1. Country and Sector Background

Karnataka is one of the most rapidly urbanizing states in India. The demand for quality urban services is increasing rapidly with the growth in urban population, incomes and competitive businesses that can be sustained only in an "efficient city" environment with reliable infrastructure and logistics. The mismatch between responsibility and financing, lack of accountability, weak capacity, and excessive controls impede service delivery, discourage investment, and stifle the economic potential of ULBs in Karnataka. Improving cities’ access to financing is necessary but not sufficient to overcome these challenges. A systematic approach is needed over the medium- to long-term to improve ULB performance, including state and local actions to: eliminate overlapping functions, institutions and distortions; streamline processes and procedures; promote transparency; improve performance incentives; monitor outcomes; and build capacity.

Limited Autonomy and Accountability at Local levels

The 74th Constitutional Amendment Act created a constitutional status for the third tier of government and, in principle, sought functional and fiscal devolution to local governments. However, in many states the devolution of administrative powers related to planning, financing, and managing municipal services has not yet become effective. Because there is little alignment between responsibility for outcomes and decision-making authority at the local level, municipalities in India continue to be entities devoid of meaningful decision-making authority, and revenue and expenditure autonomy, and hence, accountability for their performance. In all states, planning, financing, and in many instances management of municipal infrastructure and services continue to be the responsibility of state agencies. Karnataka is no exception in this regard, with highly fragmented arrangements for service delivery.

Table 1 Arrangement of Municipal Service Provision in Karnataka

<table>
<thead>
<tr>
<th>Sector</th>
<th>Planning</th>
<th>Design</th>
<th>Implementation</th>
<th>O&amp;M</th>
<th>Billing and Collection</th>
<th>Regulation</th>
</tr>
</thead>
</table>

Public Disclosure Authorized
<table>
<thead>
<tr>
<th>Service Type</th>
<th>KUWSDB</th>
<th>KUWSDB</th>
<th>KUWSDB</th>
<th>ULB / KUWSDB</th>
<th>ULB</th>
<th>GoK / PCB</th>
</tr>
</thead>
<tbody>
<tr>
<td>Water and Sewerage*</td>
<td>ULB</td>
<td>ULB</td>
<td>ULB</td>
<td>ULB</td>
<td>ULB</td>
<td>Deputy Commissioner (Traffic Safety)</td>
</tr>
<tr>
<td>Municipal Roads and Bridges</td>
<td>ULB</td>
<td>ULB(PWD</td>
<td>ULB</td>
<td>ULB</td>
<td>ULB</td>
<td>Pollution Control Board</td>
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<td>Solid Waste Management</td>
<td>ULB</td>
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<tr>
<td>Street Lighting</td>
<td>ULB</td>
<td>SEB</td>
<td>SEB</td>
<td>ULB</td>
<td></td>
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</tr>
<tr>
<td>Buildings and Structures</td>
<td>ULB</td>
<td>ULB(PWD</td>
<td>ULB</td>
<td>ULB</td>
<td>ULB</td>
<td></td>
</tr>
<tr>
<td>Slum Improvement and Upgradation</td>
<td>SCB</td>
<td>SCB</td>
<td>SCB</td>
<td>SCB/ULB</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Housing, Site and Service Development</td>
<td>KHB</td>
<td>KHB/ULB</td>
<td>KHB/Beneficiaries</td>
<td>KHB</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Note:** Water O&M: In certain cases Board maintains Bulk Supply and ULB the Distribution

* With the exception of Bangalore City where the BWSSB does everything from planning to billing and collection.

** In some cases such as in Mysore, the Mysore DA collects property tax on behalf of the Mysore CC.

While ULB responsibilities and functions are defined by the Acts, authority and financing are not congruent with these provisions, which impedes accountability and performance. ULBs in Karnataka operate with relatively little autonomy in decision making and with few incentives to improve their performance. Their functional responsibilities are compromised by a proliferation of boards and authorities (KUWSDB, KHB, SCB, DA, etc.) with overlapping scope and substantial autonomy but weak accountability and limited coordination with ULBs. This contributes to a mismatch between the supply of services and ULB needs, leading to low cost recovery and poor maintenance of the transferred infrastructure. Key ULB actions required to strengthen accountability and transparency include: enhancing financial disclosure; establishing fund-based accounting systems and conducting timely, external audits; establishing performance targets in budget formats; implementing participatory budgeting; and establishing citizen charters. As devolution proceeds, the State would need to redefine its role in the urban sector, focus on unbundling agencies such as the water and sewerage boards and the land development authorities, as well as undertake a comprehensive review of municipal and urban management legislation to reduce the highly fragmented nature of service delivery. Concurrently, Karnataka would need to build capacity in key areas of oversight and facilitation through the DMA, including: auditing, monitoring and benchmarking of municipal performance, promoting competition among ULBs; establishing MOUs and providing incentives for performance; and delegating additional local approvals.

**Limited Progress on Fiscal Decentralization and resource mobilization** An important dimension in the “unfinished agenda” created by the 74th Amendment is fiscal decentralization, especially as provided in the mandates of State Finance Commissions (SFCs). Reaching a better match (vertical equity) between functional and fiscal decentralization, strengthening the local government tax base, rationalizing transfers, and setting forth clear rules for municipal borrowing are areas that have not received the priority they deserve. Own-source revenues (principally the property tax) account for only 40% of total revenues, even in the largest cities. Similarly, ULBs in Karnataka are heavily dependent on transfers for much of their capital funding needs. Yet, most of these schemes flow to autonomous bodies rather than ULBs. In fact, ULBs have limited say in how most of these funds are used. At the same time, the resources they get through SFC grants, while “untied,” are closely linked to salary payments, which
means that ULB discretion to use these funds is also limited. At the same time SFC intercepts to pay for utilities and state level loans considerably reduce the transparency and predictability of transfers. Key ULB actions required to enhance resource mobilization include defining and implementing revenue enhancement plans with targets for improving collection, setting user charges, implementing property tax reform. Possible state actions include: repealing the 2.5 percent ULB surcharge on the stamp tax and offsetting the lost state revenue by reducing the SFC grant; eliminating the maximum property tax rate; establishing a central valuation agency to improve property valuation; enhancing the predictability of transfers, and defining a local borrowing framework to avoid local bailouts

*Rising Service Demand and Shortfalls in Investments.* Low investment levels can largely be explained by service charges and local taxes that are set too low, coupled with poor collection. Financing has been largely through budgetary allocations and a limited access to government controlled institutional finance. Urban areas need to make large investments to clear the huge backlog in the service provision while improving quality and managing existing assets more effectively. Wider coverage will require sharp improvement in cost recovery, revenue performance, budget and financial management, and creditworthiness of ULBs. Equally important for municipalities to increase the effectiveness of their investments is improved capacity to structure viable projects and identify opportunities for outsourcing.

*Poorly Performing Land Markets*  Land use efficiency is limited by regulatory and fiscal constraints. Policies and regulations (land ceiling act, rent control, regulations on conversion of use, high stamp duties) governing the land use in urban areas create artificial scarcity of urban land and fundamentally distort the economics of urban areas. Paradoxically, other regulations (e.g., subdivision regulations, FSI) tend to artificially increase land consumption. The net result is that urban land prices are abnormally high in relation to India’s household income, and households consume less floor space than they could afford if the regulatory environment were reformed. Without rationalization of regulations on land there will be no basis for a buoyant and efficient property tax system, more efficient use of existing primary infrastructure, and a decrease in illegal subdivisions and slum areas. While there has been considerable progress in Karnataka with repeal of the Urban Land Ceiling Act and Rent Control Act and delegation of some responsibilities to the municipal level, considerably more needs to be done to ensure a regulatory and fiscal framework and clarification of roles and responsibilities between the State and ULBs.

**Government Strategy**

Over the recent past the Government of Karnataka (GoK) has initiated substantive reforms to empower local governments, and is in the process of strengthening state-level administration to support and monitor performance of ULBs. With the help of various partners, GoK has implemented a number of reforms and taken action to begin to unlock the numerous constraints on effective ULB performance. It has also initiated the process of undertaking actions consistent with the national set of urban reforms promoted under the Urban Reform Incentive Fund (URIF):

- Repeal of the Urban Land Ceiling Act
- Reform of Property Tax: Karnataka has already adopted a capital value based property taxation.
- Rationalization of stamp duty tax: Studies have been launched to review options for rationalization and reduction of the rate.
- Introduction of computerized registries
- Introduction of accrual accounting systems: Fund-based accounting has been introduced, and initiatives are underway to expand this initiative
- Levy of reasonable user charges by Urban Local Bodies, with the objective of full cost recovery of O&M (operation & maintenance) by end of the Tenth Plan period: Tariff increases initiated in Bangalore, State Water Policy establishes a tariff policy for water.
In addition, Karnataka has accepted major reforms, as outlined by the committee on administrative reforms, primarily through increasing the devolution of powers, on a large scale, to departmental heads, deputy commissioners and local governments, and simplifying business processes. These include:

- Restructuring and enhancing the DMA's role in supporting system improvements in local governments, and also in overseeing all Corporations and UDA’s;
- Delegating HR and training related powers to heads of functional departments;
- Transferring supervision of corporations and personnel matters of KMAS officers to the DMA;
- Implementing a performance-based release of resources, as in the case of Bangalore City Corporation; and
- Conducting a comprehensive review of municipal legislation in the State.

On land issues, GOK has undertaken the following actions:

- Preparation by State Town Planning Board of an urbanization policy paper, including revisions to town planning legislation,
- Rationalization of staffing and automation of functions in the Town Planning Department, and transfer of select functions to Municipal Planning Authorities; and
- Simplification of planning procedures and reduction of time for plan formulation.

2. Objectives
The objectives of the project are three fold: (a) at the state level, foster the decentralization process through improved governance and oversight of local governments; (b) at the municipal level, enhance the accountability and financial soundness of the Urban Local Bodies (ULB) of Karnataka, and c) improve service delivery to the urban population.

3. Rationale for Bank’s Involvement
As noted previously, the project is in line with the GoI's strategic objectives and the Bank’s approach to urban development in India. This project focuses primarily on advancing reforms initiated by GoK and integrates components of GoI's ongoing reform initiatives, ensuring client ownership of the reform agenda. The Bank has incorporated key lessons learned in the urban sector in India and can draw on its worldwide experience in similar programs. Bank intervention would provide needed support to sustain the initiative for sector restructuring and ensure coherence between the proposed urban water municipal reform projects.

4. Description

1. Project components: (See Annex 1)

The proposed project has three main components. The detailed description is presented in Annex 1.

A. Policy Reforms and Institutional Support Component:

Key activities at the state level would potentially include technical assistance in the following areas, which would be finalized during project preparation:

- Implementing administration reforms and business process simplification in ULBs;
- Strengthening automation and capacity of DMA, regional DMA units and municipal staff;
- Improving state-level systems for accounting and establishing an urban finance framework;
- Implementing spatial policy and reforming land use regulations; and
- Rationalizing state transfers;
With regard to Bangalore Maha Nagara Palike (BMP) and other agencies such as Bangalore Development Authority (BDA), support would be available for:

- Computerization of functions in BMP, BDA and Bangalore Water and Sanitation Board (BWSSB);
- Capacity building of staff in BMP and BDA;
- TA for enhancing metropolitan governance in Bangalore;
- TA for Bangalore Unified Metropolitan Transport Authority;
- Strengthening of Strategic Land Use Planning capabilities in BDA.

B. Resource Mobilization and Financial Management Component:

- Implementing new capital-value based system and self assessment of properties;
- Automating/computerizing municipal functions;
- Strengthening financial management (budgeting, accounting, reporting and auditing) systems;

C. Investment Component

The two main subcomponents are:

Support for project development capacity and advisory services: The low level of ULBs’ capacity, especially with regard to their ability to formulate, structure, and manage infrastructure projects, is a key area of concern, especially for a project design based on self-selection of ULBs. This will be addressed through a Project Development Support subcomponent. It would include support for preparation of Capital Investment Plan (CIP) and priority infrastructure pipeline. It would also provide technical assistance to selected ULBs with regard to formulation and management of specific rehabilitation programs arising out of CIPs.

The preparation of CIP would be a two phased approach wherein, in the first phase, a rapid assessment of demands for rehabilitation and fiscal capacities will be carried out. The objective is to get an initial assessment of demand and financial capacities. This will be by way of integration of the CIP and a Financial Operating Plan (FOP). This initial plan will be debated within the local body and select stakeholders, and a priority plan will be drawn with initial costs. Based on approvals by KUIDFC, the second phase of this activity will involve detailed design. Based on the revised estimates, the local body will formalize the request to KUIDFC supported by a FOP and a revenue enhancement plan.

Performance linked investment program:

The investments support will primarily be towards rehabilitation of current assets. Access to investment for rehabilitation will be on the principle of selectivity. However, in order to firm up the pipeline of the project, an initial pre-selection will be carried out based on debt bearing capacity for select cities. For these cities, the CIP will be prepared and access to investment will depend on:

- Increase of at least 20% in property tax demand over previous year;
- Collection efficiency of over 70% with regard to property tax; and
- Demonstrated revision to water charges
- Debt servicing ability

While the access conditions mentioned above would apply to all cities, there will be a cap on level of
access by Bangalore. No restriction is envisaged in terms of withdrawals for investment.

D. Bangalore Development Program:

As the larger scope of the project is to support urban reforms, Bangalore, as the prime city in the state, will be supported by a separate component. The nature of support provided would cover all urban entities in Bangalore and investment support for basic services in BMP linked to reform / performance as outlined under Section C above.

Policy Reforms and Institutional Support Component:

Resource Mobilization and Financial Management Component:

Investment Component

Project Development Facility

Investment Support

Bangalore Development Program

Project Management

5. Financing

Source (Total (US$m))

BORROWER ($40.00)

IBRD ($160.00)

Total Project Cost: $200.00

6. Implementation

Institutional

Key concerns with regard to institutional arrangements of this project are the induction of a project manager, implementation of the outcomes of the TA’s on strengthening participating institutions (particularly KUIDFC), and the proposed division within the Urban Development Department (UDD).

Executing Agencies

UDD will assume the overall responsibility for implementing sector reforms and the project. KUIDFC is a state-level nodal agency, implementing major donor-funded urban development projects and centrally sponsored programs. KUIDFC would implement rehabilitation investment related components of the project and manage the project development advisory facility (PDAF).

As reform requires constant dialogue with the state, the Directorate of Municipal Administration (DMA) will directly oversee implementation of reform activities. The implementation structure of both KUIDFC and DMA will be determined by the Project Operation Manual and action plan of GoK on implementing the business plan of KUIDFC. However, GoK, based on the recommendation of the Administrative Reforms Committee, has streamlined procedures and restructured the office of DMA, and the project functions will be managed by staff to be inducted as part of the new structure. As KUIDFC’s exposure is limited in terms of project development and management, a strategic partner will support KUIDFC in this regard [GoK to decide]. This will be a financial institution or advisory agency and would provide support to local governments in project development and coordination of Private Sector Participation in Urban Infrastructure.

The Directorate of Town Planning (DTP) will implement urban planning and mapping components of the project. While DTP will outsource most mapping functions, the implementation structure will be
determined during preparation.

The urban local bodies (ULBs) will implement sub projects approved by UDD. Wherever necessary, services of non-governmental organizations / private sector will be procured in project implementation.

**Project Management**

Overall implementation responsibilities will rest with UDD. The project management procedures and the respective responsibilities of the key agencies will be defined in detailed Operational Manual [to be prepared by GoK].

**Financial Management**

A broad framework of the funds flow arrangement of the project has been agreed with GoK under which the funds from GoK, after having been received from GoI, would flow to the two proposed implementing agencies under the project, namely, KUIDFC for the rehabilitation investment component (including funds for BDP) and DMA for the capacity building and reform component. The exact terms (loan vs. grant, interest rate, repayment, etc.) and details of the flow of funds from GoK to KUIDFC would be finalized during preparation in line with ultimate use of the proceeds and sustainability. Financial Monitoring Reports (FMR), required from the start of the project, would be designed in consonance with the project components to track financial, physical and procurement related progress of the project. It is envisaged that the Bank shall receive comprehensive audit reports, preferably compiled at the overall project level (implementing agencies would be clearly identified in the project financial statements) within six months of the end of the fiscal year. The terms of reference of the auditors (which may be an independent firm of chartered accountants or the Office of C&AG, depending upon the legal status of the implementing agency) would be approved by Bank. Staffing for finance and accounts function, along with requisite training, at each of the implementing agencies would be assessed and finalized during the project preparation. The need and scope of the internal audit arrangements for the project will be evaluated during project preparation.

**7. Sustainability**

The sustainability of services from physical investments would be subject to the following risks: (a) the willingness and capacity of municipalities to establish improved financial management and budgetary processes, cost recovery and enhanced local revenue generation; (b) the willingness and capacity of municipalities to increase funds for O&M; and (c) the ability of state government to enable and assist municipalities with these measures.

The sustainability of municipal institutional development and capacity-building would depend on (a) the effectiveness of GoK's pursuit of urban sector reform and (b) strengthened capacity at state level to monitor and reward performance and provide support.
8. Lessons learned from past operations in the country/sector
Urban projects in India financed by the Bank have not been sustained due to limited fiscal and absorptive capacity of the borrowers, partly reflected by complex project designs and lack of client ownership. In March-April 2000, a review of the Bank’s assistance in the urban sector was carried out as an input to a Country Assistance Evaluation (CAE) review. It found the performance of most urban and urban water and sanitation projects was less than satisfactory, and the project benefits and assets financed lacked long-term sustainability. The study explained that this was the result of the complex nature of projects in relation to local client capacity and a lack of ownership of reforms needed to make the projects sustainable. However, the same review pointed to important changes in the Indian urban context and emphasized that the Bank’s decreased involvement in the urban sector in India had led to missed opportunities. Lessons learned and reflected in project design include:

State-level commitment to urban policy reform: This is essential to enhancing the fiscal, administrative, and management capacities at the local level. It requires agreement on the scope of reform and demonstrated up-front actions at both state and local level.

Sustainability of investments requires greater alignment of responsibilities for investment and O&M and enhanced capacity to structure viable projects.

Alignment of investment objectives with capacity: The limited absorptive capacity of local bodies to plan, finance, and manage urban services is due not merely to limited skills but to the constraints placed by the Acts in terms of revenue enhancement, accounting issues, fragmented responsibilities, and poor incentives to improve performance. The CIP would include a plan that demonstrates the fiscal capacity of the borrowing entity and the commitment to further improvements to achieve CIP targets. Finally, the decision to support investment would also be based on enhancement of capacities including program to upgrade staff capacities.

Selectivity in operations. While support for municipal reform would be statewide, access to investments for rehabilitation, funded under the Bank project would be based on performance. The emphasis on ULB performance and reform should also enable both the state and ULBs to access resources from the various funds created by GoI (Urban Reform Incentive Fund, City Challenge Fund, and Pool Financing).

9. Environment Aspects (including any public consultation)
   Issues:
The project is likely to make contribution towards improvement of the environmental condition in the urban areas by providing and expanding basic infrastructure, and increasing the efficiency of urban service delivery. The project is, however, expected to have moderate to significant environmental impacts, both positive and adverse, mainly associated with the proposed infrastructure investment component. There are possibilities of adverse impacts, if the investments are not properly planned, sited, designed, constructed, operated and maintained, such as site selection and safe management of solid and liquid wastes. Potential also exists for the triggering of safeguards policy related to cultural property, which includes places of worship, which are very common in urban areas.

Environmental issues and aspects of Capital Investment Plan (CIP) for individual cities and ULBs should also be considered in the regional context. While ensuring that each CIP has the relevant environmental coverage, broader environmental issues having cross sectoral linkages should also be considered. This consideration should be followed by an analyses as part of long term planning exercise. The capacity building including training to identify, assess and manage environmental issues should be integrated in the Institutional support component.
A Sector Environmental Analysis and Management Framework (SEA&MF) will be prepared to screen all of the proposed subprojects for their potential impacts (induced, cumulative, and long-term impacts) and include guidelines for preparing sub-project specific environmental mitigation plans and EA reports for those sub-projects that are likely to cause significant adverse impacts. This SEA&MF will be built on the lessons learnt from the recently closed TNUDP and ILFS projects and the similar frameworks that are being developed for the upcoming AP and Gujarat Urban projects. SEA will also include framework for sub-project review and determine the need for a project specific EA, as and when the investment component is defined. The environmental analyses will include identification of key urban environmental issues, scoping of baseline conditions, comparison of investment alternatives, identification of significant environmental effects, generic mitigation measures for expected types of investment components and also identify the implementation requirements such as institutional arrangements and capacity building at the state and local level (such as ULBs) including BMP and BDA. The SEA would also cover broader regional issues such as cumulative impacts, potential induced urbanization, and environmental management pertaining to potential private sector participation in urban infrastructure and with respect to contractual obligations and regulation. The management framework will include developing guidelines for management and a monitoring system. The monitoring system will track project's reform and investment related activities and its impacts including capacity building initiatives.

It is proposed that the Terms of Reference (TOR) for SEA&MF be developed jointly between KUIDFC and the bank, along with participation from DMAs and other appropriate stakeholders after PCD is approved. The finalized TOR would be used by GoK to competently recruit the services of consultants who would be able to complete the work before project appraisal. The TOR for SEA&MF would be prepared in close coordination with the social assessment activity.

The SEA would have three main objectives:

- Contribute to overall project enhancement by integrating at an early stage environmental concerns in institutional and policy reform, Capital Investment Plan (CIPs), preparation of performance linked investment programs, participatory planning and design of sub-projects, and monitoring and evaluation of project impacts. Accordingly, strengthen capacity of ULBs in environmental planning and management.
- Provide guidance to the formulation of project-specific environmental and social assessments to ensure sub-project compliance with national, state and Bank environmental and safeguards policies, at both preparation and implementation stages.
- Improve the quality of project design to promote the bankability of projects and attract public and private financing.

The management framework would include developing an institutional mechanism and structure for

- Environmental and social assessment at the planning/strategic level;
- Environmental and social screening of identified sub-projects,
- Environmental and social assessment of sub-projects,
- Management, mitigation and monitoring of social and environmental impacts during project implementation; and
- Public consultations with beneficiaries and framework planning workshops with concerned parties

It is understood that the project would focus on financing investment in urban basic services wherein the
significant environmental issues would relate to direct environmental impacts if the investments are not properly planned, sited, designed, constructed, and operated and maintained. In addition, significant environmental issues could also arise over the long-term due to cumulative / induced impacts of a large number of investments. As for the reform component of the project, significant indirect environmental issues could be avoided through good town planning and land management, adequate budgets for operation and maintenance of basic infrastructure, the ability of the urban poor to pay for services, adequate capacity of the municipal bodies to prepare and implement subprojects, etc. All potential social and environmental impacts -- including induced, cumulative and long-term impacts -- related to the various project components will be identified in a SEA&MF. In addition, environmental issues pertaining to potential private sector participation in urban infrastructure and environmental management - such as municipal solid waste disposal and sewage treatment and disposal, would need to be examined, particularly with respect to contractual obligations and regulation.

10. List of factual technical documents:

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Note: This is information on an evolving project. Certain components may not be necessarily included in the final project.