets, etc).

Relationship to Jalanidhi II

15. The World Bank is currently preparing a water supply and sanitation project in Kerala – Jalanidhi-II – in which Gram Panchayats will play a central role.[22] Building on the demand responsive approach established in 112 GPs under the successful Jalanidhi I predecessor project, Jalanidhi II intends to assist GoK in increasing the access of rural communities to improved and sustainable water supply and sanitation services in Kerala. Jalanidhi II will focus on another 200 GPs across the state, providing them with grant funding to support the development of their water and sanitation systems. GPs will play a central role in planning, funds management and project activity management, while Beneficiary Groups (BGs), operating under the overall oversight of GPs, will play critical project implementation and maintenance and operation (including cost recovery) roles. In addition, under Jalanidhi-II the GPs will be responsible for directly managing large water supply schemes and environmental management interventions and for developing and protecting GP-wide water resources, as well as playing an important role in ensuring the transfer of ownership and the management of existing single village water supply schemes currently owned and managed by the Kerala Water Authority (KWA) – all in line with GoI sector guidelines. The project will also provide sector-specific capacity enhancement and strengthening to both GPs and BGs in order to enhance their abilities to play their respective roles in water supply and sanitation sector activities.

16. The Jalanidhi II project is expected to be appraised soon after KLGP since it will largely utilize the project design, institutional structures and implementation arrangements adopted and tested under the first project. The complementary nature of KLGP and Jalanidhi II offers significant opportunities for developing synergies. In this regard, the following points should be noted:

[22] Pursuant to the initiation of decentralization reform in Kerala in 1997, GPs have functional responsibility for water supply and sanitation. In practice, this is being incrementally achieved as water systems and funding for these are transferred from KWA and the state to the GPs.

- First, in many respects the projects are clearly delineated. KLGP focuses on all 1038 rural and (non MC) urban local governments in Kerala; it has an institutional development objective; supports broad cross-cutting institutional capacity-enhancement and provides discretionary (i.e. non sector-specific) funding. Jalanidhi II covers 200 rural local governments; has a sectoral, service-delivery development objective; and provides earmarked funding for specific investments. The project overlaps are thus not extensive but, where they do exist, are potentially beneficial;

- Second, all of the 200 Jalanidhi II GPs may receive both Jalanidhi II and KLGP funding. Jalanidhi II is intended to cater for a specific priority need and it follows that the targeted GPs will receive such funding in addition to the discretionary funding under the PG system supported by KLGP. Moreover, the allocation of Jalanidhi II funding has a specific rationale related to the computation of this need, namely service coverage, water scarcity and water quality issues and the presence of disadvantaged communities within a GP area, etc., which should not be conflated with the broad, cross-cutting performance criteria which determine KLGP funding allocations. From a practical point of view, analysis undertaken for the KLGP, and on-the-ground experience of Jalanidhi-I, indicate that GP absorption capacity is not likely to be a problem – and, insofar as it is, both projects have capacity-enhancement measures to cater for it. In fact, the complementarity of the two operations means that activities identified under Jalanidhi-II (water resource protection and recharge needs, solid and liquid waste and other sanitation interventions, etc) can leverage investment funds through KLGP's funding allocations and/or through other funding sources managed by LSGD;

- Third, under Jalanidhi II it has been recognized that, while BGs should remain the core sub-project implementing agencies and need to retain basic maintenance and operation functions of the water supply schemes (including user charge administration) that were developed under Jalanidhi I, GPs have important roles to play both in respect of Jalanidhi project execution and, in the longer term, as regards back-up maintenance support of the water schemes, asset management, monitoring of service delivery, monitoring and management of water quality, inter-BG issues (such as dispute resolution), and the further development of water supply systems. To this end, the institutional model under Jalanidhi II has been modified such that GPs have formal accountability and oversight of the various BG-implemented sub-projects in their areas, approve the overall sub-project plan and manage and account for sub-project funding at the aggregate level.[23] Each recipient GP enters into an agreement with the state re the usage of and procedures surrounding Jalanidhi II funding and, in turn, enters into an agreement with each recipient BG regarding the specific scheme/s it will be implementing. This overall approach converges with the KLGP objective of strengthening decentralization, consolidating the de facto role of GPs in respect of their functional responsibilities, and building capacity at the local level. The cross-cutting institutional strengthening that KLGP intends to achieve will enhance the capabilities of GPs in respect of their roles as envisaged under Jalanidhi II, and vice versa. It is important to

[23] The GPs receive and manage the overall funding envelope for sub-projects in their areas, on-grant (together with their counterpart contribution) sub-project funds to BGs, and account for the usage of these funds at the aggregate level. The BGs manage the funds for their particular sub-project and account for these to the GP.

note, however, that whereas their project-specific roles are relatively well defined and institutionalized; an institutional framework relating to the long-term relationship between GPs and BGs has to be further developed. This will receive attention through the Jalanidhi II preparation and implementation process in dialogue with the KLGP project team and the relevant GoK Departments.

- Finally, it is important to note that LSGD participated in a positive and effective way in the implementation of the first Jalanidhi project –providing administrative and policy support to implement Jalanidhi's demand responsive and decentralized service delivery approach, in areas including GP/BG empowerment and controls over the GPs where needed. In order to ensure ongoing co-ordination during project implementation, a simple project co-ordination structure will be set up to ensure that the senior management of the respective projects meet periodically to review progress under the above areas of complementarity and address, as needed, any issues or difficulties that may arise in a systematic fashion at least once every six months.

Lessons learned from other projects

17. The design of the KLSDGP has benefitted from lessons learned from other recent World Bank local government projects in India and the region. In particular, the project has drawn on the experience of the Karnataka PRI project which has experienced a number of difficulties since implementation (the mid-term review was held in mid-2010). Four key dimensions may be highlighted:

- The Karnataka project focuses on 1300 GPs in the most "backward" (i.e. low capacity) blocks in the state. The KLGSDP will support municipalities and GPs throughout the state in a much higher-capacity environment. It may be noted that, on average, GPs in Kerala employ about double the number of staff than is the case in Kerala and are currently managing much higher aggregate funding flows. In municipalities, both capacity and revenues are several magnitudes higher. The local government fiscal assessment carried out for KLGSDP preparation indicates that absorptive capacity has not emerged as a significant problem at either GP or municipal level in Kerala;

- Originally, the Karnataka project confined GP non-capital expenditures to only 20 percent of the total grant receipt. Following the mid-term review this was adjusted to allow for greater discretion across capital and operating/maintenance expenditure capacities. The KLGSDP will allow complete LG discretion of expenditures for capital investment and maintenance and operational purposes;

- So far as disbursement to GPs is concerned, the KLGSDP will not employ the use of the Utilization Certificate system that the Karnataka project employed. Disbursements to LGs will be made in a single tranche at the beginning of the financial year and LGs will be able to draw on these funds according to their cash-flow needs as these are determined by their development and maintenance activities;

- GoK has indicated a very strong commitment to providing a counterpart funding contribution in the context of a broader policy commitment to increasing the expenditure discretion of LGs through the Performance Grant. The political and policy environment in Kerala as regards decentralization is also particularly positive and crosses party political lines. The LG disbursement procedures for the project have been structured to incentivize the provision of counterpart funding to the maximum degree possible. Counterpart funding failure is a risk in any project, but in the case of the KLGSDP this appears to be low.

Annex 3: Implementation Arrangements

INDIA: KERALA LOCAL GOVERNMENT AND SERVICE DELIVERY PROJECT

Overview

1. The project supports the GoK to strengthen the institutional capacities of the GPs and Municipalities for improved service delivery and local governance. The project's institutional arrangements have been designed to utilize the existing institutional structures with management, coordination and facilitation support provided by the project management and executing units at the state level. The state government is committed to strengthen the GPs and Municipalities as critical service delivery and local governance units within the PRI system. The responsibilities and obligatory duties of the GPs are specified in state legislation.

2. *Local Self Government Department (LSGD):* The LSGD, administratively led by the Principal Secretary, will have primary responsibility for project implementation and ensuring that the project development objectives are met.

3. *Execution Support Agencies:* Three execution support agencies will implement specific project components and sub components under the overall direction of LSGD:

- The KILA and SIRD will execute the capacity building training programs for GPs and Municipalities under Component 2;
- GIFT will provide the institutional "home" for the DAC and will be responsible for its establishment and governance under the overall oversight of the PMU and subject to the arrangements as specified;
- In addition, the IKM will execute the roll out of the software solutions including training and implementation of the e-governance software to the GPs and Municipalities under Component 2. The IKM is an integral part of the LSGD and is not therefore classified as an independent executing agency.

4. *Project Management*. The Project Management Unit (PMU) established under the LSGD to assume overall responsibility for day to day project management, coordination and monitoring of the project performance in line with the project implementation schedule. Its role will also be to facilitate day to day decisions for implementation of various components of the project. It will ensure that the project resources are budgeted for and disbursed, and project accounts are audited.

5. Specifically the PMU is responsible for:

i. ensuring timely implementation according to the Project Implementation Manual (PIM);
ii. preparing for annual work programs, budgets, annual procurement plans and providing quality control;
iii. preparing withdrawal applications for disbursements for submission to IDA;

iv. maintaining consolidated project accounts and arranging for project audits to be done on time and as per specifications;
v. preparing quarterly Interim Unaudited Financial Reports (IUFRs), information on financial execution, activity progress as well as procurement progress on all components of the project;
vi. supporting coordinating and interacting with Local Fund Audit for GP and Municipalities and with KILA, SIRD and GIFT, the three executing support agencies involved in the project; and
vii. ensuring proper implementation of the ESMF and VGDF within the planning process by the GPs and Municipalities.

6. The PMU at the state level will be staffed by both cross-cutting management and support staff and specialists dealing with specific technical areas. The PMU will identify focal personnel for each project component, and they will be accountable for implementation, coordination, monitoring and reporting of their respective components and sub-components. Strong leadership, technical competence and professional skills will be required for timely implementation of the project. It will be headed by a Project Director reporting to the Principal Secretary of LSGD. A full time Deputy Project Director will be responsible for overall supervision. The designated focal points will work under the overall leadership of the Project Director and the Deputy Project Director, and their assignments are reviewed periodically, with formal reviews held quarterly and annually with the PS, LSGD. The functional areas and staffing complement identified for the initial phase of project implementation are as follows:

Subject Areas	**Designated Officials**
1. Project Management	Project Director + Dy. Project Director
2. Financial Management	Finance Manager + Finance Assistant
3. Procurement	Procurement Specialist
4. Information & Communications	Communication Specialist
5. Safeguards	Environment Specialist + Social Specialist
6. Grant Management	Grant Management Specialist
7. Capacity Building	Capacity Building Specialist
8 .Performance Monitoring & Evaluation	Monitoring & Evaluation Specialist
9. Project Administration	IT Specialist + Support Staff (3 nos)
Total Positions	15

Specific arrangements for project components

7. For the implementation of the various components of the project, the institutional arrangement is described below and summarized in the chart that follows.

8. *Component 1*: At the local government level, the GPs and Municipalities will be responsible for meeting the qualifying requirements based on performance parameters and utilizing the discretionary grants (Component 1) as per the annual plans and budgets. The GPs and Municipalities will be directly responsible for the implementation of the local projects. The LSGs will develop annual plans based on the guidelines provided in the PIM and they will hold consultative meetings with the Ward Sansad and Ward Committees, at the respective ward levels

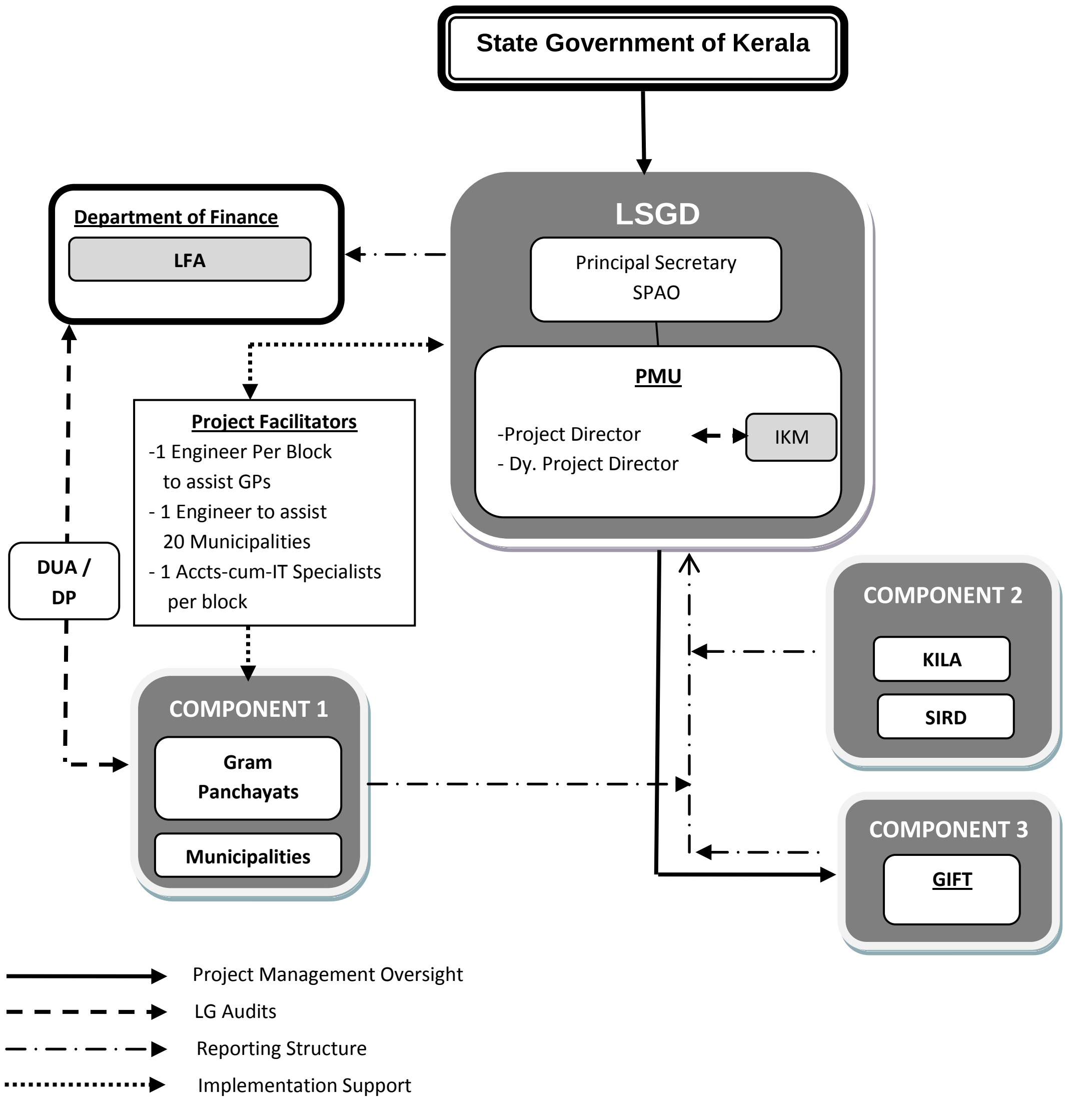
in GPs and Municipalities. The PMU will manage the services of engineers to provide technical assistance and handholding support to GPs and Municipalities on sub-projects, particularly in the areas of engineering design, ESMF, procurement and contract supervision during preparation of DPRs and supervision of works funded by the Project. The LSGs will prepare half yearly physical progress reports covering physical progress and asset creation funded by the performance grant. The physical progress reports will be submitted by participating GPs and Municipalities to the LSGD / PMU. All participating GPs and Municipalities will disclose their annual plans and expenditures to the public at their respective local government level. The reporting details are provided in Component 3. The annual performance assessment of GPs and Municipalities will be undertaken by independent agencies contracted by the PMU.

9. The project will work closely with the office of the Local Fund Audit (LFA) which is responsible for conducting regular annual audits of the GPs, and will seek to improve the quality and timeliness of its submission of Inspection Reports to the GPs and Municipalities, To this end the project will work closely with LFA to enhance performance of the state's oversight of public expenditures at the GP and Municipalities levels.

10. *Component 2*: A Memorandum of Understanding (MOU) will be in place between the execution support agencies (KILA and SIRD) and LSGD for the implementation of capacity building program of the project. Project funds will be made available by the PMU to KILA and SIRD for smooth implementation of project activities. Procurement of goods, works and consultancy services above US$50,000 to be undertaken by KILA and SIRD will be procured by the PMU based on the approved annual plans. Core faculty members and resource persons will be hired in KILA and SIRD to provide capacity building inputs to strengthen and supplement the existing systems of Municipalities and GPs. KILA and SIRD will report to PMU on the activities undertaken as per the agreements/ contracts between the institutions. In addition, IKM – which is a centre already established within the LSGD – will be responsible for implementing the e-governance activities of Component 2 under the overall supervision of the PMU.

11. *Component 3*: The Decentralization Analysis Cell (DAC) will be established in GIFT for policy analysis and strengthen the system of performance monitoring of GPs and Municipalities in state. The project will provide financial assistance to DAC to produce annual fiscal reports, just in time policy advisory support to LSGD and policy studies. A MOU will be developed between GIFT and LSGD outlining the nature of engagement between the two institutions and following the same procurement thresholds. DAC will be reporting to PMU on the project related activities as well to the Department of Finance of GoK.

Institutional Arrangements for KLGSDP



Project Implementation Manual

12. A detailed Project Implementation Manual provides a detailed description of the project and outlines the key project implementation modalities and instruments. It includes a Grant Operational Manual which deals with the specifics of Component 1 and manuals for use by the participating GPs and Municipalities.

Implementation Period

13. The Project will be executed over a period of five fiscal years, starting from FY2012-FY2016.

Financial Management and Disbursement

14. A financial management assessment of the LSGD and GPs and Municipalities was undertaken as part of appraisal. The LSG level assessment focused on the capacity of the GPs in the areas of budgeting, fund flow, accounting and financial reporting, internal controls and auditing. The key finding of the assessment was that as long as the GPs and Municipalities continue to use their current state systems of financial management and oversight, and adhere to all the relevant state rules and guidelines, they are capable of handling Component 1 funds and maintaining reasonable fiduciary oversight and control over these. A financial capacity assessment of the other proposed executing agencies for the project (KILA, SIRD, and GIFT) was also undertaken by the Bank and certain weaknesses identified. In view of these weaknesses it was felt that these entities would act as Execution Support Agencies for the PMU and be responsible for implementing certain sub- components. They will receive funding from the PMU and will report quarterly the expenditure details to them. The PMU will be responsible overall for monitoring and oversight over their work and the expenditure incurred by these entities will also be covered under the project audit of the CAG. The FM arrangements for the project will be as follows and have also been detailed in a Project Implementation Manual (PIM).

15. *Budget Line Item in Government of Kerala (GoK) Budget and fund releases*. The Government of Kerala will open a separate sub-major head under the Major Head 3604 – Compensation and assignments to local bodies and Panchayati Raj institutions in the Demand for Grants of the LSG department (for the year 2011-12) for the purpose of releasing Performance Grants to the GPs and the Municipalities (Component 1) under the Bank project. Below this, two minor sub-heads will be created for GPs and Municipalities. These budget lines will be distinct from the regular budget heads for existing SFC grants. The GoK will also open a separate sub-major head under appropriate expenditure major head for releasing funds to the PMU for implementing Components 2, 3 and 4 of the Bank project. Funds for components 2, 3, & 4 will be released under this budget line to the Treasury Savings Bank (TSB) account of the PMU. The PMU will incur expenditure from this account and also release funds to support entities like KILA, GIFT and SIRD for implementing components 2 and 3 of the project.

16. *Fund Flows, Expenditures and Payments: Component I*. Performance Grants (PGs) under Component 1 will form one of the disbursement categories for the project. The Kerala State treasury system and existing local government financial management systems will be used for releasing PG funds to the local bodies, expenditure authorization, raising bills, making payments and accounting for funds usage in the same way as for the existing grants. At the Local Government (LG) level, the PG funds will be separately identifiable in the LG budget and will be used for sub-projects and activities at the local level as per the grant rules (which include a negative list). LGs will maintain appropriate records and documentation of the work done and the expenditure incurred. The control and use of PG funding by GPs and Municipalities will be subject to the overall fiduciary and reporting arrangements of the state pertaining to local government, as well as a range of specific arrangements established for the functioning of the PG system and administered by the LSGD (PMU). These include the annual statutory audit undertaken by the LFA (which covers all LG expenditures, including those related to the PG), the six monthly financial and physical progress reports, and the annual performance assessment

which includes an assessment of local government performance in areas such as financial management (drawing on the LFA audit), procurement, safeguards, and so on. The Bank will rely on the LSG financial mechanisms, the state's fiduciary framework pertaining to LSGs, and the PG rules, systems and procedures administered by the LSGD (PMU) to provide the necessary assurance on the use of PG funds. During project implementation, Bank supervision will focus on the overall functioning and adequacy of these arrangements and the operation of the PG system at all levels.

17. The PG release will be made to the GPs/ Municipalities in a single annual tranche (in April every year except for the first year when the release will be in August) in line with the receipt of advances from the Bank based on the annual cash forecast for the full PG entitlement for the year of all qualifying GPs which, in turn, is based on the annual performance assessment. As with existing grants, "release" will not mean the actual flow of cash but will constitute an authorization limit for the local body to incur expenditure to that (accumulated) limit over a particular period.[24] Funds will be transferred from the Kerala state consolidated fund to the common state public account and thereon to the project specific treasury based accounts of the individual GPs/ municipalities. Each local body will maintain a project specific dedicated Treasury based account for the PG with the State treasury/sub-treasury, and the funds allocated to the GP/municipality for the Bank project will be allotted to this account. The transaction will be treated as expenditure in the state accounts once the amount is transferred from the state consolidated fund to the state public account. Unspent balances in the local government accounts at the end of the year will be carried over to the next financial year. As such, the GPs/ ULBs will have timely access to funds whatever their cash flow requirements. The project has an in-built mechanism to ensure that the difference between PG funds disbursed to LGs and the actual expenditure of these funds does not become too great;[25] however, this situation will be monitored and if, for any reason, significant unspent balances accumulate in aggregate, appropriate remedies will be worked out in consultation with the GoK Finance Department and LSGD to ensure that PG funds are spent by LSGs on a timely basis in accordance with grant rules. Any PG funds provided by the Bank which are not utilized by LGs by the closing date the project will be refunded to the Bank. In the event of expenditure of PG funding by LSGs on items or activities which are ineligible in terms of the grant rules (e.g. those on the negative list), remedies will be exercised, including the disqualification of receipt of PG funding in the subsequent year, in accordance with normal Bank procedures.

18. The administrative and financial approvals for the projects to be implemented by a GP are given by the GP. Typically, actual implementation is overseen by the Implementing Officers (IOs), who are usually officials of the line departments, allotted to the GP. On completion of a project, the Implementing Officers (IOs) verify the work done, and requisition the treasury for the release of funds to make payments to the contractors and/or implementing agencies. The Treasury Officers (TO) release the funds to the IOs after the local body and Monitoring Committees authorize the release, and the IO presents bills to the treasury for payment.

[24] The "accumulated limit" means the annual grant amount plus any rolled over balance from previous financial years.

[25] In Phase 2, no local government which has not spent at least 80% of its PG fund allocation for the previous year will qualify for a PG fund allocation for the next year.

19. *Disbursement arrangements*: Disbursement method for this project is Advance through the Designated Account (DA) in US$ which is managed by CAAA. The ceiling of the DA will be variable based on the project annual cash forecast. Funds are advanced from the Bank to the Government of India (GOI) based on the annual forecast which will pass these funds on to the GoK through the regular budgetary mechanisms between the GoI and the states. In turn, the GOK releases the Performance Grants based on the annual allocation of the PG that is decided in accordance with the PG access criteria and grant allocation formula described in the PIM. The GoK will forecast their total fund requirements based on annual action plans and the agreed work plans, and communicate this requirement (cash forecast) which should be provided by IUFRs. The Bank will deposit its portion of the funds (the Bank's contribution as reflected through the disbursement percentage , the balance being the counterpart funding) into the DA. The GoK Finance Department will then immediately transfer these funds (along with its own contribution) from the Consolidated Fund to a project specific sub head (to be created) in the Public Account of the State (account head 8448). Thereafter, the funds will be transferred to the dedicated Treasury based accounts of each individual GP and Municipality (to be created). For Components 2, 3 and 4, the GoK will also release funds into the TSB account of the PMU, based on their requirement.

20. In accordance with the annual budget allocation systems of the GoK, six monthly project financial reporting (through IUFRs) will report on the releases of the PG funds to eligible Local Governments (LGs) by the GoK. The IUFR will include an Annex which will report on the receipt and utilization of the grant funds, and the unspent balances, at the LG level. LGs shall record the receipt and utilization of PG funds. Individual grant utilization reports are prepared by the LGs as part of the existing LG reporting system, and do not impose any additional burden on the LGs. GoK will compile these reports, review them and prepare a summary report that will show the aggregate utilization of grant funds at the LG level. This six-monthly summary report will be an annex to the IUFR and will be used to update the Bank's internal accounting records. The IUFRs, along with annexes and the Application for Reporting Use of Funds will be conveyed to the Bank through CAAA in accordance with established procedures for the India portfolio.

21. GoK will reconcile the cumulative PG releases and their cumulative utilization by the LGs from the information provided by the LG financial reports in accordance with established procedures. Reconciliation will be done regularly and a special reconciliation will be done six months prior to the close of the project to identify any unused funds. The results of the reconciliation will be conveyed to the Bank. Any PG funds provided by the Bank that are not fully utilized by LGs by the closing date of the project will be refunded to the Bank by the GoI.

22. *Fund Flows, Expenditures and Payments: Component 2, 3 and 4.* Funds for components 2, 3 & 4 will be made available to the PMU in a Treasury Savings Bank (TSB) Account. Funds for components 2 and 3 will be released from the PMU every quarter to the respective support entities (KILA, GIFT, SIRD) in their Bank accounts, for incurring expenditure on various agreed activities. These entities will keep an account of the funds released and report to the PMU on the actual expenditure incurred under components 2 and 3. Expenditure on activities implemented by the PMU (component 4) will be expended from the TSB Account. The PMU will collate the

expenditure details for all the project components and will prepare the six-monthly financial monitoring reports.

23. *Internal audit arrangements:* The State Performance Audit Officer (SPAO) who reports to the PS, LSGD, is the designated internal auditor for the GPs and Municipalities. It was agreed that the SPAO will be the internal auditor of the project and will conduct the audit as per TORs agreed with the Bank. The internal audit will be six-monthly and will cover the performance grants being received by the GPs and the Municipalities and provide assurance that the funds are being used for intended purposes. The SPAO will also audit the expenditure incurred under Components 2, 3 and 4 of the Bank project and provide quarterly internal audit reports for the project as a whole, to the Project Director/ PS, LSGD for necessary action. The Bank will not directly review each of these reports but the PMU will prepare an extract of the key findings and share this with the Bank. In case the SPAO is unable to undertake this task, the project will engage a firm of chartered accountants to do this work. The objective of the internal audit is to strengthen the internal control framework and provide the project management with timely fiduciary assurance that: (i) the financial management, procurement systems and internal control procedures as applicable to the project are being adhered to by the GPs/ Municipalities and the support entities, and (ii) the financial information being submitted to the PMU is in agreement with the financial records and can be relied upon to support the disbursements made by the Bank.

24. *Project audits and external audit*: Project Financial Statements (PFS) of the World Bank project will be audited by the Comptroller and Auditor General (CAG) of India through the Office of the Accountant General in Kerala. The CAG audit of the PFS will be in line with the standard ToR for Bank financed projects. The PFS (which is actually the Interim Unaudited Financial Report for the second half of a year and captures the financial information for the entire year) will include the expenditures incurred under all the components of the project, including PGs to the GPs and Municipalities, expenditures incurred under components 2 and 3 by other entities like KILA, SIRD, GIFT, and the expenditure incurred by the PMU. The State Local Fund Auditor (LFA) is the designated external auditor for the GPs and the Municipalities and is responsible for issuing the annual audit certificate. As of now, the LFA financial certification audit focuses on the accuracy and correctness of the financial statements while the detailed compliance/ transaction audit that follows, reviews the expenditure incurred from the propriety angle. Every year, a summary of the LFA LG audit findings will be prepared by the PMU on the basis of a review of the LG audit reports (undertaken as part of the annual assessment) and made available to the project auditor.

25. In view of a number of weaknesses identified in the audit process of the LFA, it was agreed that the LFA audit capacity will be built through the project capacity building component and the LFA's auditors will be further trained to conduct audit in line with the CAG guidelines. They are required to provide a clear audit opinion (clean, qualified, adverse, disclaimed) at the completion of the financial certification audit of each GP/ municipality and provide an assurance that LG funds, including PG funds, are being used for their intended purposes.

26. The LFA is the statutory auditor for the GPs/ Municipalities and, over time, will strengthen the audit process through conducting the audit as per the new audit manual and

guidelines that will be prepared as part of the project capacity building. In order for any GP or municipality to receive a PG in a given year it will need to receive an unqualified or qualified opinion for a previous year[26] provided that, if the opinion is qualified, this does not indicate observations that indicate pervasive financial management weaknesses and/or a pervasive lack of integrity of the financial statements. An indicative list of such observations is provided in the PIM. The assessment of qualified audit opinions of LSGs against these criteria will be undertaken as part of the annual performance assessment. In the first year, this will be undertaken by LSGD assisted by appropriately qualified accountants; thereafter it will be undertaken as part of the contracted out annual performance assessment. GPs/Municipalities that receive either an adverse audit opinion or a disclaimer or a qualified opinion with the observations as indicated in the PIM, will not be eligible to receive project funds. A sample of the annual audit certificates and reports will be translated into English and made available to the Bank for supervision purposes on an annual basis.

27. *PMU staffing*. The PMU at the State level will have a senior level finance staff (DFA/ FM Manager/ Controller) who will be responsible for oversight and coordination of all FM requirements for the project including preparing financial monitoring reports, sending reimbursement or funding advance claims to the CAAA, and coordinating the work of the statutory auditors. S (he) will be assisted by adequate FM staff at all levels.

Procurement

28. *Overall assessment*. A procurement assessment carried out in 16 GPs/Municipalities in 2 districts Thiruvananthapuram and Thrissur and the LSG Department had found that The Kerala Panchayati Raj Act 1994, the Kerala Municipality Act 1994, Kerala Stores Purchase Rules and Kerala Panchayati Raj (execution of Public Works) Rules 1997 provide the legal foundation for the local government system and procurement management in Kerala. The review of procurement practices around various stages in a procurement cycle indicated overall higher levels of compliance with the suggested procedures, however, further improvements are recommended in developing detailed specifications, market search for bidders, consistent standards of tender conditions and detailed evaluation process. It was found that the unavailability of a defined Procurement rules, regulations and tools like clear definitions of roles and responsibilities and functional process flows, standard bidding documents, various formats for tendering, evaluation, grievance handling mechanism and a monitoring and evaluation framework cause the shortcomings in the above areas.

29. *Procurement Arrangements for Component 1*. Under this component, where the Bank will be supporting a grant from the state to local governments, the LSGs will procure goods, works and services for expenditure of PG funds using the prevailing state system for LG procurement as modified (see below). The Government issued a LSG Procurement Manual on 8 November 2010, which was reviewed and found to be acceptable. In addition, all goods, works; and services required for the Project shall be procured in accordance with the requirements set forth or referred to in Section I of the Procurement Guidelines. For project purposes, the government Procurement Manual for Goods and Services and Public Works Rules subject to the

[26] See Annex 2 for details

stipulations detailed below will constitute the procurement arrangements for GPs and Municipalities under Component 1:

- That the use of DGS &D Rate Contracts or Rate Contracts established by Kerala Medical Services Corporation will be subject to a maximum per contract value of $50,000;

- For procurement up to the value of $50,000 per contract, Rate Contracts established by autonomous and commercially operating state corporations and agencies which are not under the LSGD, if available, can be considered as one of the 3 quotations/tenders. It is essential to invite quotations/tenders in all such cases, if funding from Bank supported project is used.

- Direct Contracting using Block Grants will be carried out only when the conditions of (i) extension of an existing contract; (ii) standardization of the item being purchased; (iii) proprietary and obtainable only from one source and in (iv) in exceptional cases, such as in response to natural disasters.

- Kerala Works contracts Rules allows for 2 stage -pre qualification and tendering- above Rs 10 million (approximately $210,000). At this stage, no single contracts using the Bank support is expected to be valued above $200,000. Notwithstanding this assumption, Use of funds for works contracts from Bank support shall not follow 2 envelope/stage procurement process.

- Negotiations shall not be carried out with any bidders including the lowest bidder. In the event the bid prices are considerably above the estimated budget and a fresh bidding is not expected to result in better offers and the need for negotiations arise, these shall follow the guidelines set by the Central Vigilance Commission, Govt. of India.

30. For component 1, the supervision from the Bank will be carried as per the procedures established for CDD projects (OPCS Guidelines for Management of Procurement in CDD projects December 2009). The post review will consist of reviewing technical, financial and procurement reports carried out by the Project and will rely on the third party Annual Performance review to be commissioned by the project based a ToR and selection process agreed in advance with the Bank and the internal audit by the State Performance Audit Wing under the LSGD. Project will mandatorily make available the outcomes from such reports to the Bank during the implementation review missions. Based on the assessment of the findings and the extent of compliance with procurement manual and works rules, Bank retains a right to carry out further triangulation exercises or sample based post review of procurement in order to take informed decision on the progress of the project.

31. *Procurement Arrangements for Component 2 and 3 by LSGD, KILA, SIRD, GIFT.* A procurement assessment of the key implementing agency i.e. LGSD, KILA, SIRD and GIFT, was undertaken and the risk rated as Moderate. Assessment of other implementing entities of the project (KILA, SIRD and GIFT) will be undertaken prior to appraisal of the project.

Procurement for the components 2 and 3 will be carried out in accordance with the World Bank's "Guidelines: Procurement under IBRD Loans and IDA Credits" dated May 2004, revised in October 2006 and May 2010, and "Guidelines: Selection and Employment of Consultants by World Bank Borrowers" dated May 2004, revised in October 2006 and May 2010.

32. Prior-Review Thresholds. Prior-review and procurement method thresholds for the Components 2, 3 and 4 of the project are indicated in Table 1. PMU with in-house procurement unit is authorized to carry out procurement up to the following thresholds. Given the current capacity levels in KILA, SIRD and GIFT, the maximum value of a single contract that can be procured by these institutions is set as $50,000 under the categories of non consulting services, individual consultants; goods and equipment and works. For all consultants firms irrespective of value following QCBS, QBS, CQS, LCS or SSS and all other contracts valued above $50,000, PMU will be responsible for procurement and placing the items/services for the respective agencies.

Table 1: Procurement Thresholds

	Prior Review Thresholds Proposed (USD million)*	Procurement Method Thresholds Proposed (USD million)							
		ICB	NCB	Shopping	QCBS	QBS	CQS	LCS/ FBS	SSS
Goods	0.3	≥0.5	<0.5	<0.05					
Works	10.0	≥10	<10	<0.10					
Consulting Services	0.3 for firm 0.05 for Individuals SSS: all	NA	NA	NA	default	TBD	<0.1	<0.2	TBD

If a transaction comprises several packages, lots or slices, the aggregate, estimated value of all contracts determines the applicable threshold amount

33. Procurement Plan and Procurement Arrangements. Procurement Plan for components 2, 3 and 4 of the project, was prepared and reviewed by the Bank and accepted (during Appraisal). This plan will be updated annually to reflect the latest circumstances. For ICB contracts for goods and works, World Bank Standard Bidding Documents will be used. National Competitive Bidding (NCB) for goods and works under Component 2,3 and 4 will be conducted in accordance with paragraph 3.3 and 3.4 of the Procurement Guidelines and the following additional provisions:

- Only the model bidding documents for NCB agreed with the GOI Task Force (and as amended for time to time), shall be used for bidding;
- Invitations to bid shall be advertised in at least one widely circulated national daily newspaper, at least 30 days prior to the deadline for the submission of bids;

- No special preference will be accorded to any bidder either for price or for other terms and conditions when competing with foreign bidders, state-owned enterprises, small scale enterprises or enterprises from any given State;
- Extension of bid validity shall not be allowed without the prior concurrence of the World Bank (i) for the first request for extension if it is longer than four weeks; and (ii) for all subsequent requests for extension irrespective of the period (such concurrence will be considered by the Bank only in cases of Force Majeure and circumstances beyond the control of the Purchaser/Employer);
- Re-bidding shall not be carried out without the prior concurrence of the Association. The system of rejecting bids outside a pre-determined margin or "bracket" of prices shall not be used in the project;
- Rate contracts entered into by Directorate General of Supplies and Disposals will not be acceptable as a substitute for NCB procedures. Such contracts will be acceptable however for any procurement under the Shopping procedures;
- Two or three envelope system will not be used.
  As per paragraph 1.14(e) of the World Bank's Procurement Guidelines, the Association's right to inspect the accounts and records of bidders, suppliers and contractors will be included in the bidding documents

34. Selection of Consultants. For selection of institutional and individual Consultants for providing services, the project will use QCBS, QBS, Selection based on Consultants' Qualification, Fixed Budget Selection, Least Cost Selection, Single Source Selection, and Selection of Individual Consultants as appropriate, subject to approval by the Bank. For service contracts, World Bank Standard Bidding Documents will be used.

35. Procurement Risks and Mitigation Measures. The procurement risks at the principal implementing and oversight entity, i.e. the Department for Local Self Government is rated as Moderate, and for LSGs which will implement the major component 1 as "Low". Overall Procurement risk for the project is assessed as "Low", with the following key factors:

- Low Capacity in LSGs to implement and manage the procurement process
- Insufficient Procurement Monitoring and Accountability measures

36. Risk mitigation measures have been discussed with the Government. The measures include procurement arrangements and processes need to bring to consistent standards across the board for all LSGs, which are also acceptable to Bank standards. The most important measure undertaken towards achieving this standard has been adapting the revised Procurement Manual for Goods and Services and consolidated rules for Works for LSGs developed by the State and reviewed by Bank in August 2010. The focus of the procurement arrangement will remain a combination of beneficiary lead or open tender for activities implemented by the GPs under the untied Block Grant component. A series of capacity building measures including training the implementing officers in the LSGs on the new Procurement manual, strengthening the Performance Audit Wing through developing tools for procurement post review and training programs for skill development of PAW staff are recommended.

Environmental and Social Safeguards

37. The Project falls in the environmental screening category B as per the Bank's Operational Policy (OP) 4.01. An Environmental Assessment (EA) was undertaken by the Government of Kerala (GoK). The EA has identified the following key environmental issues concerning the activities of LGs: depletion of natural resources, changes in land use and topography, non-permissible activities in forests, natural habitats or areas of historical significance, soil erosion, inadequate waste disposal, usage of banned pesticides, and insufficient fodder resources. Accordingly, the Project triggers the following safeguard policies of the World Bank: Environmental Assessment (OP 4.01), Forests (OP 4.36), Natural Habitats (OP 4.04), Physical Cultural Resources (OP 4.11) and Tribal Safeguard Policy (OP 4.10).

38. In respect of Component 1, an Environment and Social Management Framework (ESMF) has been developed for the project to ensure compliance with the above-mentioned issues and triggered safeguards policies. No environmental impacts are envisaged under Components 2, 3, and 4 of the Project. The ESMF comprises a set of procedures for granting environmental and social (E&S) approval to sub-projects proposed by LSGs. The ESMF includes: (i) an E&S Screening process that ensures that activities don't contravene the relevant national and state regulations and Bank's safeguard policies and are categorized on the basis of perceived intensity of risk or impact of the subprojects as low or medium. (ii) Environment Guidelines to assist in the recognition of potential environmental and social risks associated with the subprojects and the corresponding measures in respect of low and medium impact sub-projects. (iii) Limited Environmental and Social Assessment (LESA) which is carried out in case sub-projects are categorized as medium impact. and (iv) Compliance formats to help document and verify compliance with suggested mitigation measures during execution of works.

39. The ESMF also includes institutional arrangements indicating the roles and responsibilities of various LG functionaries and officials, advisory bodies (such as TAG), LSG Department technical staff, line department technical staff (officials) and project staff involved in various stages of implementation of the ESMF procedures. A capacity building plan that provides appropriate guidance to KILA, the institution responsible for undertaking the training activities, in carrying out specific training and skill development in context of the ESMF for soothe above mentioned officials as to enable them discharge their ESMF-related functions effectively.

40. The monitoring of environmental and social performance will be undertaken through annual performance assessments, which will determine the eligibility of LSGs for award of untied performance grants through environment and social performance indicators, among others. In addition, a third party local service delivery technical evaluation (to be conducted twice during the project) will include a component on environmental and social management, including a compilation of best practices and lessons learnt by an independent specialized agency.

41. The ESA/ESMF report has been disclosed in public two consultation workshops organized by the GoK on June 18 and 19, 2009, in Thiruvananthapuram and Kozhikode and in a disclosure workshop organized on November 8, 2010 which was attended by the by the Principal

Secretary and Secretary, LSG Department, other officials from various Government Departments and representatives from civil society organizations. GoK disclosed the ESMF on the website of the Local Self Government Department (LSGD) and distributed it to the district collectors and district libraries on November 10, 2010.

42. The ESMF will apply to the works/activities taken up under the Performance Grant component of the project. The ESMF is comprehensive and its effective implementation should ensure that the Bank's safeguards requirements will be met in full. There are unlikely to be environmental risks that go beyond the coverage of the safeguards policies. In the future, the LSG Department of GoK could consider the option to apply it to all activities taken up by the LGs irrespective of the source of funds.

43. Involuntary Resettlement (OP 4.12). The project will not use in-voluntary land acquisition in sub-projects using the Project Funds and hence OP 4.12 is not triggered. Land requirements are expected to be small for GP/municipal sub-projects. Land requirements, if any, will be met through:

- location of facilities on appropriate public lands;
- direct market purchase (willing seller and willing buyer principle where the seller has right to say'no')[27];
- innovative benefit sharing arrangements where feasible; and
- voluntary land donations of unencumbered lands where the willingness of the contributor is documented and verifiable.

44. *Land acquisition process requirements*. The project will follow due procedures and documentation processes for all land acquisitions. The details of the land acquisition should be discussed in an open forum and compensatory measures if any shared with the local community. Due diligence, as part of the ESMF, will be exercised to avoid economic displacement as a result of sub-project activities (even when there is no land acquisition). In order to effectively monitor land acquisition, project GPs will: (i) maintain details of all lands acquired for the project; (ii) ensure proper registration and legal transfer of title deeds of procured/donated lands; and (iii) wherever the land is donated by the community, complete documentation will be carried out for the title transfer of the land. For any land donated, there will be an agreement – properly witnessed – where by the donor will state that the land is donated voluntarily giving up all rights; (iv) The land donation process should be recorded in a Grama Sabha meeting in the presence of the donor

45. *Voluntary land donations*[28]. The project will discourage land donation by poor families and vulnerable groups. The guidelines to be followed for voluntary land donations would include the following principles: (i) impacts are minor (loss of land less than 10 percent of holdings), (ii) no physical re-location; (iii) the sub project is not site specific; (iv) the land required to meet technical project criteria must be identified by the affected community, not by line agencies or

[27] Where access requirements are needed, these should be guaranteed by the title holder
28 If any loss of income is envisaged, verification of voluntary acceptance of GP/community-devised mitigation measures must be obtained from those expected to be adversely affected.

project authorities (nonetheless, technical authorities can help ensure that the land is appropriate for project purposes and that the project will produce no health or environmental safety hazards); (v) the land in question must be free of claims or encumbrances; (vi) grievance mechanisms must be available; and (vii) verification (e.g. witnessed statements) of the voluntary nature of land donations must be obtained from *each* person donating land.

46. The above framework has been integrated as part of the ESMF.

47. Indigenous Peoples Policy (OP 4.10). If there are tribal populations resident in the project areas, the Bank's Indigenous Peoples policy on such populations (OP 4.10) becomes applicable to these groups. The policy mandates: (i) informed consent of tribal groups to project interventions; (ii) maximization of development impact for such groups; and (iii) culturally appropriate interventions. The policy also stipulates the preparation of a Tribal Development Plan (where the nature and type of investments are known) or a Tribal Development Process Framework (where the investments are demand-based and not predictable in advance). In the case of Kerala, the tribal population constitutes only 1.1 percent of the total population. While the tribal population is spread over the State across districts, a large proportion of tribals (60 percent) live in the border districts of Wyanad, Idukki and Palakkad. In general, it appears that they may not form majority populations and may be largely confined to compact administrative units in most districts. A robust process/institutional framework for addressing issues of Tribals and other vulnerable groups (scheduled castes and women) has been developed by GoK as part of their decentralized planning process after extensive consultations.

48. Also, unlike in other States, substantial part the budget under Tribal Sub Plan (TSP) and Special Component Plan (SCP) flow through the PRI system in Kerala. Given this context, the Bank team recognizes the potential to adopt country systems in the form of a Vulnerable Groups' Development Framework (VGDF), which incorporates the requirements of tribal groups, scheduled castes and women. A social assessment report, which identifies key social development issues and risks for different regions/districts of the State, has been prepared by the Kerala Institute of Local Administration (KILA) in consultation with key stakeholders. GoK has developed the overall VGDF, taking into account the issues identified during the consultations.

49. The objective of the VGDF under the proposed project is to incentivize operationalisation of existing policy framework for vulnerable groups (VG) in general and for Scheduled Tribes (STs), Scheduled Castes (SCs) and Women in particular. This will be achieved through (i) Capacity building support; (ii) Measurement and monitoring of performance; and (iii) Performance under VGDF will be an integral part of the performance grant award process

Measurement and monitoring of VGDF:

50. Independent measurement of process and outcomes through specific parameters will include:

Planning:

- Is there a plan for VGs?

- Plan vs. Entitlement (Have the LSGI tried to access all available resources for VGs?)
- Is the quality of planning process satisfactory?

Implementation

- Implementation Vs Plan - Have all planned activities actually implemented for VGs?
- Is the Implementation process satisfactory

Post- Implementation

- Social Audit (Have the outcomes been achieved for VGs)

Transparency & Accountability

- Display of citizens charter
- GP report for citizens

Implementation arrangements

51. Since country systems are being adopted, existing guidelines for planning and implementation will apply as shown below as a step-by-step process (example shown for TSP):

S No	Stage	Action	Responsibility
1	Preparatory	Constitution of working group	Chairman of LSGI
2		Training & sensitization	KILA
3		Environment creation/IEC	VG Promoters
4		Situation Analysis presentation/ discussion with VGs	VG Promoters
5	Planning	Hamlet/Oorukoottam meeting	Officer assigned by LSGI/VG promoter
6		Draft Plan preparation	Chairman of LSGI/Chairman of standing committee
7		Projectisation	Working group
8		Draft Plan finalization (for ZP & TP only)	
9		Development Seminar	DPC
10		Plan finalization	LSGI - Board
11		Vetting of Plans	TAG
12		Plan Approval	DPC
13		Plan Publicity (dissemination)	Working Group/VG promoter
14	Implementation	Plan Implementation	Accredited agency/ CBO/ SHG
15		Monitoring	Social Audit – by community State planning Board/LSGD (through its designated agency) DPC monitoring teams

Annex 4: Operational Risk Assessment Framework (ORAF)

INDIA: KERALA LOCAL GOVERNMENT AND SERVICE DELIVERY PROJECT

Project Development Objective(s)

To enhance and strengthen the institutional capacity of the local government system in Kerala to deliver services and basic administration and governance functions more effectively and in a sustainable manner.

PDO Level Results Indicators:	1. 70% GPs and Municipalities will have passed the performance assessments for well-functioning fiduciary, planning and service delivery systems [29] (total = 1030)
	2. A well-established performance-based grant system is increasingly financed by GoK
	3. The number of direct project beneficiaries of which a certain percentage are female

Risk Category	Risk Rating	Risk Description	Proposed Mitigation Measures
Project Stakeholder Risks	L	Change of government policy due to change of governments. Possible difference in approach with other donors in the local government sector. Negative publicity for project	None None Carefully considered media strategy
Implementing Agency Risks	M-I	Weak HR and implementation capacities and limited experience with implementing donor-funded projects on the part of LSGD, KILA	Employment of expanded core staff in PMU is an action prior to negotiations.

[29] The quality of GPs' fiduciary and planning systems will be measured through the Project's annual performance assessment system, along with separate third party validation. (See Component 1 description). GPs will be assessed according to specific criteria in areas of: (i) planning and budgeting; (ii) project execution and service delivery; (iii) accounting, reporting and audit; and (iv) transparency and accountability. The full performance assessment will occur in the second year.

		and SIRD which could affect performance.	Accelerated recruitment and training of PMU staff and other implementing agency staff during late preparation and early implementation phases.
		Ownership of project by government could weaken if current champions change	None
		Impact of political dynamics in decision-making	Clear identification of key design issues and decision-making timelines in project preparation
		Potential for accountability weaknesses in project implementation	Clearly define institutional relationships between LSGD and non-LSGD agencies during project preparation.
		Malfeasance in LSGD and in implementing agencies may occur	Establishment of satisfactory fiduciary and procurement systems during project preparation and robust supervision during implementation
Project Risks	**M-I**		
• Design		Innovation introduced through project may create implementation challenges.	Integrate project procedures with existing government systems and processes. Simplify the performance assessment system.
		Overly ambitious universe of GPs and Municipalities targeted by project could make the project difficult to manage.	Ensure capacity of PMU and local governments are strengthened
		Transfers and delayed appointment of LG staff by state government may constrain ability of LGs to implement project and build capacity.	Ongoing monitoring and dialogue with LGSD during project supervision to ensure that problem does not escalate.
		Constraints on use of funds or other design features may proscribe the ability of the GPs	Ensure heightened discretion and flexibility throughout the project.

		and Municipalities to respond to changing client needs or conditions on the ground	
• Social and Environmental		Activities undertaken by GPs using grant funds may cause adverse environmental impacts and social outcomes. There is a risk that vulnerable groups (particularly tribals, scheduled castes and fisher folk) who have limited voice in the planning and implementation will be excluded from development process.	Design and implementation of Environmental Management and Social Framework The project will implement a Vulnerable Groups Development Framework (VGDF) Annual performance assessments include conditions for ESMF.
• Delivery Quality		Fiscal position and policy orientation of GoK could constrain the sustainability of the performance grant system after project ends. Lack of data and measurement systems may make measuring project results difficult Inefficiently implemented PA contract could disrupt the local government planning budget and implementation cycle Project may undermine current trend to increase GoK funding for LG investment and/or GoK may not deliver on counterpart funding requirements Political dynamics may weaken project integrity	State counterpart funding requirement to phase in sustainable fiscal commitment to performance grant system during life of project. The performance assessment system and related additional MIS/reporting measures introduced under the project will provide a robust oversight system and the data collected and technical studies undertaken will form the basis for establishing a state oversight and monitoring system under the project Procurement plan timeline is worked out. Enhancing procurement and contract management capacity in PMU Commitment from GoK to maintain current levels of state-sourced financial flows to GPs and Municipalities in real terms during project preparation and implementation and covenants governing counterpart funding commitments Criteria used for assessing grant-funding eligibility based on objective parameters. Grant

			funds allocated on basis of transparent formula and independent, out-sourced performance assessment. The grant assessment criteria and annual grant award will receive wide publicity.

Overall Risk Rating at Preparation	**Overall Risk Rating During Implementation**	**Comments**
M-I	M-I	This rating reflects the view that a number of key decisions regarding the basic scope and design of the project are vital. While the chances of positive outcomes are reasonably good, the impact of poor decision-making on these issues would be highly deleterious for the realization of the PDOs. There is a fairly wide range of risks to the project during implementation, so the likelihood of at least some of these materializing is quite high, but their overall impact is likely to be manageable during the life of the project.

M-I = Medium Impact; L= Low

Annex 5: Implementation Support Plan

INDIA: KERALA LOCAL GOVERNMENT AND SERVICE DELIVERY PROJECT

Strategy and approach for Implementation Support

1. The strategic approach for the implementation support (IS) has two objectives: (i) to monitor the implementation of the risk mitigation defined in the ORAF and provide the technical advice necessary to facilitate achieving the PDO; and (ii) to monitor implementation progress on the project and to contribute to the quality of the capacity building of stakeholders by providing best practices and benchmarks.

- Procurement. Implementation support will include: (i) ex-ante and ex-post review of project; (ii) review of the Procurement Plan and procurement performance; and (iii) provide training and guidance on the Bank's Procurement Guidelines to the implementing agencies, e.g. LSGD PMU, KILA, SIRD, etc.

- Financial Management. Supervision will review the IUFRs as the basis for disbursements, and reporting expenditures, audit reports, and agreement on measures to address any audit observation and monitoring their implementation. The Bank team will also work with the Project Management Unit to assist in improving coordination among the three agencies for financial management and reporting.

- Environmental and Social Safeguards. The Bank team will supervise the implementation of the Environment and Social Management Framework (ESMF) and the Vulnerable Groups Development Framework (VGDF). Field visits are required on a semi-annual basis.

- Monitoring and Evaluation. During the implementation review, the Bank team will review the results monitoring framework and the implementation of the risk mitigations identified in the ORAF.

- Governance and Anti-Corruption. The Bank team will supervise the implementation of the agreed GAAP and provide guidance in resolving any issues identified.

2. Other Issues (implementation capacity of LSGD, closely linked to the risk assessment and project design issues)

Implementation Support Plan

3. Most of the Bank team members will be based in the India country office to ensure timely, efficient and effective implementation support to the client. Formal supervision and field visit will be carried out semi-annually and detailed inputs from the Bank team are outlined below:

- Technical inputs.

- Fiduciary requirements and inputs. Training will be provided by the Bank's financial management specialist and procurement specialist before the commencement of project implementation. The Bank team will assist LSGD to identify capacity building needs to strengthen its financial management capacity and the procurement specialist will provide timely support on procurement issues. For supervision of financial management will be carried out semi-annually, while procurement supervision will be carried out on a timely basis as required by the client. The financial management specialist and procurement specialist are both country office based.

- Safeguards. Inputs from an environment specialist and a social specialist are required. Training is required on environment monitoring and reporting. On the social side, supervision will focus on the compliance to the VGDF. The social and environment specialist are both country office based.

- Operations. A project team member, based in the country office, will provide day to day supervision of all operational aspects, as well as coordination with the client and among Bank team members.

4. The main focus of the implementation support is summarized below:

Time	**Focus**	**Skills Needed**	**Resource Estimate**	**Partner Role**
First twelve months	Procurement review of the bidding documents	Procurement Specialist	4 SWs	N/A
	Procurement Training	Procurement Specialist	1 SW	
	FM training and supervision	FM Specialist	2 SWs	
	Project supervision coordination	Local Government Specialist	8 SWs	
	Task Team Leadership	TTL	8 SWs	
12-48 months	Financial Management, disbursement and reporting	FM Specialist Local Government Specialist	2 SWs 8 SWs	N/A
	Procurement monitoring	Procurement Specialist	2 SWs	
	Environment/Social monitoring	Environment Specialist Social Specialist	2 SWs 2 SWs	
	Task Team Leadership	TTL	8 SWs	

N.B. SW – Staff Week

5. Staff Skills Mix Required

Skills Needed	**Number of Staff Weeks**	**Number of Trips**	**Comments**
Task Team Leader	8 SWs annually	2-3	Washington based
Procurement	2 SWs annually	Field trips required	Country Office based
Financial Management Specialist	2 SWs annually	Field trips required	Country Office based
Environment Specialist	2 SWs annually	Field trips required	Country Office based
Social Specialist	2 SWs annually	Field trips required	Country Office based
Local Government Specialist	8 SWs annually	Field trips required	Country Office based

Annex 6: Team Composition

INDIA: KERALA LOCAL GOVERNMENT AND SERVICE DELIVERY PROJECT

Name	Title	Unit
Roland White	Sr. Institutional Development Specialist, Task Team Leader	SASDU
Soma Ghosh Moulik	Sr. Institutional Development Specialist	TWIWA
Abdu Muwonge	Economist	SASDU
Atul Deshpande	Sr. Financial Management Specialist	SASFM
Andre Herzog	Sr. Urban Specialist	WBIUR
Susan Wong	Sr. Social Development Specialist	SDV
Kalesh Kumar	Sr. Procurement Specialist	SASPS
Priti Kumar	Sr. Environmental Specialist	SASDI
R.R. Mohan	Sr. Social Development Specialist	SASDS
Puneet Kapoor	Consultant	SASFM
Rowena Martinez	Consultant	SASDU
Parimal Sadaphal	Consultant	SASDI
Anil Das	Consultant	SASDU
Tim Williamson	Consultant	SASDU
Nirmala Chopra	Team Assistant	SASDO
Lilian MacArthur	Program Assistant	SASDO

Annex 7: Economic and Financial Analysis

INDIA: KERALA LOCAL GOVERNMENT AND SERVICE DELIVERY PROJECT

1. *Introduction*. The economic and financial analysis demonstrates that the project will help the Government of Kerala (GoK) to implement key reforms aimed at deepening its decentralization. It analyzes the benefits, costs and risks of the project as well as the likely impacts of the project. It provides the justification of public sector intervention, alternative project argument, rate of return argument, sustainability and risk analysis. The performance of the GPs and Municipalities in terms of service delivery and governance will be enhanced through a fully discretionary performance grant and strengthened institutions. The reforms implemented under the project would help strengthen the systems and processes, including financial management, procurement, e-governance, performance monitoring, local planning and budgeting.

2. The project is likely to contribute to greater efficiency in the delivery of public goods and services at the GPs and Municipalities. The social benefits of the chosen sub-projects under the project are likely to outweigh their costs. Suppose that as a result of a participatory planning process, local governments choose rural roads as one of the sub-projects to be financed by the project. Village connectivity roads are typical local public goods—they are non rival and non-excludable in nature. Normally, one person's consumption of the connectivity roads or a small bridge connecting nearby villages does not exclude another person from using it (assuming no congestion). It is also impossible to restrict consumption to only those who pay. With non-rivalry and non-excludability, the private costs of producing the rural roads or small bridge will outweigh the private benefits. Public sector intervention can increase social welfare if it increases the production of locally public goods that are non-exclusive in production and non-rival in consumption.

3. On equity grounds the project is expected to contribute to the State's poverty reduction efforts. Improving access to and quality of the basic public goods and services in GPs and Municipalities is likely to reduce poverty in the State.[30] A recent survey by the National Sample Survey Organization (NSSO) found that there are an estimated 3.76 million people living below the poverty line in Kerala. It also found more poor people in the urban areas than in the rural regions. Compared to rural areas where roughly 13 percent of the rural population is below the poverty line, urban poverty is estimated at 20 percent of the urban population. The recent increase in urban population is likely to strain existing public goods and services.[31] The Economic Review (2009) points out that there is presently inadequate drinking water and sanitary facilities in urban areas. Besides the discretionary grant, the project will provide some capacity support under KILA or SIRD to Kudumbashree, a self help group organization of women that is heavily involved in poverty reduction in the State.

[30] In India, the poor are defined as those under the poverty line, that is, unable to attain 2400 calories/day in rural areas and 2100 calories/day in urban areas (Government of Kerala, Economic Review, 2009).

[31] Assuming a population growth rate of 1.4 percent per annum, average municipality population is estimated to be roughly 58,000 people.

4. *Alternative project argument*. The project design is compared with possible alternatives, including a no project scenario or a project for which funds are totally tied. Doing 'nothing' implies foregoing an opportunity to enhance systems and processes of GPs and Municipalities and thus, a setback to deepening Kerala's decentralization. On the other hand, a project with tied funding restricts local autonomy of GPs and Municipalities to undertake decision making regarding public investments. Furthermore, in the context of the State's improved fiscal position, a "gap filling approach" on fiscal transfers would be difficult to justify.[32] Therefore, a project that incentivizes GPs and Municipalities through a discretionary performance grant is a better option likely to provide greater impact under the State's current decentralization agenda.

5. *Economic rate of return argument*. What are the possible likely benefits to expect by investing a total of US$ 200 million in GPs and Municipalities? A strong assumption in this analysis is that the decisions taken by the GPs and Municipalities will reflect people's local preferences of possible investments identified through a local planning process. And that the chosen local public investments are likely to yield better rates of return over time. A priori, it is difficult to determine the exact type of public investments to be undertaken in a particular GP or municipality. It is also difficult to determine the magnitude of the flow of benefits over time. However, more broadly, it is known that the menu of public investments to be chosen draws from the twenty nine devolved functions in Kerala. Typically, such investments would include small roads, water supply and sanitation.

6. Generally, the efficiency gains associated with decentralization programs are difficult to quantify. The benefits include capacity enhancements to GPs and Municipalities and improved systems and processes, which are difficult to quantify. GPs and Municipalities will have access to discretionary grants that would incentivize them to better manage and execute their annual plans and budgets. The assumption is that more efficient GPs and Municipalities will highly likely invest in local public goods that carry a positive economic rate of return. Evaluations of similar subprojects such as those anticipated under the project show that they carry positive rates of return and/or have significant impact on rural livelihoods. Better rural connectivity increases accessibility to basic social services, schools, market centers, health centers and business centers. Strengthening rural connectivity increases mobility of people, lowers operating costs due to travel, and is likely to facilitate local economic development. In 2001, the Central Road Research Institute (CRRI) in Delhi carried out a study to evaluate rural roads in Rajasthan and found the internal rate of return to be 15.64 percent. The benefits estimated included the net incremental agricultural production value, net agricultural transport cost savings and non-agricultural vehicle operating cost savings. In another study by the Asian Development Bank (ADB) in 2002, rural roads were found to be important to enabling conditions for livelihood development for people in rural areas. The poor benefited through the indirect impact of road improvements, of better access to public services in the villages. In 2004, a study by the National Bank for Agriculture and Rural Development (NABARD) found net benefits from investments under rural roads per month in the range of between 20.2 percent in Tamil Nadu and 36.2 percent in Gujarat. A recent implementation completion report (ICR) of Kerala Rural Water Supply and Sanitation (KRWSS) project found that the project investments yielded an economic rate of return of 18.7 percent or a net present value of more than Rs. 400 million (US$ 8.9 million). The quantified benefits included (a) the value of time avoided from collecting water; (b) the value of incremental water

[32] See next section on fiscal sustainability.

consumption; (c) the salvage value of the infrastructure investments after 20 years of operation; and (d) the costs that would have to be incurred to retain existing water arrangements, including maintenance cost of existing water source, household level coping cost related to individual treatment of water (boiling) and individual storage (water tank). Overall, it is plausible to assume that the physical investments to be created by the GPs and Municipalities are likely to yield higher rates of return of 15 percent or more; since enhanced support to these LSGs is likely to improve their capacities and decision making processes.

7. *Fiscal sustainability*.[33] The analysis examines three issues related to fiscal sustainability: first, the impact of additional block grant funding on state transfers and the budgets of local bodies; second, the impact of the block grant on the macroeconomic situation of the State; and third, the incentives that the block grant would provide to GPs and Municipalities to support operations and maintenance of new as well as existing assets.

8. The project will provide US$ 238.6 million in performance grants to GPs and Municipalities over a four year period 2011/12 to 2014/15. The performance grant will be fully funded by the Bank for the first year; thereafter the GoK funding will phase in gradually over the subsequent three years. GoK funding will peak in the final year of the project. Table 1 shows the potential impact of the block grant under two potential scenarios: scenario 1 with projections over 2012/13—2015/16 is based on the GoK's own Medium Term Fiscal Framework (MTFF). This scenario assumes a growth rate of 14 percent in SFC transfers and state revenues. Scenario 2 assumes a growth rate of 10 percent in SFC transfers and state revenues over the projection period.

[33] This analysis draws from the Background paper, *Fiscal Analysis of Local Self Governments in Kerala*, which was prepared to inform the design of this operation.

Table 1: Aggregate Funding Scenarios for Additional Block Grant Allocations[34]

Total Rs Crore	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
Proposed Additional Allocations to Performance Grant						
Total Additional Performance Grant Allocations	**-**	**165**	**287**	**318**	**353**	**-**
Of which World Bank	-	165	240	224	212	-
Of Which GoK	-	-	47	94	141	-
Scenario 1 - Current MTFF Projections extended for 3 Years (14% growth 2012/13 to 2015/16)						
Total SFC Transfers	**2,889**	**3,488**	**4,109**	**4,692**	**5,359**	**5,729**
SFC Transfers Allocations in MTFF (Extended for 3 Yrs)	2,889	3,323	3,821	4,374	5,006	5,729
Additional Performance Grant	-	165	287	318	353	-
State Own Revenues	**23,199**	**27,491**	**31,372**	**35,906**	**41,096**	**47,035**
Additional Performance Grant as a % of total SFC Transfers	*0.0%*	*4.7%*	*7.0%*	*6.8%*	*6.6%*	*0.0%*
Existing SFC as a % of State Own Revenue	*12.5%*	*12.1%*	*12.2%*	*12.2%*	*12.2%*	*12.2%*
Additional Performance Grant as % of State Own Revenues	*n/a*	*0.6%*	*0.9%*	*0.9%*	*0.9%*	*0.0%*
Total SFC transfers as % state own revenues	*12.5%*	*12.7%*	*13.1%*	*13.1%*	*13.0%*	*12.2%*
Scenario 2 - Conservative Projections (based on 10% annual growth in State Own Revenues and SFC transfers)						
Total SFC Transfers	**2,889**	**3,343**	**3,784**	**4,164**	**4,584**	**4,653**
SFC Transfers Allocations with a 10% Annual Increase	2,889	3,178	3,496	3,846	4,230	4,653
Additional Performance Grant	-	165	287	318	353	-
State Own Revenues (10% Increase Annually)	**21,102**	**23,212**	**25,534**	**28,087**	**30,896**	**33,985**
Additional Performance Grant as a % of total SFC Transfers	*0.0%*	*4.9%*	*7.6%*	*7.6%*	*7.7%*	*0.0%*
Exising SFC as a % of State Own Revenue	*13.7%*	*13.7%*	*13.7%*	*13.7%*	*13.7%*	*13.7%*
Additional Performance Grant as % of State Own Revenues	*n/a*	*0.7%*	*1.1%*	*1.1%*	*1.1%*	*0.0%*
Total SFC transfers as % state own revenues	*13.7%*	*14.4%*	*14.8%*	*14.8%*	*14.8%*	*13.7%*

Source: Government of Kerala (2010b) and own computations

9. Under both scenarios, additional performance grant funding represent an additional allocation of between 7% and 8% of SFC allocations or one percent of total state own revenues. In case of scenario 1 these shares decline over time as growth in SFC and own source revenues outstrip the 10% increase in performance grant funding, whilst in scenario 2 they remain constant. Over time state transfers are maintained at around 13% of state own revenues under scenario 1 and 15% under Scenario 2. Under scenario 1 there is more fiscal space for GoK to take over the additional funding commitment. However, even under the more conservative Scenario 2, the project would still remain fiscally sustainable beyond the life of the project.

[34] GoK MTFF projections incorporate 13th National Finance Commission recommendations.

10. Table 2 shows the effect of introducing additional performance grant funding to Local Government budgets. Performance grant allocations would amount to approximately Rs 25 Lakh per GP and Rs 70 Lakh per municipality in 2012/13, rising to Rs 31 Lakh per GP and Rs 86 Lakh per municipality respectively by 2015/16. In per capita terms, GPs and Municipalities will in 2012/13 raise approximately Rs. 70 for GPs and Rs. 124 for municipality respectively.

Table 2. The effect of increasing discretionary revenues on GP Budgets[35]

	Gram Panchayat			**Municipality**		
	Rs Lakh excl PG	**Per Capita excl. PG**	***% Increase from PG***	**Rs Lakh excl PG**	**Per Capita excl. PG**	***% Increase from PG***
Additional funding from Performance Grant						
In first full year 2012/13	25	70	*N/A*	70	124	*N/A*
At end in 2015/16*	31	86	*N/A*	86	152	*N/A*
Potential effects of Performance Grant on overall expenditures						
Estimated LSG Expenditures in 2012/13	363	1020	*7%*	1182	1903	*6%*
Plan	226	*633*	*11%*	470	828	*15%*
Non-Plan	138	*387*	*18%*	712	1253	*10%*
Potential effects of Performance Grant on fully discretionary expenditures						
Discretionary Funding in 2012/13	46	130	*54%*	239	414	*30%*
Plan	*37*	*105*	*67%*	*15*	*27*	*464%*
Non-Plan	*9*	*25*	*283%*	*223*	*388*	*32%*
Potential effects of Performance Grant on capital and maintenance Expenditures						
Capital	50	140	*50%*	86	152	*82%*
Maintenance	43	120	*59%*	341	600	*21%*

Source: Government of Kerala (2007, 2008-2010, 2009, 2010c) and own computations

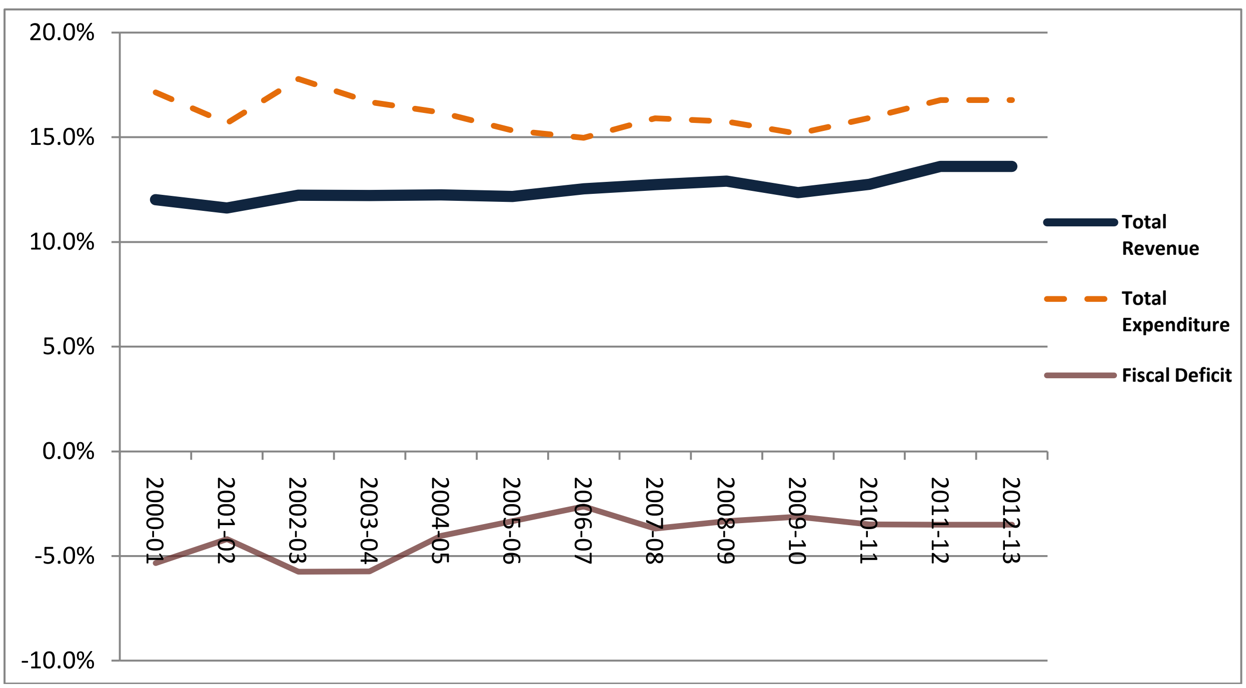
11. Overall, the impact of the performance grant funding on GP and municipality budgets is relatively small, amounting to a 6—7 % increase in funding. The effects are also small for both plan and non-plan expenditures. If the performance grant were to be totally untied, it would increase fully discretionary revenues by 51% in GPs and 28% in Municipalities. As a greater share of own funds are spent by GPs on plan expenditures, the effects of an untied grant would be greater on non-plan budget than on the plan budget. The opposite is true for Municipalities.

[35] These calculations are based on scenario 2. It is important to note that, whilst the absolute allocations increase at 10% a year, in relative terms the effects on discretion would decline slightly under Scenario 1.

12. If the performance grant were to be tied to capital and maintenance only, as is planned, then this would have significant effects on the discretionary funding available for these areas of expenditure. For capital, it would increase discretionary funding by 48% in GPs and 78% in Municipalities. For maintenance, it would increase discretionary funding by 56% in GPs and 20% in Municipalities. Overall, the performance grant allocations funded by the project appear fiscally sustainable. There is potential for a performance grant under the project to have a significant effect on the discretionary funding available to GPs and Municipalities for capital and maintenance. The performance grant is likely to provide incentives for local bodies to improve performance in terms of services delivered to the citizens.

13. In terms of the ability to sustain the project, the analysis shows that unlike in the early 2000s when the State faced fiscal stress, it has succeeded in reducing fiscal deficits and the projections suggest the trend to continue, at least over the life of the project. In other words, the State's overall fiscal position has improved over the last decade. State revenues have increased from 6,529 Crore in 2000/01 to 17,549 Crore in 2008/09, an increase of over 80% in real terms. With transfers from the centre also buoyant, overall state revenues have risen from 8,731 Crore to 24,512 Crore, an increase of 90% in real terms. These improvements have been sustained through the global financial crisis. The fiscal deficit as a share of state GDP has generally been on a downward trajectory falling from 5.2% of State GDP to 3.3% over the same period. The stock of debt and associated interest payments have also fallen as a share of State GDP. The 2010/11 budget projects overall revenues to be 106% higher than in 2000/01 in real terms at Rs 31,181 Crore, and the fiscal deficit only marginally higher at 3.5%. Over the medium term the state plans to maintain a similar sized deficit relative to state GDP.

Figure 1. Overall Fiscal Position of the State (% GDP)



Source: Government of Kerala (2010b) Medium Term Fiscal Plan

14. *Risks and mitigation measures*. The allocation of the discretionary grant is based on the assumption that GPs and Municipalities are able to absorb and expend the additional financial resources. However, there are risks that may impede implementation progress of the project. Such risks may include weak administrative capacity, elite capture, misappropriation of project funds, manipulation of the grant allocation process and corrupt practices in the award and execution of contracts. The project Governance and Anti-Corruption Action Plan (GAAP) (see Annex 8) analyzes the potential risks along the entire transaction chain, and provides mitigation measures to counter them. The mitigation measures include a performance assessment, allocation of grants based on an objective formula, enhanced transparency of resource utilization through local public planning and budgeting reporting, strengthened accounting and procurement practices in GPs and Municipalities, including prior and post-procurement reviews and audits.

Annex 8: Governance and Accountability Action Plan

INDIA: KERALA LOCAL GOVERNMENT AND SERVICE DELIVERY PROJECT

1. The project will strengthen existing governance arrangements at the State level as well as the LSGs with the objective of mitigating potential governance risks that may impede the project from achieving its objectives. The key tool for this is a Governance and Accountability Action Plan which has been developed through an analysis of the key transactions which are intrinsic to the project. At every stage in this “transaction chain”, potential risks are identified and corresponding mitigation measures have been developed.

2. In order to mitigate potential governance risks, measures have been carefully developed within the project to align with existing institutional arrangements. These measures take into account that all implementing agencies are governed by the Right to Information (RTI) law. The State has agreed the following management and reporting arrangements that will enhance governance arrangements of the project. The PMU will be responsible for decision of which GPs and Municipalities qualify for annual allocations of resources and the amounts of these allocations. All major contracts, and in particular, the selection of the independent consultants to undertake the annual PA, will require LSGD approval. The PMU will have the responsibility of reporting on these contracts to LSGD. The PMU will have significant governance responsibilities, including overseeing the implementation of project activities carried out by other project implementing agencies (e.g. KILA, SIRD, IKM, and DAC (in GIFT)). In other words, KILA, SIRD, IKM and DAC (in GIFT) are accountable to and report regularly to the PMU. The annual Quality Assurance Audit (QAA) will be contracted out to independent consultants who report directly to LSGD.

3. The matrix below summarizes the risks and mitigating measures which comprise the GAAP.

Governance and Accountability Action Plan

Transaction	Risk	Mitigation Measures and Indicators	Responsibility	Cost (US$ million)
a) Determine which GPs/Municipalities from universe receive grants in any given year.	Decision on which GPs/Municipalities qualify annually for Performance Grant might be politically based influenced.	Grant allocation based on objective, assessment of verifiable performance. PA subject to annual, independent, external quality assurance audit (QAA). PA and QAA contracted out. Results of PA and qualifying GPs/Municipalities simultaneously announced. Performance criteria and annual grant award given widely publicized. *Indicators: (a) 100% of GPs/Municipalities assessed annually; annual QAA confirms integrity of the PA process; (b) 80% of GPs/Municipalities qualify to receive grants by EOP.*	Managed by PMU and implemented by independent consulting firms.	Annual pro-rated share of following: PAs: $3.23 m QAAs: $1.33 m Communication Strategy: $2.55 m Supervision budget Management O/head (PMU)
b) Determine amount of annual grant allocation to each qualifying GP/municipality	Annual grant allocation (both amount and timeliness) to each GP/municipality could be politically manipulated.	Grant amounts determined by objective formula. Grant amounts verified annually. *Indicators: PA and QAA confirm the grant allocations were made according to the agreed formula for the year under review.*	Undertaken by PMU, approved by LSGD. World Bank supervision.	Annual pro-rated share of following: Supervision budget Management O/head (PMU)

Transaction	Risk	Mitigation Measures and Indicators	Responsibility	Cost (US$ million)
c) Local GP/Municipality control/management of Funds	Misappropriation of project funds at GP /Municipality level.	Strengthened accounting practices in GPs/Municipalities, fostered by: systems strengthening, timely external audits and linkage of adverse audits to disqualification of GPs from grant receipt. *Indicators: No. of GPs/ Municipalities which have well functioning fiduciary and planning systems, assessed independently (PAs and QAAs).*	PMU	Annual pro-rated share of following: Systems improvements sub-component ($2.0 m) PAs: $3.23 m QAAs: $ 1.34m Communication Strategy: $2.55 m Management O/head (PMU) $ 0.012m pa
d) Effective use of grant resources by GPs/Municipalities	Elite capture resulting in funds being used for purposes not in line with local needs.	Increased transparency of resource utilization through local public planning and budgeting reporting. *Indicators: numbers of GPs/Municipalities producing and disseminating local public reports.*	PMU, KILA and GPs. This is verified through performance assessment process.	Annual pro-rated share of following: PAs: $3.23 m QAAs: $ 1.34m GP and municipality Performance Impact Analysis: $0.22m (year 1) $0.27m (year 5) Management O/head (PMU) GP/municipality service delivery

Transaction	Risk	Mitigation Measures and Indicators	Responsibility	Cost (US$ million)
				and governance assessment subcomponent: $ 0.22 m (year 3) $ 0.27 m (year 5)
e) Procurement of goods, works and services by the GP/municipality level	Corrupt or fraudulent practices at GP/Municipality level in the award and execution of contracts.	(i). Improved procurement processes; (ii). Ongoing internal performance audit process; (iii). Capacity building program focused on strengthening procurement capacity. *Indicators: (a) Interim procurement and safeguards performance assessment of 10 % random sample GPs/Municipalities 18 months after project effectiveness; (b) annual PA of GPs/Municipalities .*	PMU, PAW, KILA.	Annual pro-rated share of following: PAs: $3.23 m QAAs: $ 1.34 m Interim Safeguard and Procurement Review: $ 0.206 m (year 1) GP and municipality Performance Impact Analysis: $ 0.218m (year 1) $ 0.27m (year 5) Management Overhead (PMU)
f) Procurement of goods and services at State level	Corrupt or fraudulent practices in the award and execution of contracts.	(i).Acceptable procurement procedures adopted and implemented; (ii) Prior and post-	Oversight by LSGD.	Prorated share of World Bank supervision.

Transaction	Risk	Mitigation Measures and Indicators	Responsibility	Cost (US$ million)
(LSGD and other executing agencies).		procurement reviews to be conducted; and (iii) Project audit. *Indicators: (a) results of the review processes.*		
g) Use of funds by executing agencies	Funds not used for agreed/ intended purposes	(i). Submission of utilization certificates to PMU; (ii). End of year audits; and (iii). Project supervision *Indicators*: timely utilization certificates.	LSGD (PMU)	Pro-rated share of supervision