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From Crisis to Greater Fiscal Independence

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ABBREVIATIONS AND ACRONYMS

GCI	General Control Institute
GHI	Government Health Insurance
GPIC	Gaza Pension Insurance Corporation
MOEHE	Ministry of Education and Higher Education
MOF	Ministry of Finance
MOH	Ministry of Health
MOP	Ministry of Planning
MOSA	Ministry of Social Affairs
MRC	Ministerial Reform Committee
MTDP	Medium Term Development Plan
NHSP	National Health Strategic Plan
ODP	Organizational Development Plan
PA	Palestinian Authority
PCBS	Palestinian Central Bureau of Statistics
PECDAR	Palestinian Economic Council for Development and Reconstruction
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PHC	Primary Health Care
PIF	Palestine Investment Fund
PICCR	Palestinian Independent Commission for Civil Rights
PMA	Palestinian Monetary Authority
RCSU	Reform Coordination and Support Unit
TEI	Tertiary Education Institutions
TIM	Temporary International Mechanism
UNRWA	United Nations Relief and Works Agency

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CHAPTER 1: RECENT MACROECONOMIC AND FISCAL DEVELOPMENTS

1. Key Issues and Challenges

Recent political events have ushered in a period of exceptional uncertainty in the West Bank and Gaza. Hamas' election victory in January 2006 led to a stalemate in political dialogue between the Palestinian Authority government, donors and the Government of Israel. The internal political rift between the two dominant Palestinian factions, Hamas and Fatah, fueled tensions and resulted in intermittent violence, especially in Gaza. After a series of f failed attempts, negotiations to form a coalition government have finally been successful, with an agreement between Hamas and Fatah reached in Mecca in early February 2007. Many donors, chiefly the United States and the European Commission, have imposed anti-terrorist financing legislation on transactions with the PA and ceased all financial support channeled through the PA. The Government of Israel decided to withhold the customs tax and VAT it collects on behalf of the PA. Severe restrictions on the movement of Palestinian people and goods, which the GOI argues are necessary for security reasons, remain firmly in place.

Beset by closures, violence and a fiscal crisis, the Palestinian economy is declining from an already low level. According to preliminary Palestine Central Bureau of Statistics (PCBS) data, real GDP per capita could decline by 8–10 percent in 2006, bringing the cumulative decline in average incomes to over 30 percent since 1999. About a quarter of the Palestinian labor force is out of a job. The situation is particularly tenuous in Gaza, where the unemployment rate increased to 36 percent in 2006, versus 29 percent in 2005. Stepped-up donor support in 2006 played a major role in preventing the economy and household incomes from falling even more rapidly. The economic outlook is precarious. In the short term, continued high levels of donor assistance are critical for sustaining the Palestinian economy. A solid foundation for future growth, however, depends critically on two factors:

- *Radical improvement in Palestinian movement and access.* Under the current set of restrictive measures the Palestinian economy will remain moribund.
- *Stabilization of the PA's fiscal situation.* This would require resumption of the transfer of clearance revenue and a significant fiscal adjustment by the PA.

Even before the present financial crisis, the PA's fiscal situation was unsustainable. The immediate crisis was precipitated by a combination of factors arising in the wake of Hamas' victory in January 2006. These factors include the Government of Israel's decision in February 2006 to suspend the transfer of clearance revenue, which accounts for over 60 percent of the PA's revenues.[1] The PA's past profligate spending policies exacerbate the current crisis. For example, despite a revenue crunch during the *intifada*,

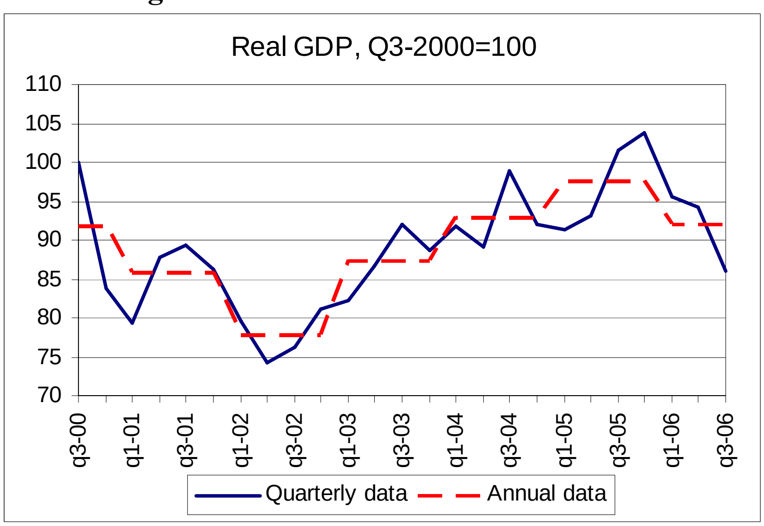
[1] For a description of the clearance mechanism, see *West Bank and Gaza–Economic Developments in the Five Years since Oslo,* by Alonso-Gamo, Alier, Baunsgaard, and von Allman, IMF 1999.

the PA's wage bill increased unabated at a rate of 11 percent between 1999 and 2005. Moreover, since 2003 the PA has increasingly been the "financier of last resort" that covers unmet financial obligations of other public entities (e.g. fuel purchases by the Palestinian Petroleum Commission and electricity purchases by West Bank municipalities). In 2005 such payments drained the public resource envelope by $344 million, or more than 5 percent of GDP. New social benefit programs and pension laws were adopted which have also increased the burden of social transfers for the PA. The resulting increase in the deficit was mostly covered through domestic financing (PIF, bank loans), but this source of financing has reached its limits. Thus, if and when the current crisis is resolved, the PA will still face significant challenges. If they are not addressed, these challenges will be a source of instability and a detriment to future growth.

2. Recent Macroeconomic Trends

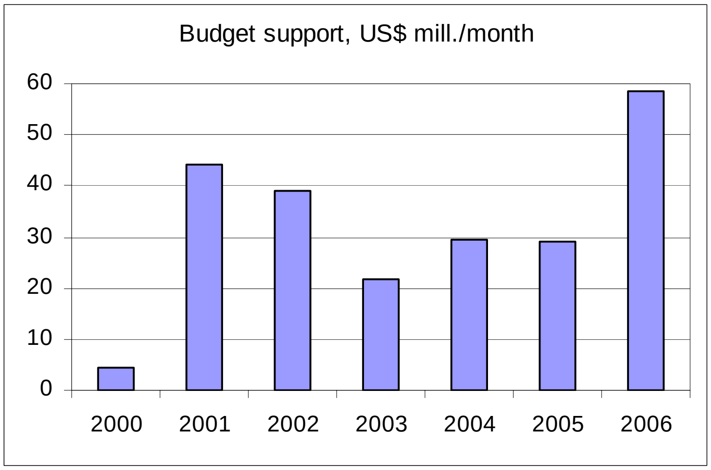
The Palestinian economy is declining. Quarterly GDP data recently released by the Palestinian Central Bureau of Statistics show that GDP (in real terms) declined steadily during the first three quarters of 2006 (figure 1.1).[2] Calculated as an average over the year, the decline is equal to 5–6 percent—adding population growth of 3–4 percent, the decline in per capita GDP amounts to 8–10 percent. This is a sharp reversal of economic trends for the past three years, in which the Palestinian economy recovered from its precipitous decline during the first three years of the *intifada*. A decline of this magnitude would leave GDP per capita around $1,000 and real GDP per capita some 32 percent lower than in 1999.

Figure 1.1: Real GDP Declined in 2006



[2] The Quarterly National Accounts data are only preliminary and may be revised later. Due to difficulties on the ground, the quality of the underlying data is deteriorating. PCBS estimates of indirect taxes—which determine the difference between GDP at factor costs and GDP at market prices—is particularly subject to uncertainties, as the clearance revenue is not being transferred.

Figure 1.2: Budget Support from Donors to the Palestinian Authority, 2000–06



Stepped-up donor support has played a major role in sustaining the economy and household incomes. Following the inauguration of the Hamas' government in March 2006, donors were unwilling or unable to provide direct financial flows to the PA government (see discussion below). At the same time, however, donors significantly increased the flow of rapid-disbursing assistance flowing to the West Bank and Gaza through channels outside the government. The IMF estimates that a total of $700 million was provided in budget support in 2006, compared to $349 million in 2005. Data for other types of donor support (emergency/humanitarian assistance, mainly development aid) are notoriously more difficult to measure. Indications are that disbursements of emergency/humanitarian assistance have increased in 2006, while disbursements of development aid have declined.[3] The Bank estimates that $100 million in additional donor support increases Palestinian GDP by 2–3 percent—therefore, the increase in budget support alone may have prevented a further fall in GDP of 8–10 percent.

Figure 1.3: Exports to Israel, 2000–06

[3] For example, as of September 30, 2006, the UN's Refugee and Works Agency (UNRWA) had received pledges worth $129 million against their emergency appeal, an increase of 15 percent over the pledges for the full year in 2005.

Closures remain tight, to the detriment of Palestinian export. Movement restrictions and border closures continue to stifle the normal conduct of commercial activities. In interviews for the Bank's forthcoming West Bank and Gaza Investment Climate Assessment more than 60 percent of Palestinian businesses reported that instability and transportation issues are the most important impediments to Palestinian private sector activity. The Bank's ongoing monitoring of Palestinian movement and access shows that the number of trucks carrying exports from Gaza have dropped 40 percent from an already low level at the beginning of 2005, and remain far from the targets set in the November 15, 2005 Agreement on Movement and Access. In their monthly business survey, the Palestinian Central Bureau of Statistics reports that conditions continue to worsen for business owners. In 2005, when economic growth was relatively strong, perceptions leaned toward the positive, with only 10 percent of firms on average indicating month to month that conditions had deteriorated. In 2006, that proportion more than tripled to 34 percent. Palestinian export to Israel, the main market for Palestinian exporters, declined by 15 percent in nominal terms during the first half of 2006 compared to the previous six-month period.[4]

Figure 1.4: Workers in Israel, 2000–06

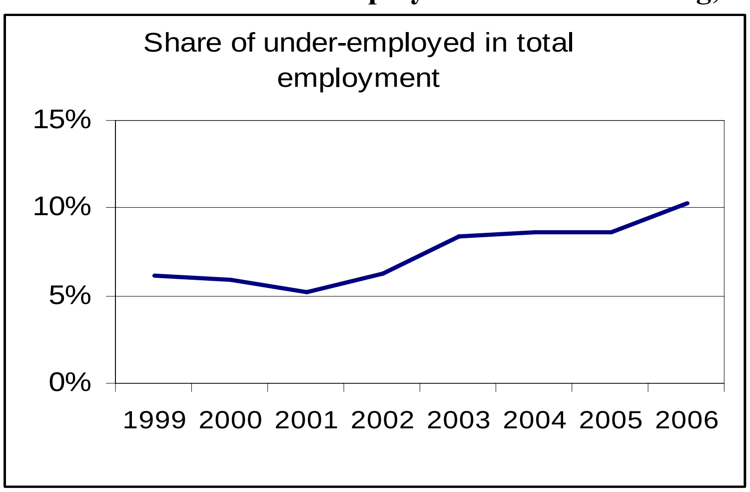
Movement restrictions have reduced the number of Palestinians working in Israel. An average of 35,000 Palestinians worked in Israel and Israeli settlements during the first six months of 2006, compared to 40,000 in the year 2005—a decline of 12 percent.[5] The decline was especially large for workers without permits, indicating increasing difficulties for clandestine workers in circumventing Israeli checkpoints and other restrictions, including the Separation Barrier. The number of Palestinian workers with permits declined 7 percent. Virtually no Palestinians from Gaza work in Israel anymore.

[4] While this is a large decline and an indication of a further tightening of the closure regime, it is still smaller than assumed in the March 15 "Worst Case" Scenario.
[5] The numbers exclude an estimated 24,000 Palestinians residing in East Jerusalem who can work unhindered in Israel.

Figure 1.5: Levels of Employment in the West Bank and Gaza

Although employment declined in Gaza, it held steady in the West Bank. During the first nine months of 2006 the number of jobs in Gaza declined 11.2 percent compared to the same period a year before. Between the third quarter of 2005 and the third quarter of 2006 almost 20,000 jobs were lost in Gaza. At 166,924, the number of jobs in Gaza has fallen close to its level six years ago, on the eve of the *intifada*. The unemployment rate (by ILO definition) in Gaza reached 36.3 percent. By contrast, in the West Bank employment levels during the first 9 months of 2006 have increased moderately compared to the same period a year ago, partly as a result of increased employment in the service, manufacturing and transport sectors. Consequently, the unemployment rate in the West Bank remained roughly unchanged and reached 19.1 percent in the third quarter of 2006.

Figure 1.6: The Share of Under-Employed Workers is Rising, 1999–2006



Increased scarcity of jobs has led to more part-time workers. The share of workers reporting that they work less than full time has increased steadily the past year. In the third quarter of 2006 the share reached 11.6 percent, up from 7.3 percent in the fourth quarter of 2004.[6] Employment data for the fourth quarter of 2006 is scheduled to be released in February 2007. Projections based on the current situation would estimate further job-losses, although the olive-harvest was reportedly exceptional this year, and may have led to an increase in temporary job creation.

According to the IMF (2006), the banking sector remains relatively sound, despite the depressed economy. Private sector deposits continue to grow, albeit slowly, and banks are liquid. While banks have a sizable exposure to the PA and to its employees, the situation should be manageable, at least for the near future. PIF assets guarantee a large part of bank loans to the PA, and the PA employees' debt service obligations currently due are small. Some banks recently deducted small amounts from the latest partial wage payment to government employees to help cover interest due. Banks did not suffer much from the decline in the stock market—a fall of about 50 percent since mid-January 2006—as their exposure was fairly limited and the book values of equity investments had not reflected the substantial gains made prior to the drop in share prices.

3. Fiscal Trends—A Brief Historical Review

In its early years, the PA's revenues increased rapidly. During the five-year period from 1995 (the first full year of the PA's functioning) to 1999, the PA's revenues almost doubled, from $510 million in 1995 to $942 million in 1999. The main driver was a rapid increase in clearance revenue, which reached $580 million in 1999, 62 percent of the total revenues for the year. Domestic revenues also increased strongly, due to the rapid establishment of tax collection capacity in the West Bank and Gaza. By 1999, the revenue-to-GDP ratio had reached 22.6 percent, up from 15.8 percent in 1995 (see table 1.1).[7]

The outbreak of the *intifada* in 2000 and the associated economic crisis had an immediate negative impact on PA revenues. In July 2000, PA revenues reached their pre-*intifada* peak at $95 million. By December 2000—three months into the *intifada*—revenues had declined to $49 million, a decline of roughly 50 percent.[8] The steep decline reflected tightened restrictions on the movement of goods in and out of the West Bank and Gaza, and cutbacks in Palestinian consumer spending, both of which reduced imports. Consequently, fewer trade taxes were collected by the Government of Israel on behalf of

[6] The number of hours worked by those who report being under-employed is unknown. Assuming that they work half-time, the increase in the share of under-employed has resulted in a 2.2 percent decline in the total number of man-hours.

[7] Following the increase in revenue collection, concerns about transparency in public finances emerged, particularly concerning the diversion of tax revenues to accounts outside the control of the Ministry of Finance, the growth in semiprivate PA investments and the unauthorized revenue collection by various PA entities, notably the security services (Brynen 2005; IMF 2003). Significant improvements in public financial management were carried out from 2002 onward and redressed many of the past deficiencies (World Bank 2004).

[8] These revenue figures include clearance revenue collected by GOI but not transferred during 2001−02.

the PA. The moribund economy kept PA revenues at an average of $52 million per month through 2002. Beginning in 2003 revenues gradually started to recover. By December 2003, revenues (in nominal terms) reached pre-*intifada* levels for the first time.

Box 1.1: Clearance Revenue

The Paris Protocol of Economic Relations of 1994 established the guidelines for a revenue clearance system between the GOI and the PA. Under the operation of the quasi-customs union, Israel collects a duty on foreign imports entering the West Bank and Gaza, as well as a VAT for Israeli products destined to the Palestinians. Indirect tax collection is based on actual payments or bookkeeping transactions and has a unified invoice system to support the claims. For custom duties, VAT, and purchase taxes on third- party goods imported by Palestinian companies for the West Bank or Gaza, a code sharing system ensures the correct amounts are being transferred. Indirect taxes like the VAT are collected and transferred to each side after the reconciliation of accounts and according to a "destination principle." At the end of the month, the PA reports the amount of taxes collected by Israel, and the Israeli administration, conversely reports its share collected by the PA, over which a net claimed is settled. The GOI charges a 3 percent handling fee of the total gross clearance revenue collection.[9] For direct taxes paid by Palestinian workers in Israel and its controlled areas the Protocol established that the income tax collection should be shared by both governments. Therefore, the PA keeps 100 percent of the health fees and receives 75 percent of the income tax under the assumption that workers will most likely consume social services in the West Bank and Gaza.

Clearance revenues were transferred on a monthly basis up to the start of the second *intifada* in 2000. Transfers were suspended by the GOI in December 2000 and only resumed in late 2002. Clearance revenues are the most important source of income for the PA, accounting for two thirds of total revenue (see the table below). Gross clearance transfers amounted to US$757 million for 2005, equivalent to US$63 million per month. Thus, the decision of the GOI to stop transferring clearance revenue by mid – February after Hamas' election victory at the January 25 Parliamentary elections resulted in an average revenue shortfall of about US$ 60 million per month for the PA treasury.

PA revenues (US$ millions)[10]

	2001	2002	2003	2004	2005
Revenue	275	295	763	954	1,233
Domestic revenue	275	223	291	337	476
Tax revenue	183	141	167	191	231
Non tax revenue	92	82	124	146	245
Clearance revenue[11]	0	72	472	617	757

Source: IMF and MOF

The GOI's decision to stop transferring clearance revenue is a violation of the Oslo accords, under which there is no clear provision for Israel to withhold clearance revenues. It is not illegal under Israeli law, which grants such discretion to the Minister of Finance and recognizes international agreements only to the extent that their provisions have been ratified by the Knesset. A case was brought to the Israeli Supreme Court in which the petitioners sought to force the GoI to release the funds. However, the Supreme Court rejected the petition, and in so doing agreed with the GoI that withholding the funds was within the discretion of the Minister of Finance to prevent the funding of terrorist activities. In terms of international law, the issue is open to debate.

[9] West Bank and Gaza Strip: Economic Developments in the Five Years Since Oslo, IMF, November 1999
[10] Economic Monitoring Note, World Bank, Spring 2006
[11] Clearance revenue figures include VAT refunds.

In the initial Oslo period, the PA's recurrent expenditures increased rapidly but were broadly in line with revenues. High initial growth in public expenditures and staffing were expected as a new government apparatus was to be set up basically from scratch. However, the increase also reflected attempts to integrate returning Palestine Liberation Organization employees into the public service and to absorb workers being repatriated, mainly from Gulf countries, in the wake of the first Gulf war and for this reason expenditure growth clearly exceeded what was necessary for the PA to take up its new responsibilities (World Bank 1999). Public employment increased from 57,000 in 1995 to 99,000 in 1999, an annual staffing growth of almost 13 percent.[12] The concurrent growth in the wage bill amounted to approximately 14 percent a year, implying a relatively modest increase in average public salaries of 1–2 percent a year. By 1999 public expenditures amounted to 22.6 percent of GDP, or some $78 million per month, and were fully covered by PA revenues, leaving a balanced recurrent fiscal position.

[12] Thus, in this period, the growth in the public payroll outpaced population growth by more than 2 to 1.

Table 1.1: PA Fiscal Operations, 1995-2005
(millions of dollars)

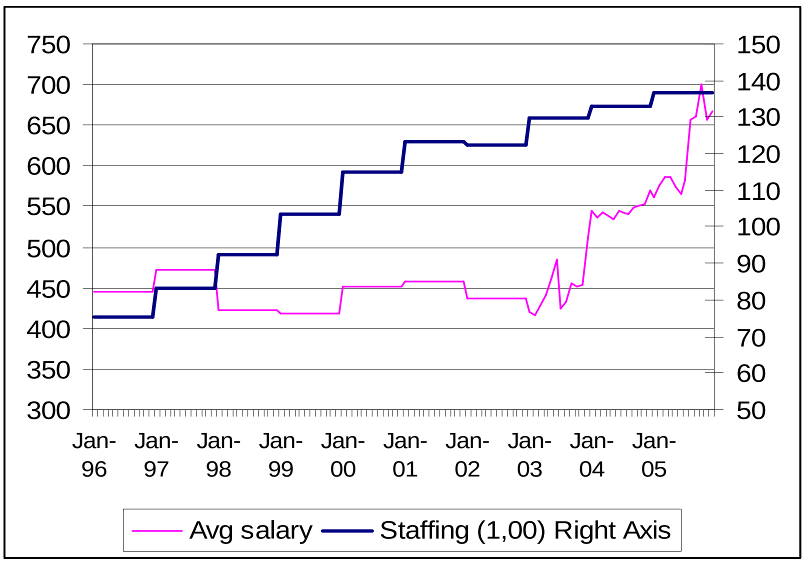
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Revenue	510	645	807	868	942	939	275	296	763	954	1,232
o/w Gross domestic	244	294	331	324	362	352	275	224	291	337	476
o/w Tax	144	208	213	228	248	241	183	141	167	191	231
o/w Nontax	100	86	118	97	114	111	92	82	124	146	245
o/w Gross clearance	266	352	476	544	580	587	0	72	472	617	757
Total expenditure (including net lending and VAT refunds)	578	781	862	838	937	1,212	1,119	1,022	1,292	1,528	1,994
Recurrent expenditure	578	781	862	838	937	1,199	1,095	994	1,067	1,320	1,594
o/w Wages	304	403	470	467	519	622	678	642	743	870	1,001
o/w Civil service	194	na	na	na	320	378	426	404	456	538	614
o/w Security services	110	na	na	na	199	244	252	239	288	333	387
o/w Nonwage expenditures	274	377	392	372	418	577	417	352	324	449	593
o/w Operating	na	na	na	na	na	na	na	na	124	193	179
o/w Transfers	na	na	na	na	na	na	na	na	201	257	375
o/w Debt service	13	10	9	16	17	7	–1	6	10	25	39
PA-financed capital expenditure	0	0	0	0	0	13	22	23	36	36	44
Balance	68	135	55	30	5	274	842	721	340	402	406
Net lending	0	0	0	0	0	0	0	0	173	157	344
VAT refunds	0	0	0	0	0	0	2	5	16	16	12
Overall balance	68	–135	–55	30	5	274	844	726	529	574	762

Source: Ministry of Finance, IMF, and World Bank staff estimates.

Despite the revenue crunch during the *intifada*, the PA's wage bill continued to increase at a rate of 11 percent a year between 1999 and 2005. Compared with the pre-*intifada* period, the increase was driven more by increases in average public sector salaries than by higher payroll numbers. Nevertheless, by the end of 2005, 137,000 persons were on the PA payroll, compared with 104,000 at the end of 1999, an average annual growth of 4.7 percent. The period 2003–05 witnessed two large salary hikes. The first occurred in late 2003 when part of the wage increase envisaged in the Civil Service Law, pending since 1998, was implemented. As a result, average wages in the first quarter of 2004 jumped more than 20 percent compared with levels a year before. There was another 20 percent increase in average salaries in the second half of 2005.

In the last quarter of 2005, the average salary for a PA employee reached $676 per month, up from $559 the year before, an increase of 21 percent (figure 1.7). The second round of salary increases disproportionately benefited security service staff relative to civil servants.[13] At the beginning of 2003 civil servants earned 20 percent more on average than security service staff. By the end of 2005 the difference had narrowed to less than 5 percent.

Figure 1.7: Palestinian Authority Staffing and Average Public Sector Salary



Note: The average salary is calculated by dividing the monthly wage bill with the year-end staffing levels; thus, the monthly variations in the average salary reflect wage bill variations and should be treated with some caution, though the trend is believed to be robust.
Source: Ministry of Finance, International Monetary Fund and World Bank staff calculations.

[13] Average wage numbers are subject to several uncertainties. First, monthly payroll data do not exist for the entire period. Only year-end data are available, and monthly data have been linearly interpolated from the annual data. Second, payroll data for the security services are particularly weak because the security service payroll is not fully controlled by the MOF. The quoted figures are based on MOF data; if payroll figures underreported the actual number of staff, the calculated average salaries would be similarly overestimated.

Since 2003 the PA has increasingly been the “financier of last resort” covering unmet financial obligations for other public entities, among them chiefly the following:

- The PA settles utility bills from Israeli suppliers that municipalities have not paid. Municipalities, in particular in the West Bank, are the main retail providers of water and electricity. These payments are “netted out” from the monthly transfer of Palestinian customs revenue and amounted to a total of $132 million in 2005 ($11 million a month).
- The PA has a contractual obligation to supply fuel for power generation by the Gaza Electricity Company, which cost $119 million in 2005 ($9 million a month).
- The PA must make payments to the Petroleum Commission, the PA owned monopoly importer of petroleum products. The Petroleum Commission sells its product at a loss, which has to be covered by the PA. In 2005 this amounted to $98 million, or $8 million a month (table 1.2).

Table 1.2: Net Lending in 2005
(millions of dollars)

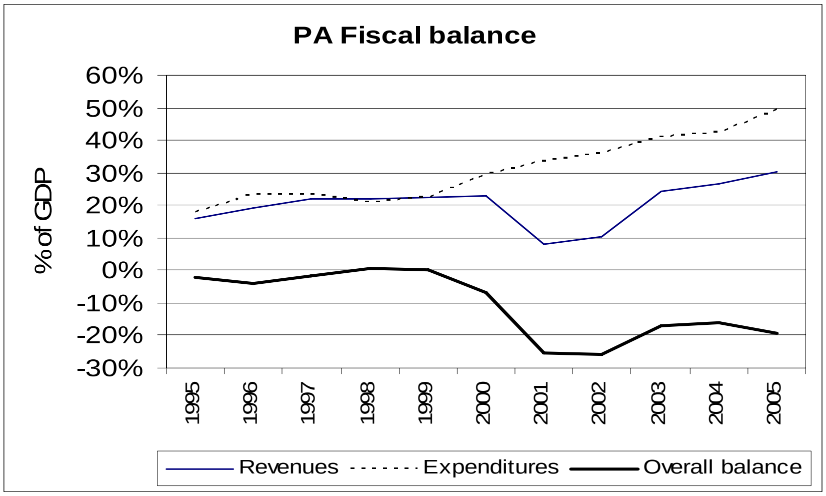
	Monthly	Annual
Deductions from clearance revenue by government of Israel	11.0	132
Electricity	8.3	100
Water	2.5	30
Sewage	0.2	2
Direct payments from PA	17.7	212
Gaza Electricity Company	9.9	119
Petroleum Commission	8.2	98
Other (negative number implies repayment to the PA)	–0.4	0.5]
Total	**29**	**344**

Source: Ministry of Finance, International Monetary Fund.

Continued expenditure expansion in the context of the economic crisis during the *intifada* resulted in a rapid increase in the expenditure-to-GDP ratio. By 2005 the ratio had more than doubled from its 1999 level of 22.6 percent to 49 percent, one of the highest ratios in the world. Of the 122 countries for which the World Development Indicators report central government expenditures, only Eritrea was higher, at 53 percent in 2004.[14]

[14] It should be noted that figures for other countries include capital expenditures, while the data for the PA does not.

Figure 1.8: Palestinian Authority Fiscal Balance



Source: Ministry of Finance, International Monetary Fund and World Bank staff estimates.

4. The Current Fiscal Crisis

The Palestinian Authority (PA) is experiencing an acute fiscal crisis.[15] During the first six months after the new Palestinian Government was sworn in, domestic tax revenues (on a cash basis) amounted to only $17 million per month, compared to $104 million during the same period a year earlier (table 1.3). Commercial banks significantly reduced their exposure to the PA government, mainly for fear of possible legal repercussions abroad. Banks reduced credit lines by offsetting their tax liabilities and by withholding other revenues accruing in the MOF's bank accounts against credit previously extended to the PA. Also, banks did not roll over loans falling due. The IMF estimates that bank loans to the PA were reduced by an average of $25 million per month between March and September 2006. By contrast, in the same period last year, commercial banks increased their lending to the PA by about $30 million a month. Outstanding PA debts to commercial banks (including banks abroad) as of end-September 2006, are estimated at about $500 million down from a peak of $695 million in February 2006.

[15] For a more in-depth analysis of the PA's fiscal crisis, see *Recent Fiscal and Financial Developments*, IMF, October 2006.

Table 1.3: Palestinian Authority Finances in the Second and Third Quarters of 2005 and 2006
(millions of dollars)

	Monthly averages		
	Q2–Q3 in 2005	Q2–Q3 in 2006	Change
Resources (net)			
Tax revenues (net)	104	17	–87
Domestic revenues	41	17	–24
Clearance revenues	63	0	–63
Domestic financing	50	–4	–53
Banks	31	–25	–56
Palestine Investment Fund	18	21	3
Previously withheld clearance revenues	9	0	–9
External financing	38	69	31
Total	192	83	–109
Expenditures			
Wages and allowances	81	45	–36
Transfers	34	4	–30
Operating and capital expenditures	27	9	–17
Net lending (subsidies)[1]	30	23	–7
Total	172	81	–90

1. In 2006, mostly fuel payments that do not include deductions from clearance revenues for payment of utilities supplied by Israeli companies.
Note: All figures are on a cash basis, though 2005 figures include some unpaid pension contribution commitments.
Source: IMF 2006.

The decline in revenues has partially been offset by an increase in external assistance. Donor financing to support the central government's recurrent budget operations amounted to $69 million a month in April–September 2006. This was significantly higher than the average of $38 million a month received in external support in the same period last year. Total support for the central government's recurrent budget operations in 2006 is estimated at $700 million, double the amount provided in 2005 ($350 million). The bulk of the external support came from Arab donors, who provided about $420 million, or an average of $47 million a month. An additional $164 million was channeled through the Temporary International Mechanism (TIM).

In such a tight liquidity situation, expenditure policy is reduced to the selection of which payments to make when funds become available (IMF 2006). The Palestinian Legislative Council initially extended the deadline for the submission of a 2006 budget until September 1, 2006, but this deadline was not met. Therefore, the PA government operates under the legal authorization to make monthly expenditures of up to one-twelfth of 2005 expenditures.[16] All expenditure categories have been severely curtailed.[17] Salary and transfer payments were reduced by almost 60 percent, from $115 million in quarters 2 and 3 in 2005 to $45 million in the same period in 2006.[18]

On average, public sector employees have received payments of about 40 percent of their normal incomes. There have, however, been large differences between the various categories of employees, with the lowest-paid civil servants receiving up to 75 percent of their normal incomes while higher-paid employees received a much smaller fraction. Line ministries operating expenses were cut to a third of their level a year ago—$9 million a month in quarters 2 and 3 in 2006, compared to $27 million a month a year earlier.

Government finances have become increasingly fragmented and public finance reforms implemented in recent years are being compromised. Government receipts and expenditures, instead of being channeled through the Ministry of Finance's (MOF) Single Treasury Account, are now handled by several institutions, including the MOF (now only to a very limited extent), as well as the Office of the President and directly by international donors, via the TIM, or other sources outside the PA, such as the Palestine Investment Fund (PIF). As a consequence, reporting and transparency in public finance have deteriorated significantly.[19, 20]

In the absence of sharp corrections, the fiscal outlook is dire. A passive projection of fiscal trends suggests that the PA's fiscal deficit on a commitment basis could reach about $110 million a month, or about $1.3 billion (roughly 30 percent of GDP) on an annual basis—an amount unlikely to be fully covered by external support and domestic financing. Difficult political measures are needed to address the underlying problems and reduce the fiscal gap. The government urgently needs to reduce its wage bill, improve the collection of utility bills, eliminate the subsidization of petroleum products and streamline social transfers.

[16] The MOF sent out a budget circular for the preparation of the 2007 budget to ministries in August 2006, despite continuing uncertainties about future resource flows.
[17] Note that principal repayments to banks are treated as a (negative) financing item, reducing the envelope of available resources. But if debt service payments (principal and interest payments combined) were treated as an expenditure instead, this would be the second largest spending category, with an estimated $160–$170 million in debt service payments.
[18] Including the so-called Social Allowances paid under the TIM.
[19] The PIF is a public endowment fully controlled by and reporting to the President. Its Board of Directors are largely from the private sector.
[20] Any funds received in cash that have not entered any government accounts are difficult to track.

Box 1.2: Macro-Fiscal Policy Recommendations

Donors:

- Continued high levels of donor assistance are critical for sustaining Palestinian economy in the short term.
- In the short-term, reach agreement between the PA and major donors on a viable fiscal framework to be supported once aid flows resume, including an agreed upon strategy for containing the wage bill, reducing net lending and addressing major problems with pensions and transfer payments.
- Once the political situation improves, there should be an immediate resumption of Donor/PA dialogue on fiscal reforms, especially regarding implementation of a strategy for a sustainable PA wage bill. Donor support should flow in a timely and predictable manner consistent with the broader fiscal stabilization plan.

Government of Israel:

- Radical improvement in Palestinian movement of goods and persons is needed, including implementation of the 2005 *Agreement on Movement and Access*.
- Release clearance revenues directly to the PA and do not use them to settle arrears with private PA service providers prior to a careful inventory, verification and prioritization of outstanding arrears.

Palestinian Authority

- Put in place a high-level, emergency task force consisting of senior representatives from relevant ministries to develop a strategic plan for achieving a sustainable fiscal framework based upon a conservative, realistic set of revenue forecasts once the transfer of clearance revenues and traditional donor support resumes. Major work streams should include: (1) wage bill containment; (2) net lending; and (3) social transfers.
- Implement initial measures for containing the wage bill outlined in the civil service section, including a detailed personnel inventory, hiring freeze, and termination of ghost workers and double dippers. Develop strategic plan for reducing to the wage bill to approximately $80 million per month, including the possible roll-back of salaries, implementation of Voluntary Retirement Schemes and the like.
- Implement measures outlined in this chapter and the chapter on intergovernmental fiscal relations with regard to net lending, including gradually phasing out the subsidization of petroleum products; improving the collection of utility bills by municipalities; and moving from emergency assistance grants to performance based grants based on improvements in local revenue collection.
- Implement measures outlined in the chapter on social safety nets, particularly the redrafting of the pension law and, even more important, security services pension legislation.
- Relevant sector ministries to pursue efficiency gains outlined in individual PER chapters

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CHAPTER 2: PUBLIC FINANCIAL MANAGEMENT ISSUES

1. Key Issues and Challenges

The current position of public financial management (PFM) within the West Bank & Gaza is particularly difficult to characterize. On the one hand, it is an area where both the Palestinian Authority (PA) and the donor community have been heavily engaged for over a decade and a considerable stock of knowledge has been accumulated. The PA's accomplishments in the area of PFM until late 2004 were impressive, but more work clearly remained to be done. The bulk of the Public Expenditure Review (PER) PFM recommendations have been drafted with this ongoing agenda in mind, in the hope that they could help provide a way forward once direct donor funding to the PA resumed. But recent political developments have worked against a number of these accomplishments, as alternative mechanisms have been developed to channel resources to the Palestinian people that bypass many of the mechanisms that the PA and donors worked hard to create.

As noted in the Country Financial Accountability Assessment (CFAA) conducted by the World Bank during 2003/04, the PA made considerable progress between 2002 and 2004 towards the implementation of a Public Financial Management (PFM) system that provides adequate financial control and transparency. Important reforms were implemented, including:

- Setting up a Central Treasury Account through which all government revenue is collected and from which payments are made.
- Formulating an annual budget that is approved by the Palestinian Legislative Council and forms the basis for budget execution allocations.
- Putting into place a basic accounting system that provides a basis for orderly budget appropriations and budget execution.
- Establishing tight controls over expenditure through placing Ministry of Finance (MOF) financial controllers in spending ministries and agencies.
- Transferring payroll responsibilities to the MOF to improve the control of new recruitment and payment of all public sector salaries through bank accounts and ensure that all payees are in place and being paid correctly.
- Undertaking structural reforms to improve the operation and oversight of the PA's public enterprises and trading and investment activities through the establishment of the Palestine Investment Fund and restructuring of the Petroleum Commission and the government owned Cement Company.

- Enhancing fiscal transparency by posting the budget speech, approved annual expenditure estimates and actual data for previous fiscal years and monthly expenditure reports on budget implementation on MOF's website.

Unfortunately, one of the most important accomplishments of the earlier reform agenda, the Central Treasury Account—which provided strong central management and transparency for PA finances—has been a casualty of the broader political standoff between the donor community and Hamas government. The reversal of donor support for this mechanism and donor refusal to finance the PA directly—instead channeling funds through the Office of the President (OOP)—has made the Central Treasury Account inoperable and raised the risk that this achievement may be undermined. The extent to which the PA's financial control and internal audit arrangements discussed later in this chapter are currently being applied to payments now made through the OOP is also unclear. Anecdotal evidence has raised concerns of a significant reduction in transparency and accountability because of erroneous reporting and a failure to submit financial reports regularly. This slide may be reversed if a broader political compromise is reached and donor funding resumes through normal channels. The prospects for doing so, and the extent to which PA capacity has been degraded, remain open questions.

Even in areas directly under the PA's control, there has been little further improvement in the two years since the CFAA was completed. To the PA's credit, progress was made in reforming procurement in the security sector with the passage of new legislation in 2004. There has been some progress in developing the internal audit and financial control functions, particularly the former, but there is continuing confusion in line ministries about their respective roles. There has been limited progress in establishing the new external audit institution (the Financial and Administrative Control Bureau) since the new law was promulgated one year ago. Although its president has been appointed and has begun work, the organization is severely hampered by lack of capacity and resources. There has been slow progress in external financial reporting. The audit report on the 2003 financial statements is still not available and the 2004 financial statements are of poor quality and have not yet been submitted for audit. MOF does not appear to have sufficiently appreciated the importance of audited aggregate financial statements in providing assurance that information is being correctly reported and that the underlying systems of control which produce this information are functioning adequately. Finally, there has been some progress in developing a medium term development plan (MTDP) to better prioritize expenditures through integrating planning and budgeting, and in particular to better integrate donor project funding into the budgetary exercise.

If the arrangements prevailing in 2005 and before are to be restored, there is a need for a new thrust by the PA to improve the PFM system through a clearly defined action plan focusing on developing PFM capacity and identifying the training and technical assistance needed to advance this agenda. This program must be demand driven and coordinated between all potential providers of technical assistance. In addition, the work in this report has indicated other ongoing PFM problems that need to be addressed. The main ones are:

- Reform of the accounting system, in particular reforming the chart of accounts and the classification system, and ensuring that the redevelopment of the central accounting system as far as possible meets the needs of line ministries.

- The need for line ministries to be more responsible for their own expenditure management and to locate this responsibility at the level of spending units within ministries.

- The need for the PIF's recent lapse in financial transparency to be rectified and for improvement in financial transparency in three important public institutions: the GPIC and the two major state owned enterprises, the Petroleum Corporation and Cement Company.

- The need for international donors to harmonize their project financial management requirements and as far as possible make use of the Central Treasury Account and the PA's accounting system.

This chapter examines in more detail upstream budgeting issues only briefly addressed in the CFAA—namely, the integration of planning and budgeting through the MTDP—reflecting the need to address the lack of any focus on performance, policy or priorities in budget development and execution, and to integrate donor projects into a more comprehensive budget. Reforms in this area being pursued by the PA are moving in the right direction, but there is a considerable way to go, including obtaining full involvement from MOF. Detailed recommendations are provided in the summary and conclusions section at the end.

Finally, to establish a baseline on the quality of the PA's PFM system, this report assesses the system by using the set of performance indicators developed by the Public Expenditure and Financial Accountability (PEFA) secretariat in 2005.[21] These indicators are presented in Attachment 1. They are expected to come into general usage over the next few years as the basic mechanisms for identifying weaknesses and the rate of improvement in country PFM systems.

Credibility of the PA Budget

An important aspect of PFM performance is the extent to which budgets are realistic and are implemented. A comparison of actual out-turns for 2003–05 shows significant variances between actual aggregate expenditures and the approved budget, which worsened in 2005.

These over-expenditures more than offset higher than expected revenues for all three years. In 2003 the deviation over the budget was 6.3 percent, even given additional

[21] The PEFA measurement framework is intended to assess PFM progress within a country over time, rather than make comparisons between countries. More information about PEFA can be found on the following website: http://www.worldbank.org/wbi/governance/assessing/pdf/pefa_pres.pdf.

revenue collection. This increase in spending was the result of a rising wage bill that, when coupled with unforeseen net lending costs and lower external budget support, resulted in a deterioration of the PA's fiscal position. Similarly, in 2004 the deviation was 4.3 percent above the budget. During 2005 actual expenditures accelerated to 14 percent above budget as a result of additional hiring in the security forces during the third quarter, along with the acceleration of net lending costs (driven by subsidizes paid to the Petroleum Corporation to restrain petroleum costs) and the lower than anticipated external budget support.

When too many reallocations occur within budget lines and the composition of expenditure varies greatly from the original estimates, the budget loses its value as a policy tool. Analysis of the PA's adherence to budgeted expenditure composition during budget execution in 2003–05 reveals significant reallocation across budget items, reflecting implementation very different from the original approved budget in 2003 (table 2.1).[22] The situation improved for 2004–05, there were still significant reallocations but the position improved, reflecting a stricter adherence to the approved allocations. Nonetheless, such deviations are another indicator of the tight fiscal situation of the PA, where the unbudgeted rising wage bill and net-lending costs crowd out non-wage expenditures, and reallocation across budget items becomes necessary to cover non-budgeted obligations.

Table 2.1: Expenditure Deviations and Variance in Excess of the Total Deviation
(percent)

	For PI-1*		For PI-2**
Year	Total expenditure deviation	Total expenditure variance	Variance in excess of total deviation
2003	6.3	32.0	25.7
2004	4.2	10.4	6.2
2005	13.9	19.8	5.8

*PI-1: Performance Indicator 1 – aggregate expenditure out-turns compared to original approved budget
*PI-2: Performance Indicator 2 composition of expenditure out-turn compared to original approved budget

The PA also recorded revenue out-turns above the budgeted forecasts for 2003–05 as a result of improvements in tax collection and administration and external shocks, rather than weaknesses in revenue forecasting.[23] In 2003 revenue inflows were 30 percent

[22] Variance in expenditure composition was calculated as the weighted average deviation between actual and originally budgeted expenditure, calculated as a percent of budgeted expenditure, on the basis of functional classification and using the absolute value of the deviation. This measures the extent to which reallocations between budget lines have contributed to the variance in expenditure composition beyond the variance in the overall level of expenditures.
[23] Revenue out-turns were calculated as the difference between actual and budgeted domestic revenues as a percent of budgeted revenues for last three years.

greater than budgeted, reflecting the GOI's decision to resume previously withheld clearance revenues. Furthermore, domestic tax collection increased in 2004 to 6 percent above budgeted revenues due to the broadening of the tax base and better administration. The revenue out-turn for 2005, at 23.4 percent above budget, reflects a combination of factors, including a shift in the composition of revenues. While indirect taxes remained at around 60 percent of total revenues, the share of VAT receipts gave way to a greater proportion of petroleum excises; hence, high oil prices had a positive impact on actual revenue collection. Finally, a higher than budgeted dividend payment from the PIF reflected its higher profits and also helped to boost revenue inflows.

Donor Practices

The PA is highly dependent on external financial assistance through both budget support and project financing.[24] In the 2005 budget, external assistance accounted for over 50 percent of total revenues. In 2004 and 2005 budget support was provided by several donors through a multi-donor trust fund administered by the World Bank that was subject to the PA meeting certain specified policy benchmarks. Prior to this, the Bank initiated the Emergency Services Support Project (ESSP) in 2002, which funds PA budget non-wage spending in the social ministries (Education, Health and Social Affairs). As of June 2006 $174 million had been provided by the Bank and eight other donors, making this a key budget support instrument. In addition, a number of bilateral Arab donors have made direct and unconditional payments to the PA. Further details of donor assistance in relation to overall PA expenditures are set out in the fiscal chapter of this PER.

Donors have traditionally funded the great bulk of PA capital expenditures. Unfortunately, full information on the various sources of donor project funding is not readily available. The Ministry of Planning (MOP) is mandated by Cabinet to endorse and sign all external projects and program agreements, although it has not always adhered to this requirement. Prior to 2006, the MOP was successful in having most donor funds channeled through the Central Treasury Account and information on such funding is readily available. Some donors prefer or are required by their own laws to establish management and accounting systems for project assistance outside the PA's systems. Project financial assistance is funded by a number of donors through the Palestinian Economic Council for Development and Reconstruction (PECDAR), which in light of its importance in overseeing donor projects is discussed separately below. Donors have shown varying degrees of willingness to share information on their projects with MOP.

The MOP has now developed a project database covering projects approved since 2002 that is available on its website, but this database is neither complete nor fully accurate.[25] In some cases (for example, for United Nations Development Programme and U.S.

[24] Although not directly part of the PA or its budget, it is worth noting that the United Nations Relief and Works Agency (UNRWA) provides social services (education, health and income support) through its own administrative structures to the 40 percent or so of the Palestinian population who are registered refugees. Likewise, international NGOs, who tend to work directly with community groups, municipalities or line ministries, undertake significant service delivery in some sectors.

[25] See www.mop.gov.ps/amc/

Agency for International Development funded projects), no financial information is available, although other information is provided. Information for the database comes directly from donors and, in some cases, from PECDAR and the line ministries. The database is not linked directly with the Central Treasury Account through the central accounting system, and the classification system is not adequate for project management.

Since March 2006, the majority of external finance has been channeled through the Office of the President (OOP). According to the OOP, bilateral funds received between March and October 2006 amount to $265.5 million, of which $246 million has been provided from Arab League States, including Saudi Arabia, Qatar and Kuwait. The remaining $19.5 million has been received from Russia, Norway, Spain and Sweden.

Funds have also been received through the Temporary International Mechanism (TIM) endorsed by the Quartet on May 9, 2006. Under TIM, total commitments made by the EU amounted to €90 million (approximately $114.7 million). The TIM has three windows:

- *Window I.* Commitments made through the World Bank administered ESSP, including €10 million ($12.7 million) for essential supplies and running costs of hospitals and health care centers.

- *Window II.* The Interim Emergency Relief Contribution, which aims at financing the procurement of fuel for hospitals in both the West Bank and Gaza, received a €40 million ($51 million) commitment from the EU for uninterrupted supply of energy utilities.

- *Window III.* The Cash-Transfer Scheme, which provides allowances for both front-line health sectors workers and for the poor, received €40 million ($51 million) to support vulnerable Palestinians through the payment of social allowances.

Under Window III, payments as of October 20 include €12.9 million ($16.5 million) in the first three installments of social allowances to nearly 12,000 workers in the health sector. Payments were also made to 44,609 low income cases (LICs) and 5,126 retirees to the amount of €13.6 million ($17.3 million). A second round of payments was made to LICs (both civil servants and pensioners), with health care workers included in the scheme during October. The number of beneficiaries in this round reached 61,627 beneficiaries with total payments reaching €16.8 million ($21 million). Additionally, €9.6 million ($12.2 million) was paid to 35,047 social hardship cases. Around €12 million ($15.2 million) has been allocated by the European Commission (EC) outside of TIM for technical assistance and capacity building to the OOP (TIM 2006).[26]

Following U.S. Office of Foreign Asset Control (OFAC) prohibitions, a number of banks stopped all transactions with the PA after the elections. Chief among them is the Arab Bank, which maintained the PA's central treasury account. A major achievement of the

[26] Numbers obtained by phone interviews with TIM staff, in addition to the TIM activity report (2006).

reform agenda during the past five years, this system was developed to consolidate financial flows and allow for more accountable and transparent financial management. A key consequence of the current crisis is that the Central Treasury Account is no longer operational, which has raised concerns about how comprehensively external finance is being accounted for and whether an overall weakening of transparency in financial management is taking place.

Another key challenge is how to physically transact and disburse donor funds. For example, some donors have historically maintained special accounts with the local banks through which donor funds are disbursed to the PA. Checks can be written against these accounts by relevant authorities. But following OFAC prohibitions, local banks refused to allow replenishments into donor special accounts. This policy was later reversed in a few cases, although new accounts are not allowed. There are also restrictions in place for funds flowing in the reverse direction, from the PA to donors.

Looking beyond the current difficult political environment, the donor community will need to move toward meeting the commitments made at the Paris High Level Forum of 2005 to harmonize donor financial management and reporting requirements as far as possible and to use country financial management systems wherever they are adequate rather than require parallel ones. Many current donor practices are failing to positively impact the role of the PA budget as a policy instrument.

Palestinian Council for Development and Construction

The Palestinian Council for Development and Construction (PECDAR) was established in 1993 as a funding recipient and implementing agency for donor projects. It focuses on infrastructure projects, which have so far totaled about $585 million. PECDAR carries out project preparation, implementation and monitoring in conjunction with donors. It maintains its own engineering and other project staff. PECDAR focuses more on infrastructure type projects rather than social assistance projects.

PECDAR's operating expenditures are financed by a contribution to its salaries from the PA budget, plus a four percent management fee charged against all projects. It publishes a separate annual report which includes audited financial statements, which have received "clean" opinions from the private auditors. It has a well-functioning accounting system and has been able to produce the financial reports required by donors as well as its own audited financial statements. Although line ministries and other agencies have gradually assumed a greater role in implementation of donor-financed projects, PECDAR continues to be used by donors, including the World Bank, and appears to have performed to the satisfaction of most donors.

PECDAR operates in a relatively autonomous manner in that it reports direct to the President and does not answer to the Palestinian Legislative Council. A proposal submitted in June 2005 to merge PECDAR with the Ministry of Public Works was rejected by the Cabinet. Transactions through PECDAR are not made through the Central Treasury Account. Payments are authorized by the Managing Director of PECDAR and all payments over $10,000 also require the signature of the President. The MOF has no involvement in or information concerning PECDAR's financial operations. Ensuring that all PECDAR payments are made through the Central Treasury Account once it again becomes operational—which will require the compliance of all donors currently utilizing PECDAR's services—would contribute to overcoming the problem of a lack of comprehensive information available to MOF and MOP concerning the implementation of donor projects.

PECDAR projects are included in the MTDP and require the same Cabinet approval as all other donor financed projects. They were included in the budget book for 2006, along with other donor financed projects, and are thus intended to be part of the budget preparation dialogue in the future. This will assist in improving overall expenditure prioritization, as discussed later.

The Legal Framework for Public Financial Management

The legal framework for PFM comprises the financial management provisions of the Basic Law, the Organic Budget Law (1998), the Annual Budget Law, the Financial and Administrative Control Council Law No. 17 (2004) and the Regulations for General Budget and Financial Affairs (2005).

The Basic Law contains some PFM provisions that are largely repeated in the Organic Budget Law. Provisions in the Basic Law have constitutional level protection. Some provisions in the law concerning the responsibility for the implementation of the budget, the Central Treasury Account and the budget contingency reserve should be more clearly defined to provide this level of protection.

Both the Organic Budget Law and the Annual Budget Law are administered by MOF. The former gives permanent authority, and the latter annual authority. There are instances of the Annual Budget Law being used for purposes for which there should be a permanent provision—for example, each Annual Budget Law has provided that the PA may not borrow from the Palestinian Monetary Authority (PMA).

The Organic Budget Law provides a framework for budget management that is reasonable, albeit general and incomprehensive in its provisions. Some aspects of the law have not yet been implemented: internal audit (Article 63), external audit (Articles 18, 66 and 68) and the requirement to hold the consolidated fund balance at the Palestinian Monetary Authority (Article 13)—at present this balance is held in commercial banks. The Organic Budget Law defines roles for the revenue collection agencies, spending agencies, MOF, Legislative Council and Council of Ministers and defines terms such as public funds, special funds, current expenditure and capital expenditure.

The Organic Law covers ministries and agencies and other public institutions such as autonomous budget funded institutions. It does not cover companies or corporations owned in part or in full by the PA, nor does it cover public enterprises, which operate under the Companies Law. It provides the institutional basis for a number of important processes, requirements and principles, such as:

- The preparation, submission and authorization of budgets, together with an established budget calendar providing the dates at which actions are to be taken.

- Financial procedures in the event the budget law is not enacted in time for the start of the financial year (which has been the case in 2006).

- Use of the Central Treasury Account for pooling government revenues.

- Expenditures to be drawn from the Central Treasury Account only in accordance with the budget law.

- The required contents of the budget circular and Annual Budget Law and the requirement for the latter to be a public document.

- Execution of the budget, including the MOF's leading role in this area.

- Lapse of unused funds at year-end.

- The annual budget to establish the upper limit for government borrowing.

- Procedures for preparing and submitting quarterly reports and annual financial statements.

- Entering into loan agreements or providing guarantees, both of which require approval from the Minister of Finance.

While the Organic Law is adequate on budgeting issues, its provisions regarding accounting could be strengthened. Accounts and audit are covered in only four Articles (63–66), including one on internal audit. Clear deficiencies in the existing legislation appear to be:

- A lack of clarity concerning virement or the ability to transfer funds between budget items during the year (Article 50; see discussion below).

- Lack of a specific requirement for reporting on the use of the budget contingency reserve (Article 37).

- Lack of clearly defined responsibilities of line ministries for managing their own finances, including lack of a clear definition of the individuals who may commit expenditure and a clear separation of this role from approving payments.

- Lack of a similar designation of responsibility within MOF, for example for the role of an Accountant-General position or its equivalent, with responsibility for the preparation of budget execution reports and aggregate fiscal statements.

- The matters to be covered in annual financial statements are only briefly indicated.

- There is no formal requirement for an audit of these financial statements.

- A separate accounting manual should set out the procedure to be followed for consolidating accounts and preparing the aggregate statements.

The *Regulations for General Budget and Financial Affairs 2005,* comprising some 80 pages (in English), replaces the previous Financial Regulations 1997–98 (known as the Fiscal Directives). The new regulations are a mixture of very detailed procedural provisions (for example, custody and submission of forms) which would be better placed in an accounting manual and principles; in some cases, they duplicate identical provisions in the Organic Budget Law. The Financial Control Department of MOF has begun to develop an extensive training program for MOF and line ministry staff on the new regulations.

2. Scope of the Budget

Chapter 3 of the Organic Budget Law sets out detailed and appropriate procedures for Budget construction. The budget includes all PA ministries and agencies in addition to public institutions such as the Environment Authority, Ports Authority, Tobacco Authority, Civil Aviation Authority, National Radio and Television, Palestine Information Center, Palestine News Agency and Palestine Water Authority. Their expenditures are covered by budget appropriations and their revenues are paid into the Central Treasury Account. In 2005, there were some 63 budget entities (though these seem to change annually) comprising a mix of major ministries and relatively small agencies grouped under eight broad categories: general administration, security, fiscal administration, foreign affairs, economic development, social affairs, culture and information affairs and transport and communications.

The Annual Budget Law covers only recurrent expenditures plus the relatively small amount of capital expenditures funded from PA revenues (about 13 percent of the budget in 2005). Most capital expenditure is funded by donors, for which the Ministry of Planning (MOP), created in 2003, is the coordinating agency. A gradual expansion of the scope of the budget exercise began in 2003 with the inclusion in budget documentation of the capital expenditures (estimated at $212 million in that year) financed by those donors who use sub-accounts within the Central Treasury Account for their project assistance. As discussed later, from 2006 a de facto capital budgeting exercise managed by MOP and MOF has been developed and the budget circular issued by MOF and the intended budget dialogue for 2006 are designed to include as far as possible all expenditures on behalf of the PA, whether formally part of the Annual Budget Law or not.[27] While MOP is responsible for aid coordination and capital expenditure planning, under the Organic Budget Law the Minister of Finance has the sole authority to conclude loan agreements with donors.[28] For financial assistance grants (as opposed to loans) authority rests with MOP because of a Cabinet decision that MOP should maintain the MTDP, which covers all projects, whether funded by the PA or by donors. There is a strong case for locating this responsibility in MOF given its overall responsibility for fiscal and financial management.

Budget Classification

For each budget entity, expenditure is broken down into two chapters, current expenditures and capital and development expenditures. The two chapters are broken down further in accordance with a standard 14-item input classification, and each item is broken down into sub-items, there being some 60 in the case of current expenditures.

The classification system and chart of accounts are inadequate in a number of significant respects. A standard chart of accounts is used, consisting of eight digits, of which only four are used to analyze expenditures—by ministry or agency, chapter, item and sub-item. This does not include a breakdown of expenditure by spending unit or activity, reflecting the fact that budgets may be held centrally within ministries and not allocated to individual spending units. Nor is there any allowance for a program or activity classification which will be needed in a future move to a more performance oriented budgeting system. Nor is there provision for classification by function, such as the United Nations COFOG or International Monetary Fund GFS system. To provide information on a responsibility center and program/activity basis the chart of accounts will need to be expanded to around 30–40 digits. In addition, the 14 item economic (object) basis of classification is not consistent with the GFS economic classification, and some of the line items are not mutually exclusive, leading to possible inconsistency in information.

Nature of Budget Appropriations

Since the budget is cash based, budget appropriations are an authority to make payments. There is no formal system of commitment control, an issue MOF will need to consider as it further improves the PFM system (see discussion below). Budget appropriations extend only to the two chapters and 14 items set out above, and are thus at a relatively high level of aggregation. The Organic Budget Law (Article 50) provides that funds cannot be reallocated between chapters without Palestinian Legislative Council approval, in effect requiring a revised appropriation. The Annual Budget Law also provides that budget entities may not reallocate from one of the 14 predefined expenditure items without the approval of MOF. Article 50 of the Organic Budget Law provides for such a rule to be incorporated in the Annual Budget Law and, by implication, be potentially subject to change, rather than incorporated, as is more general practice in the Organic Budget Law.

[27] That is, to the extent that donors make such information available.

[28] With the exception of past activities of the Islamic Development Bank and the Saudi government, this requirement appears to have been observed.

Article 37 of the Organic Budget Law provides for a budget contingency allowance, or reserve, which is controlled by the Minister of Finance and subject to the approval of the Council of Ministers. It is intended for emergency or unforeseen expenditures. This figure is high by international comparisons, at about 3 percent of the total budget, which makes it particularly important that the use of this reserve is reported in budget execution reports and eventually in the audited financial statements, so that it does not become a source of significant non-transparent expenditure. The use of the reserve is reported as it occurs in the monthly budget execution statements. It would also be desirable that the use of this reserve be separately accounted for in the aggregate financial statements and thus subject to audit to ensure that its use has been consistent with the law. It is generally accepted PFM practice that the use of this reserve should thus be reported to and reviewed by the legislature as part of its review of budget execution.

As mentioned above, the budget appropriations are at a high level of aggregation based only on ministry or agency and expenditure item or object. The Organic Law (Article 45) gives each minister the responsibility to allocate the budget estimates across spending units in his/her budget entity. The Annual Budget Law thus does not allocate funds to particular spending units or responsibility centers, such as hospitals or educational institutions. MOF does not monitor the implementation of the budget in this way, rather on the more aggregate information as set out in the Annual Budget Law. The budget documents do not provide any information at this level, thus limiting the information base for the budget dialogue. While some ministries may allocate budgets to spending units (for example, MOH uses a chart of accounts in its stand alone accounting system which includes location, cost center, funding source and detailed object items), it appears that in some ministries, particularly those constrained by using the central MOF accounting system, spending units may not have an assigned budget.

Establishing Line Ministry Accountability for Expenditure Control

The fact that MOF makes various payments centrally on behalf of line ministries over which they have no control results in a situation where spending units either do not or cannot take responsibility for the management of their own budgets.[29] Typical items of expenditure paid directly by ministries and agencies are office expenditures, maintenance, transportation and consumable stores. The proportion of such direct expenditure varies between ministries. For example, the Ministry of Social Affairs only directly pays around 5 percent of its budgeted expenditures; for the Ministry of Health the figure is around 50 percent. Line ministries do not receive reports from the MOF until the end of the year on expenditures paid directly by the MOF. In effect, they are not considered responsible for managing this expenditure and therefore have no need to know

[29] These payments include salaries and operating expenditures such as rent; utilities such as electricity and water; and travel, training and capital expenditures.

about it. Thus line ministries are in effect managing only a small part of their budget, which also limits the possibility of tradeoffs between different expenditure items.[30]

Thus the current system does not allow line ministries to account for the use of resources in a way that enforces responsibility and accountability for expenditure. This negatively affects the incentives for line ministries to deploy resources in the most efficient and effective way and may actually prevent them from doing so.

There is also a need to establish financial accountability for unit-level spending by providing for it in the chart of accounts. This would not of itself necessitate formal budget appropriations made in greater detail, only appropriations supported by more detailed information. It is also important to review the central payment of operating expenditures by MOF so as to provide incentives for line ministries to prioritize or trade-off within their total operating expenditures. MOF, rather than the relevant line ministry, appears to "own" these expenditure items.

Budget Timetable

The Organic Budget Law (Article 25) requires the preparation by MOF by 1 May of a comprehensive report to the Cabinet on the macroeconomic and fiscal situation along with forecasts and expenditure commitments, likely available resources for the remainder of the fiscal year and recommendations for policy initiatives to respond to the emerging macroeconomic scenario—in effect, an early mid-year review of budget progress. The Cabinet is intended to use this report to establish guidelines and policy directives for preparing the budget for the coming fiscal year. However, it does not appear that such a report is prepared on the basis of this timetable, which further limits the Cabinet's input into the budget process. Article 26 provides for the budget circular to reflect indicators and policy objectives from the Cabinet, but it is not clear to what extent such prior discussion within the Cabinet exists.

The budget circular must be issued to line ministries and agencies by 1 July (Article 26 of the Organic Budget Law). The budget circular contains indicative appropriation figures developed by the Budget Department of MOF. Ministries and agencies have one month to respond with their proposed budget. Following this, line ministries and MOF engage in detailed discussions of ministries' needs. The Palestinian Legislative Council Budget and Financial Affairs Committee is consulted on the contents of the circular before it is issued.

Under the Organic Budget Law the proposed budget should be submitted by MOF to the Council of Ministers (Cabinet) by 15 October. In turn, the Cabinet is required to present the budget to the Palestinian Legislative Council by 1 November, to be passed before the commencement of the Fiscal Year on 1 January. While this timetable does not provide much time for serious consideration by the Cabinet or Palestinian Legislative Council,

[30] A broader issue is the central management of personnel costs through MOF, which provides no incentive for line ministries to trade off personnel costs against other operating expenditures. This can be addressed only in the longer term.

the lack of serious review of the budget more likely reflects the budget's current role largely of a detailed costing of inputs, rather than a policy document explicitly focusing on the PA's strategic priorities, and the highly aggregated nature of the budget appropriations. It may also reflect a lack of budget literacy on the part of the Palestinian Legislative Council. In future the budget timetable will need to incorporate review of the MTDP and upstream Cabinet and Palestinian Legislative Council involvement in this review would improve their input into the budget.

The timetable has been adhered to, except for minor slips, since the 2003 budget. (Prior to this there was no meaningful budget system at either the preparation or execution stage.) However, the budget has not been passed by the Palestinian Legislative Council prior to the commencement of the fiscal year. The 2003 budget was not passed until 1 February 2003, the 2004 budget was not passed until 15 January 2004 and the 2005 budget was not approved until 31 March 2005. Given the current special circumstances in West Bank and Gaza, the 2006 budget presented by the previous administration has not yet been passed. It also appears that for various reasons the macroeconomic framework is sometimes finalized only after the budget discussions with line ministries and within the Cabinet have taken place, meaning that MOF may find it necessary to make unilateral changes in the budget presented to the Palestinian Legislative Council.

If the budget is not passed before 1 January, the law provides for monthly expenditure to continue at the rate of one-twelfth of the previous year's budget appropriation for up to three months. There has been a difference of opinion between the executive and the Palestinian Legislative Council as to whether this provision applies if, as was the case with the 2006 budget, the budget is not formally presented to the Palestinian Legislative Council.[31]

In summary, there is a clear budget timetable which has generally been followed. In the future, the timetable will need to allow for full consideration of the MTDP and include greater upstream involvement by the Cabinet and Palestinian Legislative Council in the MTDP.

Budget Documentation

The key budget document is the Budget book which is published around March of each year. While this document contains a range of detailed information, there is scope for improving both the comprehensiveness and quality of public budget information. Although this is a public document (published in Arabic), it is not widely available. Only about 400 copies are generally printed and it is not posted on the MOF website. The 2005 book contains the Annual Budget Law in a comprehensive document consisting of some 300 pages of revenue and expenditure tables, figures and narrative explanation.[32] The 2005 book provides information on each budget entity's actual expenditure in 2003, the

[31] In June 2006 the PLC passed a law that allows the government to submit the Annual Budget Law after the three-month period. It also allows MOF to collect revenues and continue expenditures until the end of the year at the rate of one-twelfth of the 2005 budget allocations.
[32] It appears that no Budget book was prepared for 2006.

budget for 2004, the estimated actuals for 2004 and the proposed budget for 2005. For each budget entity, expenditure is broken down into the 14 expenditure items. It indicates proposed financing transactions, both external and internal, including borrowing from the banking system to cover the financing gap. It also includes comprehensive data on authorized civil service employment and sets a legal limit on civil service employment growth.

PECDAR transactions were first included in the 2005 Budget book, a practice which was intended to be continued in 2006. This information is included in the brief description of all PA development projects, which is in an annex to the Budget book.

As the scope of the budget dialogue expands to include donor funded projects, more information is needed on whether project disbursements take place through government accounts and are reflected in the government's books of accounts, and on the responsibilities, objectives and activities covered by line ministry expenditures.

The Minister's budget speech and a summary budget document are published in English on the MOF website, but this budget summary does not provide details of individual revenue and expenditure items, and could usefully be expanded. Likewise, the whole Budget book could be included on the MOF website. For completed financial years, actual expenditure against approved budget estimates should be reported.

Macroeconomic Forecasting

Since 2003 the budget documents have been prepared on the basis of careful macroeconomic analysis involving the MOF, Palestine Central Bureau of Statistics (PCBS), the World Bank and the International Monetary Fund (IMF). This has led to one common set of macro-planning indicators. The budget documentation typically offers three macroeconomic scenarios based on alternative political developments and discusses exchange rate assumptions and monetary statistics.

Revenue estimation is extraordinarily difficult given uncertainties about the continuation of closures and their economic impact, the likely levels of donor budget support and the stability of the transfers of customs and VAT revenues by Israel. The ability to accurately forecast and control revenues is an essential precondition for sound PFM. The resolution of such issues is fundamentally political in nature and lies beyond technical PFM issues. Revenue fluctuations can be mitigated, though not eliminated, through the development of several annual planning scenarios, as was done for both the 2003 and 2004 budgets. More timely preparation of the macroeconomic framework would facilitate this task. Revenue estimation is further complicated by the fact that the MTDP and budget documents may in part reflect efforts to raise donor funds rather than produce a considered estimate of likely receipts.

Budget Development Dialogue

The 2006 budget circular, issued on 15 July 2005, gave line ministries a month to respond with their proposed budget. It set out the medium-term macroeconomic framework and provided estimates of medium term (2006 to 2008) budget funding by donors. In terms of signaling expenditure priorities, it referred to the need to limit public service and security service staff numbers and salary increases, limit overtime and travel costs and expenditure on new accommodation and vehicles and give priority to the education, health and judicial sectors. It required ministries to submit extensive detail in support of their budget requests, including information on expected external grants and assistance and domestic and foreign loans. For the first time ministries were also required to submit details of all capital and development projects, whether financed from the budget or from external sources, over the three years 2006–08, thus laying the foundation for a more comprehensive and medium-term budget dialogue, covering both recurrent and capital expenditures.

The information presented by budget entities on 2007 and 2008 expenditures does not appear to have been directly used by MOF. Rather, this requirement was intended to force budget entities to think in terms of a multi-year budget framework. It also assisted in the identification of future recurrent cost implications of donor projects.

Discussions with budget entities on their recurrent expenditure proposals appear to involve a reasonable dialogue, but focus on costing inputs rather than on policy, priority or performance related issues. Discussion of the salaries item has focused on determining the accuracy of the number of people employed and their salary level. Likewise, discussion of those operating expenditure items paid directly by the MOF appears limited. There is a pronounced lack of ownership and limited incentive for budget entities to suggest possible savings or trade-offs against other items. Funding pressures have frequently resulted in the MOF reducing expenditure levels agreed to prior to submission of the budget to the Palestinian Legislative Council. There is a general discussion for all budget entities on the level of the expenditure arrears and the provisions of funds to clear them.

Discussions with MOI on the security services (which account for around 25 percent of the total budget) take place at an aggregate level, and the depth of these discussions is questionable, despite efforts by the MOF Budget Department. The security services have taken the view that certain budget items may not be discussed and have successfully resisted MOF pressure. In the past, the President has not supported the provision of more detailed information on security services expenditures to MOF and Palestinian Legislative Council. Information on security services expenditure is presented in the same level of detail, even though that is rather aggregated, as other budget entities.

In the end, the nature of the budget dialogue should change to reflect a more policy-driven process as the budget becomes more comprehensive through the development of the MTDP.

Improving Expenditure Prioritization

The 2004 CFAA identified two major weaknesses in budget construction. First, the budget dialogue between MOF and line ministries on the recurrent budget appears to have been focused almost entirely on costing necessary inputs (salaries, travel, transfers). It was not informed by any strategic policy objectives and had no explicit focus on performance or prioritization beyond a general commitment for greater emphasis on health and education to meet increased demand due to population growth. There was no discussion on or incentives for budget entities for trading off between different inputs (for example, replacing personnel costs with increased operating expenditures). Second, most donor funding was still excluded, making it difficult to properly determine priorities and to integrate capital or developmental expenditures with recurrent expenditures into the budget.

Several steps are required to improve this position and some of them are now underway. A key priority is to change the mindset that no prioritization or re-prioritization is possible, given that much of the PA's budget expenditure is on salaries perceived as "fixed" items. This view ignores the fact that additional staff are added to the PA payroll each year to meet emerging needs (such as in education and health), and that funding for additional positions may also become available in the medium-term by attrition. There is also a need to prioritize, as part of a more comprehensive budget exercise, the significant expenditures provided by donors by way of project assistance, which for some ministries (like the MOH and MOE) provide funding for key service delivery. And there is a need to ensure that the allocation of this project assistance reflects PA priorities rather than donor priorities.

In addition, as identified in the 2004 CFAA, the following steps are necessary to improve the overall prioritization of expenditures through the integration of planning and budgeting:

- A well-formulated and articulated medium-term PA development strategy.
- Coordination among donors and between donors and the PA to ensure that their expenditures collectively address the key development and relief needs of the Palestinian population in a coherent manner.
- A system under which the PA (MOP and MOF) has full information about donor activity.

In addition, there is the need for collective ownership, or "buy in," by the Cabinet of the budget as a whole, which can be facilitated by its involvement in a more comprehensive and policy-based budget through the MTDP. The previous Cabinet is said to have been extensively involved in the MTDP, but the real extent of this involvement in terms of prioritization and ownership is difficult to determine. There is also a need for full coordination between MOF, MOP, spending ministries and PECDAR. The key role of

MOF and MOP in managing any competition between ministries in dealings with donors needs to be developed further.

Some progress is being made on all of these fronts, although there is still a considerable way to go. With the assistance of the UK Department for International Development, which is providing technical advice on improving the integration of planning and budgeting, MOP has developed an interim Medium Term Development Plan (MTDP) covering all expenditures, both budget and donor funded, for 2006–08. A Cabinet decision requires all projects to be included in the MTDP and for all project agreements to pass through MOP for approval. MOF is also involved in clearing any recurrent cost implications as well as the proposed financial management and reporting arrangements for each project. The outgoing administration intended to present the interim MTDP to the Consultative Group Meeting in April 2006 and to use it as the basis for an expanded budget dialogue in 2006.

Although the interim MTDP has been very important in beginning the process and potentially improving the dialogue with donors, there are a number of important steps still required before it can be fully effective as the basis for a comprehensive and well prioritized annual budget.[33]

- It needs to be developed within an overall medium-term fiscal framework, which is all the more important given the uncertainty that surrounds both domestic revenues and external assistance. While work has commenced on the MTFF, it is not yet complete.

- There is a need for well-defined and costed sectoral plans or strategies which are owned by the PA and the relevant line ministry and supported by key donors. In some sectors there is no useful plan; in other sectors there are several competing or mutually inconsistent plans.[34] The capacity of line ministries in planning and prioritization should be developed through the establishment of ministry planning units, which are linked with the budget unit.

- Full information on all donor funded activities is necessary.

- There needs to be full and close collaboration between MOF and MOP in the MTDP's development. In the past there was some reluctance by MOF to become fully involved in the MTDP, perhaps reflecting its preoccupation with shorter-term budgetary pressures. Collaboration between MOF and MOP has since improved and the draft MTDP exercise appears to have been useful in ensuring better identification of the recurrent cost implications of donor project assistance to the PA budget.

[33] MOP states that its objective is to reach this position for the 2008 budget.
[34] For example, there are said to be four separate strategies developed for the water sector

The latter two points raise the important issue of the likely advantages of merging the MOF and MOP to create one organization managing the raising and allocation of PA funds.[35] This would ensure consistency of approach, integrate the planning and budgeting systems and avoid the current fragmentation of responsibilities. This issue should be given careful consideration by the PA. Any such change would involve MOP shedding its current physical or spatial planning responsibilities and relocating them within an appropriate spending ministry. In the interim, the MOF should become more closely involved in the MTDP, working collaboratively with the MOP.

Role of Palestinian Legislative Council in Budget Development and Execution

The Palestinian Legislative Council Committee on Budget and Financial Affairs, which consists of 15 members from the total council membership of 120, has potentially important roles in both budget development and budget execution and follow-up.[36] It performs several valuable functions determined by the Palestinian Legislative Council. It can review the draft budget law, proposing reductions in expenditure but not increases, and recommend approval/rejection of the law to the Palestinian Legislative Council. It can question the government on its financial plans and issues of fiscal stability. It can question ministers on financial matters, and it can discuss and approve proposed budget amendments during the year.

In general only the Minister of Finance and MOF officials participate in Committee meetings. The Committee has access to some professional support, and a researcher and a legal advisor have been attached to the Palestinian Legislative Council office in Ramallah. The Committee may also request an investigation into the financial operations of any ministry or agency. The Organic Budget Law (Article 52) requires the quarterly reports on budget execution to be submitted to the Council of Ministers and to Palestinian Legislative Council. While this is now being done, it does not appear that the Palestinian Legislative Council yet makes significant use of these reports.

As discussed above under the Organic Budget Law, the budget is required to be submitted to Palestinian Legislative Council by 1 November and passed before the beginning of the fiscal year. The Palestinian Legislative Council may reduce proposed appropriations, but may not increase them. It was the general practice of the previous Minister of Finance to discuss the proposed content of the budget circular with the Committee before its issuance. The Committee's stance has typically been to try to reduce staffing increases sought in the draft budget (except in health and education) so as to protect the level of operating expenditures. It has also expressed views on the priority given to various payments in view of the PA's difficult budgetary situation, stressing the importance of expenditures on infrastructure rehabilitation and medicines and payments

[35] For a discussion of the general issue of integrating recurrent and capital budgets, and their implications for the roles of separate ministries of finance and planning, see the 2005 Implementation Note, "Integrating Recurrent and Capital Budgets," available on the PEFA website.

[36] PLC members themselves select which committee they will serve on. Each member may serve on two committees. Other committees currently include those covering economic, legal, human rights, interior/security and education/health issues.

to families of prisoners, among other items. One future issue for the Committee will be to develop its role in the scrutiny of the security services budget.

The development of the MTDP provides an opportunity for more robust involvement of the Committee in the development of the budget, given the greater scope and information base of the budget compared with the Annual Budget Law. Likewise, the availability of more detail on proposed expenditures, in particular on proposed expenditures not appropriated by spending unit and activity, would provide a better information base for discussion of the budget.

The Committee has undertaken detailed and useful work on key legislation. The previous chairman was largely responsible for drafting the Organic Budget Law of 1997. The detailed work on the development of the new Law on Finance and Administrative Control Bureau (the external audit institution) was undertaken by the Committee, as was work on the new Pensions Law and Anticorruption Law (the Law on Illicit Gains).

MOF provides quarterly budget execution reports to the Palestinian Legislative Council, as required by the Organic Budget Law. The Committee discussed budget execution issues with the Minister of Finance weekly until movement restrictions put in place by Israel made it difficult to meet on a regular basis. The work of the Committee has been hampered by lack of time to review the proposed budget (less than two months) as well as the lack of detailed budget information and annual audited financial statements. The establishment of the new external audit institution, the Financial and Administrative Control Bureau, with a direct reporting line to the Palestinian Legislative Council will strengthen the role of the Committee in the review of budget execution. However, it will take some time for the new organization to become fully effective. In addition, the Committee should become formally involved in reviewing reports on the use of the budget contingency reserve.

Revamping the budget dialogue through the MTDP will provide an enhanced information base for the Palestinian Legislative Council review of the budget. The provision of more detailed information below the budget chapter levels would also assist this review function. The work of the Committee would benefit from greater time to review the proposed budget, improved detail on budget expenditure information and access to audited financial statements covering both budget execution and financial position. Developing a well-functioning national audit institution once the Financial and Administrative Control Bureau becomes operational would provide the basis for an enhanced role for the Committee in reviewing budget execution.

Budget Execution and Predictability of Funding To Line Ministries

Civil service and security service salaries, which are paid centrally by MOF, are the first priority expenditure and have until now always been paid on time. But given the precarious and volatile financial position of the PA—reflecting both inadequate funds to finance the budget and the lack of predictability on the revenue side (budget support from the donor community and PA clearance revenues transferred by Israel)—this predictability of salary funding comes at the expense of predictability for other expenditures. Predictability (and adequacy) of funding for operational expenditures continues to be a perennial problem.

In theory, line ministries are to receive one-twelfth of their budget allocation each month. In practice, this does not and cannot occur because of funding shortfalls. It is not clear on what basis the MOF budget department determines the release of funds for payments on behalf of line ministries as opposed to those paid directly by line ministries. But it is clear that even in 2005 funding for line ministry direct expenditure was highly unpredictable and the criteria used by the budget department of MOF for the release of funds are not transparent (box 2.1). In 2006 the situation was much worse for all ministries and departments.

Box 2.1: Examples of Unpredictable Funding

Ministry of Public Works and Housing. As of early December 2005 the ministry had received only one-third of its operating expenditure budget for the year. In February 2005 it received 4 months of its 2004 allocation to be used to pay off expenditure arrears.

Ministry of Agriculture. As of December 2005 NIS 5 million of the NIS 15 million operating budget had been funded. This prevented the ministry from providing agreed counterpart funding for some donor projects.

Ministry of Labour and Social Affairs. This ministry had received only one-twelfth of its operating expenditure allocation by November 2005.

Source: The ministries concerned.

Funding of expenditures from donor project funds, which in the case of ministries such as Education and Health comprise a significant portion of their total expenditure, is clearly dependent on the funding provider rather than MOF except in cases where local counterpart funds are required. Project funding through PECDAR appears more predictable, but depends on the behavior of individual donors. Funding through ESSP also appears more predictable.

The result of this unpredictability in the release of funds is that line ministries accumulate expenditure arrears based on the implicit assumption that these will be paid by funding from MOF in due course. While the formal budget allocation is normally regarded as the upper limit on the level of commitment, this may not always be the case given the lack of any formal system of commitment control. There is strong evidence that the accumulation of payment arrears has led suppliers to increase their prices to compensate for delays in payment. Ministries are required to advise MOF every month of the level of their expenditure arrears as recorded in unpaid purchase orders where goods or services have been provided, and to account fully for arrears, including copies of invoices at the end of the year, so that funding of these arrears may be provided in the ensuing budget year. This information is checked by the financial controller in each ministry. MOF budget department may release funds to line ministries, either in the current or following year, for the payment of such arrears. However, there does not appear to be any clear and widely understood system for determining which arrears are paid when, or for determining the relative priority of arrears held by line ministries as opposed to those held centrally for payments made by MOF. In summary, funding of line ministry operating expenditures, in particular those paid directly by line ministries themselves, is highly unpredictable and is not governed by transparent processes, with consequent adverse impact on service delivery.

Budget Execution and Cash Management

Before 2006, all PA revenues were channeled through the Central Treasury Account. A separate MOF unit had been set up to monitor the receipt of these revenues. IMF monitoring and a review by the 2004 CFAA team confirmed that clearance revenues from Israel, receipts of individual spending units, profits from PA commercial undertakings and budget support provided by donors were being paid into the Central Treasury Account. This latter practice has also been verified in the operation of the MDTF.

The balance of the Central Treasury Account was held in several commercial bank accounts. Spending agencies could choose (with MOF approval) from about 15 commercial banks for the operation of bank accounts from which their expenditures are funded. In 2004 the chart of accounts consisted of a relatively large number of bank accounts for both revenues and expenditures, including more than 1,500 accounts and sub-accounts and over 400 accounts used for advances only. This situation changed in 2006, as several Palestinian Banks elected not to hold PA accounts to avoid being blacklisted by the United States Office of Foreign Assets Control for "terrorist financing."

The cash management arrangements that were in place immediately prior to 2006 already represent a considerable improvement. There is, however, still scope for further improvement.

- Revenue and expenditure accounts could be swept daily rather than weekly (with a system of zero bank balance at the end of each day's business) and the number of bank accounts could be further reduced. Consideration should be given in the longer term to consolidating all bank accounts into one single account, with sub-accounts added as necessary.

- More attention should be given to regular checks between accounting records and bank statements (bank reconciliations), and the practice of writing and holding payment orders before issuing them should be eliminated.

- The practice of borrowing from commercial banks should be brought under strict control, with the Palestinian Legislative Council involved in approving both temporary and end-of-year borrowing limits and receiving reports of actual borrowing compared with agreed borrowing limits. Under the 2003 Annual Budget Law the PA cannot now borrow from the PMA or other PA institutions. In due course such controls on borrowing should be incorporated into the Organic Budget Law.

It is hardly surprising that no systematic cash forecasting system governing both cash management and budget execution exists. This reflects the continuing unpredictable fiscal conditions. At present, expenditure releases are determined by two factors: available liquid funds and an assessment of day-to-day priorities, leading to highly unpredictable funding of operating expenditure payments. With a return to more normal conditions, cash forecasting will be necessary for better cash management and budget execution. Such conditions would permit a more systematic approach to cash management.

As explained in a previous IMF report on West Bank and Gaza, financial planning is needed for both smooth budget execution and minimal borrowing costs (Hovland and Nashashibi 2002). A cash plan should be prepared to support the orderly execution of the budget. Such plans should be regularly updated to reflect changes in key parameters. It may not be possible to implement the budget as planned for the West Bank and Gaza due to revenue unpredictability. But a Cash Management Committee with representation from the Budget, Treasury and Revenue Departments of MOF could be an effective means of ensuring regular and frequent updates in budget execution and cash management plans.

Monitoring Palestinian Authority Debt and Liabilities

The Annual Budget Laws since 2002 have provided that the PA cannot borrow from the PMA or from other PA institutions, such as PIF. In due course, such intended generic provisions concerning borrowing should be incorporated in the Organic Budget Law. However, it should be noted that the PMA law allows PA borrowing up to 10 percent of the estimated budget deficit. Even through the PMA is not a central bank, it is not unreasonable to provide for some borrowing during the course of the year from such an institution, subject to limits and to clear reporting. The Organic Budget Law (Article 55) requires that the Annual Budget Law establish limits on new borrowing and on borrowing from commercial banks but it does not appear that this is done.

Given the absence of regular reporting on the state of PA finances (the monthly budget execution reports do not discuss liabilities) it is difficult for the PA to monitor its overall position. The production of regular consolidated accounts, preferably on a quarterly basis, which include timely information on the PA's financial assets and liabilities would facilitate such monitoring. The amount of the first two categories below debts to suppliers and to commercial banks, is more regularly managed and monitored as part of the budget execution process. The size of these debts reflects the significant fiscal problems being faced by the PA.

The following liabilities or debts exist:

- *Private sector suppliers*, most of which is in arrears, are clearly a major concern, although the exact magnitude is currently unknown. They were a problem in 2005, and anecdotal evidence indicates that they have exploded in 2006 as a consequence of the PA's severe fiscal compression.

- *Commercial banks* for short-term borrowing to finance the budget estimated by previous the Minister of Finance at $540 million at end-2005.

- *Civil service and security service pension schemes*. The two separate civil service pension schemes—the now closed West Bank "pay as you go" scheme and the Gaza contributory scheme—are not financially sustainable in the long term. The West Bank scheme has been closed to new entrants and all new civil service appointees join the Gaza scheme. Although a new Unified Pension Law was passed in 2005, it has not yet been implemented.[37] For both the current schemes there is a PA liability estimated at $253 million at end of 2005 covering employee deductions.[38] Previously there was no pension scheme for the security services, although a small number of older employees are now covered. While there is currently no scheme for the rest of the security services, it appears that salary deductions have been made in anticipation of the establishment of one, creating an additional liability. The two schemes are administered by GPIC, which holds assets amounting to some $120 million.

- *Public debt*. Debt recording and management is a responsibility of a unit in the Treasury Department of the MOF. It uses the UNCTAD (DMFAS) debt information system installed at the end of 2001. There was previously no central recording of PA debt and debt servicing payments were not always made on time, leading at one stage to a suspension of World Bank loan disbursements. The system is deemed to operate satisfactorily, but an independent audit (as part of the audit of the annual financial statements) would be required to confirm this. The amount of public debt is reported in detail in each year's Budget book and is required to be reported in the annual consolidated financial statements. Total debt at end-2005 is stated by the former Minister of Finance to be $1,060 million, with $480 million of this being a series of "soft loans" from the Islamic Development Bank which are intended to be, and therefore are better classified as grants (Fayyad 2006).

There appears to have been a lack of attention to the long-term liabilities being accumulated under the two pension schemes and a lack of financial accountability by GPIC, which has been chaired by the Minister of Finance with a governing board

[37] World Bank analysis suggests that the scheme is not financial sustainable. There are also serious concerns about its proposed governance arrangements.
[38] This figure does not include the long-term actuarial unfunded liability, which is estimated at several billions dollars.

comprising other ministers. GPIC has prepared audited financial statements for 2002 and 2003 (the latter presented only in June 2006) but no financial statements, audited or otherwise, since then. The World Bank has been providing advice on improving the governance arrangements for the schemes and strengthening the operations of GPIC. However, the GPIC information systems appear to operate well. The Bank has also assisted in a review of GPIC's investment portfolio, which has yielded low returns. There is an urgent need for improved financial accountability by GPIC, including the timely production of audited financial statements. There is also a need for pro-active monitoring of pension liabilities by MOF.

There are said to be no significant contingent liabilities by way of guarantees which require monitoring. This requires verification, and would normally be addressed by the external auditor of consolidated financial statements. Guarantees may be issued only by the Minister of Finance (Article 58 of the Organic Budget Law). No limit is placed on the amount, although the guarantees must be reported in the official *Palestine Gazette*.

3. The Accounting System

The current accounting system is a significant area of weakness in the PA PFM system. It does provide adequate control over the accurate and safe recording of receipts and the making of payments throughout the PA. But it does not provide adequate information for management by line ministries except in cases where ministries have developed their own accounting systems, which provide for more detailed breakdown of expenditures. Nor does it provide adequate information for MOF to be able to fully monitor budget execution. This reflects the proliferation of stand-alone accounting systems in line ministries which do not provide adequate information to MOF for this purpose. The redevelopment of the central MOF system is taking place without adequate involvement of and regard for the needs of line ministries.

The system is based on cash payments, reflecting the cash basis of budget appropriations, and does not include a commitment module, which is a major deficiency. It is also not integrated with the payroll system, so a manual interface is necessary.

The accounting system has two main parts: a central system (Oracle-based) operated by MOF, and separate systems operated by line ministries and agencies based on varying platforms. The first part covers the Central Treasury Account, which the MOF operates in accordance with the authorized budget, making payments on budget lines that it controls directly (the main ones are wage-related line ministry operating expenditures for which it makes payment and interest payable). There is no accounting manual to provide procedures and other operating guidance to accounting staff.

The second part concerns monthly transfers from the Central Treasury Account into bank accounts controlled by the line agencies. Line ministries make payments from these accounts in accordance with the budget lines for which they are responsible, and are also responsible for accounting for them. Ministries and agencies report their monthly expenditure to MOF, drawing from separate accounting records based either on the central system, their own accounting system or on manual systems. Thus the information technology solution varies from agency to agency. Some have accounting manuals. Some report quickly and accurately, others do not. The detail and frequency of management reporting for expenditures also varies. Some ministries (MOLSA and MOE) have developed their own systems in house, and these appear to operate satisfactorily. They may also provide more than a payments control function—the MOLSA and MOE systems also integrate stores accounting whereas the MOH systems covers only cash payments. On the other hand a purpose built system developed with donor assistance for MOH is apparently now being set aside in favor of the existing MOF system.

In summary, responsibility for accounting is partly centralized in MOF and partly decentralized to line ministries. The uniform chart of accounts, a single set of financial regulations and uniform reporting requirements bring the two parts of the accounting system together. For such a system to provide accurate, timely and complete consolidated reports, two conditions must be fulfilled. First, line ministries must report their final expenditures to MOF in a form suitable for aggregate monitoring and reporting. Line ministries need good accounting systems to produce, or their expenditures can only be reported in a preliminary way, as lump sum advances received. Second, MOF must establish and comply with standard accounting procedures and carry out comprehensive accounting routines according to a set schedule. This involves, among other things, carrying out regular proofs of accuracy to ensure that final figures can be easily prepared, verified, aggregated and reported.[39]

The central accounting systems itself has some strengths. It automates all financial transactions from initiation to final settlement. It also automatically generates accounting records and permits financial reporting. The system has a single point of data entry and thus a transaction is entered only once. All authorizations are automated through the system. Access to the accounting system is restricted to authorized personnel who only have access to modules under their assigned duties. The new central accounting system provides a wide range of financial reports to MOF, including balance sheet data, bank balances, payment status and advances. Backup is made daily by MOF.

The new central system has combined the two previously separate West Bank (the Bisan system, an off-the-shelf system) and Gaza (Al Bakr, an internally developed system) systems. It is being redeveloped in house rather than being based on any customized off–the-shelf system. Whether this approach will become degraded through lack of adequate in-house technical skills to maintain the system requires further study, but clearly there are some risks in departing from off-the-shelf systems. The redevelopment commenced two years ago and the system was scheduled to develop direct connections with separate line ministry systems in 2006, which should significantly speed up the preparation of the annual financial statements as well as improve the quality of information in the monthly

[39] A donor project to develop a comprehensive GFMIS (Government Financial Management Information System) commenced by the World Bank in 1994 and later taken over by another donor was eventually abandoned.

and quarterly budget execution reports.[40] The new system is being piloted at MOF and will be rolled out to all line ministries within 12–24 months, with priority given to the ministries of health and education.

Currently, the MOF loads the annual budget of all line ministries into the budget module at the beginning of the fiscal year. In the future, budget data will be entered at the level of the line ministries or their basic units and aggregated at the MOF level. This will facilitate budget preparation and execution and also expedite the implementation of changes to budget allocations that may happen during the fiscal year. The Palestinian Legislative Council will be given access to the system and will thus be able to directly review budget execution. Procurement and commitment control modules will be added in the future.

It appears that the redevelopment of the central accounting system is taking place without full involvement of and consultation with accounting staff of line ministries. The Steering Committee for this redevelopment comprises two information technology and two accounting specialists, but none of them represents a line ministry.

While there has been no review of the functionality of the separate systems operated by line ministries, it seems clear that lack of adequate technical staff may make it increasingly costly and difficult to operate and maintain this range of separate systems. It also appears that some may be focused more on transactions processing than on producing financial reports. A particular limitation of the central accounting system information is that it is not sufficiently detailed for all line ministries, going only to budget entity and line item information and not to spending at the unit level; it is also clear that overall the redeveloped central MOF system will not be capable of meeting all perceived needs for management information on behalf of the line ministries. There is a need to standardize these separate systems as far as possible and ensure that their information can be integrated with the MOF system.

Payroll Issues

Transferring the function of payroll control from the GPC to the MOF was an important step to improve payroll management, along with control over recruitment, promotions and other salary increases.[41] The fact that the MOF operates a payroll management system that covers both civil servants and security services personnel in both West Bank and Gaza facilitates the linkage between personnel decisions and budget appropriations. The personnel management function still rests at the GPC, which handles all personnel profiles in an Access-based system, with the exception of the MOI, MOE and MOH electronic personnel systems.

[40] A senior treasury official suggests that this should enable the production of the financial statements within six months of the end of the year.

[41] This section summarizes the payroll arrangements that existed prior to March 2006. A more detailed discussion can be found in Chapter 3 of the PER.

The 2004 CFAA noted the major advances made in payroll controls through having all civil servants and security personnel paid through personal bank accounts (beginning March 2004), with the release of payment requiring validation of the employee's name by the bank (thus ensuring that payments are made only to real persons). A partial payroll audit by the Internal Audit Department of MOF in July 2005 focused on identifying partial and double dippers, ghost workers and the lack of documentation in awarding allowances. A more detailed follow-up audit is planned, as discussed in the next section. Given that payroll comprises such a large proportion of total expenditure, payroll controls are also assumed to have been reviewed by the external auditor of the PA's aggregate 2003 financial statements, but the extent or nature of payroll issues raised in the management letter resulting from this audit is not known.

- Decisions on adding civil servants to the payroll are highly centralized at the MOF and subject to strict controls.

- Control over recruitment at the security forces is not subject to such strict procedures. Recruitment and promotions for the security forces are the responsibility of the payroll department at the MOI, which is autonomous from the MOF and provides the input into the single payroll system operated by MOF for both the civil service and the security service. It does not necessarily observe the rules on recruitment and promotion which apply to all PA employment decisions.

- The linkage between the GPC, the MOF and the MOI systems is paper-based, resulting in limited integration between personnel records and the payroll data and no reconciliation of the information, increasing the possibility of error and data manipulation. However work is underway to create a unified human resource management database.

- The payroll system is not linked to the MOF accounting system and the fact that manual journals are used to post payroll entries to the accounts gives room for further manipulation and human error.

Internal Audit

Reflecting the lack of an adequate external audit institution, the previous Minister of Finance placed considerable emphasis on developing an internal audit function located in MOF and reporting directly to him. Initially it was linked with the ex ante financial control function, and their relationship was and is a source of some confusion in spending ministries. Internal audit is an ex post review function, as opposed to the ex ante role of financial control. As identified in the 2004 CFAA, developing a collaborative, non-competitive and synergistic role between internal audit and the new external audit institution is an issue which will need to be explored as the new external audit institution is established. It is clear that internal audit will confine itself to systems reviews and will not undertake any financial statement audit work.

By ministerial decree, a separate Internal Audit Department was created in MOF in May 2004 with a well-qualified Director-General appointed and a draft charter approved by the Minister of Finance.[42] The *Palestine Gazette* of September 2005 set out the legal responsibilities of the new department. Good progress has been made in developing this department, which now has a staff of 52 with 15 more to be added. All staff appointments have now been converted to civil servants, a change providing tenure and improved salaries. Most of the staff have undergone training under the EC financed financial control and internal audit technical advice and training program provided by Ernst and Young in 2002/03, and a second program commenced in 2006. Unfortunately, given current political situation and donor decisions this program has ceased.

One major audit of the payroll system has already been done, and follow-up work in this area was planned for 2006. Sixteen other key audits have also been undertaken covering areas such a customs and income tax administration, some public works activities and the Ministry of Foreign Affairs, with the selection based on risk assessment. A three-year strategic plan has been developed. A major audit of MOA is planned, both as a substantive audit and as a training exercise. The previous Minister of Finance stated that reports he received were valuable and had been acted on. The Director-General of the Department commented on general acceptance by ministries of the role of his department and their willingness to cooperate.[43]

As one of the PFM benchmarks for the MDTF, an internal audit committee has been established to oversee and coordinate the implementation of the three-year strategic plan and the recommendations from specific audits.[44] Under the second EC consultancy, Ernst and Young also reviewed the current development of internal audit and financial control. An agreement was reached with the Internal Audit Department to decentralize its functioning. It is proposed by MOF that in future major line ministries will have dedicated internal audit staff that report to an audit committee of that ministry. Smaller ministries and other budget entities would be served by a central pool of internal audit staff. The role of the Director-General would become one more of professional support, guidance and review. This proposed new arrangement will require the approval of the new Minister of Finance.

Good progress has been made in developing a viable internal audit function, but it will take some time before the Department becomes fully effective. The proposed new decentralized internal audit arrangements should help.

[42] This person has subsequently resigned (May 2006).

[43] Discussions by the PER team with line ministries have indicated some confusion in their finance directorates between the roles of financial control and internal audit which will need to be clarified over time. Some still perceive internal audit as ex ante expenditure approval.

[44] The committee comprises the Deputy Minister of Finance (chair), the Director-Generals of the Internal Audit Department and the MOF Budget Department, a Director-General from the Ministry of Education and a private sector auditor (from Ernst and Young).

Financial Control

Reflecting the very lax expenditure control systems before 2002, the previous Minister of Finance obtained Cabinet approval in February 2004 to establish a strong ex ante expenditure approval department in MOF. Previously, each ministry had a financial controller reporting to its chief executive, who was responsible for this ex ante expenditure approval. A separate Department of Financial Control was established in MOF in 2004 with financial controllers out-posted to spending ministries as MOF staff members reporting to the Director-General of the Financial Control Department. The *Palestine Gazette* of September 2005 sets out the legal responsibilities of the new department. The Deputy-Director-General is located in Gaza and reviews the work of financial controllers located there.

Financial controllers have now been appointed in almost all ministries, with the exceptions of a few significant organizations such as the Customs and Income Tax departments. The security services have their own financial controller located in the finance directorate of the security services in Gaza who works independently of the Department of Financial Control and reports direct to the Minister of Finance.

The Financial Control Department had a total staff of 136 in December 2005, 74 located in West Bank and 62 in Gaza, nearly all of whom are contract staff. Training has been provided under the EC program and manuals developed. The Department is requesting an additional 25 financial controllers in West Bank and 15 for Gaza. For the longer term, the Director-General of the Department sees a need for some 300 staff in total. This may be unduly high, given the need for the finance directorates of line ministries to in due course to assume prime responsibility for financial control.

Apart from ex ante approval of payments, financial controllers also review proposals for persons to be added to the payroll, ensure that required bank reconciliations are carried out and that advance accounts are reconciled and review the information on payments made directly by the spending ministry from its own Bank accounts to MOF.[45] Issues in dispute between the financial controller and the ministry are forwarded to the Director-General for adjudication, and may in some cases be referred to the Minister of Finance.

With the development of the financial control function, MOF was intending to abandon its previous ex post review of all expenditure transactions, which was necessary before expenditure could be regarded as final and was one reason for the delay in preparation of financial statements. However, it is not clear whether this has been done. Given the normal responsibility of the finance directorate of a spending ministry itself for the tasks which are undertaken by the financial controller (as set out above), it may be argued that this second guessing adds another layer of control with the possibility of delays and little

[45] This approval involves checking that the payment has appropriate documentation, that calculations are correct, that funds are available and that the expenditure is otherwise legal.

value added.[46] Discussions between the PER team and five line ministries indicated mixed views of the operation of the financial control function.

MOF does not consider any relaxation of financial control arrangements to be appropriate now, fearing that there might be a return to previous fiscal indiscipline. However, as indicated in the 2004 CFAA, it appears appropriate to regard the existing financial control arrangements as an interim step, with greater devolution to line ministries occurring as the culture of financial control becomes further instilled in their operations. This was being addressed in the context of the EC funded review of internal audit and financial control and MOF tentatively agreed that the function should be further devolved to line ministries. However the details have yet to be worked out and would require the approval of the new Minister of Finance.

In summary, the financial control function appears to have provided increased assurance in the correctness and legitimacy of payments.[47] It is important that this function be undertaken in an efficient manner, avoiding unnecessary second guessing of line ministry finance departments. A proposed greater devolution to line ministries appears appropriate, although further detail is required before any firm conclusion can be reached.

Aggregate Financial Statements

The Organic Budget Law (Articles 65 and 66) provides for the PA to present preliminary consolidated financial statements to the Council of Ministers within six months of the end of the financial year and final accounts for subsequent submission to the Palestinian Legislative Council within 12 months of the end of the year.[48] The Financial and Administrative Control Bureau Law of 2004 has slightly different provisions, requiring presentation of preliminary consolidated financial statements to the Bureau within six months of the end of the year (although no reference is made to auditing them) with final accounts to be presented to the Bureau within 12 months of the end of the year, with the Bureau to "study and make relevant observations" before referring them to the Palestinian Legislative Council.

The absence of such provisions in the Organic Budget Law thus implies that the Palestinian Legislative Council might receive un-audited statements, which would seem inappropriate. The Organic Budget Law also sets out some general requirements for the content of the statements (repeated in the Financial and Administrative Control Bureau Law), which are reporting "opening and closing balances of the consolidated fund and the special funds," and "details of financial operations implemented to manage the fiscal deficit and the net public debt." These requirements fall far short of requiring meaningful information on key issues as the financial position of the PA. Reflecting CFAA

[46] The Financial Control Department has set a performance standard of dealing with all payment requests within three days.

[47] It is not known to what extent these financial control arrangements are being applied to payments now being made through the Office of the President.

[48] As pointed out in the 2004 CFAA, this period of time seems unduly long and should be reduced to six months.

recommendations, the General Budget and Financial Affairs Regulations 2005 require reporting on financial assets and liabilities as well as budget execution. Clearly, there is a need to develop more consistent and meaningful requirements for the content of the consolidated financial statements, and for these to be in the Organic Budget Law.

No financial statements were prepared until 2002. The 2002 statements were submitted to the Palestinian Legislative Council in January 2004 but were not audited. Although they marked a reasonable attempt to provide meaningful information on the extent that donors utilized the Central Treasury Account, they were largely a statement of budget execution and they were difficult to follow, comprising a number of sub-statements that were insufficiently linked to each other.

The preliminary 2003 statements were posted on the MOF website in April 2004. Terms of reference for an external audit to be carried out by a private auditing firm were developed by MOF in consultation with the World Bank in late 2004.[49] Price Waterhouse Coopers was selected and the audit was completed in January 2006, following which a detailed management letter of some 100 pages was sent to the PA for response. No response was received, so there is as of yet no audit report available on the 2003 statements. It now appears questionable whether any such audit report will ever be issued or if, given the passing of time, its contents will be very relevant.

Reflecting the recommendations of the 2004 CFAA that the statements need to be more than just statements of budget execution, but should also provide information on the financial position of the PA,[50] some of this information was included in the 2003 statements. However, none was included in the 2004 statements, apparently reflecting a view in MOF that cash based statements could not include information on accrual based concepts such as assets and liabilities. As discussed above, it should be possible to produce aggregate statements on a quarterly basis to assist in the monitoring of the PA's overall financial position on a more regular basis. The International Public Sector Accounting Standard (cash basis), which provides for reporting on a cash basis as well as the disclosure of supplementary information on an accruals basis (assets and liabilities), would be an appropriate future framework for these statements.

The 2004 preliminary financial statements were completed by end of June 2005 and sent to the Palestinian Legislative Council in July, but have not been posted on the MOF website and as yet no arrangements have been made for their audit. Based on the translated English version they appear to be less satisfactory than the 2003 statements, difficult to follow and limited to a summary statement of budget execution (no supplementary information on financial assets or liabilities or any reference to the PA's financial position). The calculation of the financing balance is also difficult to understand.

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[49] The use of private sector auditors was seen as an interim measure, pending the establishment of an effective Palestinian external audit institution.

[50] For example, inclusion of PIF investments and other financial assets, inclusion of public debt, amounts owed to Palestinian commercial banks, ordinary creditors including arrears and other long-term debt, contingent liabilities, write offs and use of the budget contingency reserve.

The position concerning aggregate financial reporting is very unsatisfactory. As of June 2006 no timely, adequate or audited financial statements for the PA have been produced. This appears to reflect two problems. The first is inadequate technical resources and guidance in the accounting department of MOF. For example, there are no manuals or instructions concerning the end of year closing of accounts. The delay in closing or reconciling various advance accounts to obtain final expenditure figures has also delayed production of the accounts. The second problem is a lack of priority from the MOF for the preparation of these statements. There does not appear to have been sufficient appreciation of the importance of audited financial statements to the financial credibility of the PA and to the ability of donors to maintain budget support. Not only would a satisfactory audit report lend credibility to the reported information, but the auditors' review of the adequacy of the control systems in place would also provide an independent professional opinion on whether the financial control framework is adequate and operating as intended.

4. External Audit

The 2004 CFAA identified the lack of a credible, professional external audit institution as a major deficiency in West Bank and Gaza's PFM system. It noted that while a formal external audit institution, the General Control Institute (GCI) had been created under Law 17 of 1995 it lacked independence, capacity and impact. It reported formally to the President, but neither reported to nor was responsive to the Palestinian Legislative Council. While the GCI's mandate contained some desirable features of an external audit organization, such as adequate budgetary independence and the power to obtain information, its reports were not forwarded to the Palestinian Legislative Council nor made public by the President, nor apparently followed up. The President was also able to exempt any organization from audit. Anecdotal evidence from auditees suggested that its capacity was weak and the quality of its work low. Overall, it appears to have had no discernible effect on public accountability.

In 2004 the Palestinian Legislative Council passed law No. 15, creating a new national audit institution, the Financial and Administrative Control Bureau. Please put the President sentence back – it is important – even if a law is passed the President has to sign it before it can be implemented The legislation has a number of deficiencies, such as combining within the organization the separate functions of administrative review and audit and not clearly providing for both performance and financial auditing, including an audit opinion on the PA's financial statements. But the Bank and the EC have assessed the legislation as providing an overall adequate basis for the functioning of a new external audit institution. In particular, it provides for the Council to report to both the President and the Palestinian Legislative Council (at any time, quarterly and annually) and requires Palestinian Legislative Council endorsement of the nomination of the President of the Bureau, who is approved by the President of the PA on nomination by the Cabinet. It provides for coverage of all PA entities, including local government, and for reporting to the Palestinian Legislative Council on the quarterly budget execution reports prepared by MOF.

Unfortunately, implementation of the new law has proceeded extremely slowly, with the appointment of the new President of the Bureau being made only in December 2005. The Minister of Finance correctly took the view that the development of this institution was the responsibility of the Palestinian Legislative Council or the President's or Prime Minister's Office, rather than of MOF, given the MOF's position as an auditee. A benchmark in the MDTF requiring the development by the PA of an action plan for the establishment of the new institution was not met.

The 132 staff of GCI have been transferred to the new Bureau. Of the two other statutory appointments, both of which are nominated by the President of the Council but subject to the approval of the Cabinet, the Vice-President has been appointed and the Director-General is about to be appointed. All staff are civil servants and the Bureau is administratively attached to the PA President's Office.

The action plan, which was a benchmark of the MDTF, was designed to incorporate the following:

- Assessing the human and other resource needs of the new institution.
- Developing the priorities and methodologies to be adopted.
- Assessing the extent to which transferred GCI staff and existing methodologies may be suitable to the new organization.
- Assessing gaps in human resource capacity and methodologies.
- Developing a plan for filling these gaps.

The new institution has commenced work, but it is severely hampered by lack of capacity and resources, including having only 18 staff in the whole West Bank and having no functioning office in Ramallah. It has taken steps to require declaration of financial interests by Ministers and members of the Palestinian Legislative Council, which it intends to extend in due course to civil servants. It is currently focusing on reviewing the functioning of the MOF financial controllers system and the work of the MOF Internal Audit Department, which will be the subject of its first report.[51] It has developed a general master plan and a work plan for 2006 which includes capacity building and professional development and financial control activities

While this plan includes some of the elements set out above, more work is required in needs assessment and methodology development. Consideration has to be given to the relative roles of the Bureau and the Internal Audit Department of MOF and appropriate coordination is necessary to avoid overlap and duplication of activity. The Palestinian Legislative Council and the PA President's Office should also have input into this plan.

[51] This review should use rather than duplicate the review of these issues already conducted by Ernst and Young.

External assistance, by way of a peer review by another national audit institution, would also be highly desirable in finalizing the plan, as would significant external assistance in methodology and training from one or more national audit institutions to develop capacity. The donor community should stand ready to offer all necessary technical assistance.

A key priority for the new institution should be to develop its financial auditing capacity so that it is able to undertake the external audit of the PA's financial statements, which have been audited by private external auditors as an interim arrangement, and to undertake the audit of financial statements of donor funded projects. The latter would be consistent with the donor community's commitment to move to the use of country systems in project FM arrangements to the greatest extent possible.

There is as of yet no adequately functioning external audit institution. Developing the capacity of the new Financial and Administrative Control Bureau is a high priority.

Palestinian Authority Commercial Investments

Cement Company. This wholly owned PA company is the monopoly supplier of cement in West Bank and Gaza. It is part of the PIF portfolio, and is thus overseen by the PIF board. As it is also a state-owned enterprise, the PIF board should ensure that it publishes separate audited financial statements.

Petroleum Corporation. This is the largest state owned enterprise, with a monopoly on the importation of petroleum products (from Israel) and their distribution. Control of the corporation was transferred to MOF in 2004 to combat alleged widespread corruption in its operations. Since 2005 it has been receiving significant transfers from the budget to subsidize the price of petroleum, but no annual audited financial statements appear to have been prepared, which is a significant lapse in terms of fiscal transparency.

Palestine Investment Fund (PIF). Since its establishment the PA has invested in a range of commercial undertakings, both with a view to generating revenue for the PA, and to stimulating economic growth in West Bank and Gaza through strategic local investments.

PIF was formally established by Presidential decree in October 2002 as a component of the 100 days Palestinian Reform Plan to manage the PA's commercial investments. PIF is an autonomous entity wholly owned by the PA and is incorporated under PA Companies legislation. Under the decree it is illegal for the PA to conduct any commercial activity or hold commercial assets outside of PIF. PIF is allowed to invest liquid funds in temporary investments, but is not allowed to lend to the PA budget. PIF transfers a share of its profits to the budget as determined by the Minister of Finance.

PIF replaced the previous Palestine Commercial Service Organization (PCSC), which used PA revenues not paid into the budget (petroleum, tobacco and alcohol excises plus on-going profits from these commercial operations) for investment in some 79 commercial undertakings, both within West Bank and Gaza and abroad. These included monopolies in cement and petroleum, which were acquired at an early date. There was little transparency and accountability concerning its operations.

In late 2002 the new PIF board engaged the international firm of Standard and Poors to undertake a valuation and "transparency assessment" of the companies in which PIF held shares. A report was issued on 9 March 2003 listing all investments along with their valuation.[52] In addition, the report listed current bank accounts formerly controlled by the Palestinian Commercial Services Company (PCSC). The report was presented to and discussed by the Palestinian Legislative Council. The transparency assessment reviewed the availability and reliability of financial and other data, as well as how each entity is owned, organized and operated, and whether based on the findings it will be judged both "transparent and respectable" by international standards. Anti-competitive behavior, unfair or preferential relationships with the PA and corruption issues were included in the diagnostics.

The articles of association of PIF outline the authorities and responsibilities of the Board of Directors and the management of the company and provide for proper management and governance of the PIF. Three directors' signatures are required for any investment decision. Apart from the Articles of Association, a detailed policies and procedures manual governs its operations. The governance arrangements for PIF have recently undergone a major change, with a Presidential decree providing for its transfer to the Office of the President. The Chief Executive is now officially an adviser to the President and chairmanship of PIF has moved to an external appointee rather than the Minister of Finance. The Minister of Finance, along with the Minister of Economy, remains a member of the board, which has a private sector majority.

Under its Articles PIF is required to prepare an annual report within a "reasonable time" of the end of the financial year. It is also required to prepare quarterly statements (which although not formally audited include an audit review to determine the likelihood of material misstatement) and annual audited financial statements. In April 2004 PIF presented its first annual financial statements, those for the year 2003. These were audited by the international firm Ernst and Young and received an unqualified audit opinion. The financial statements for 2004 were made publicly available through the PIF website on 16 May, 2005 and were formally published as part of the PIF Annual Report issued on 15 September, 2005. They also received an unqualified audit opinion.

The 2005 statements indicate a net equity of $956 million at 31 December 2005, compared with net equity of $713 million at 31 December 2004. This net equity increased to $1,292 million at 31 March 2005, the most recent period for which interim statements are available on the PIF website. PIF has thus been a highly profitable undertaking, achieving particularly significant returns from its investments outside West Bank and Gaza in the Orascom Telecommunications Holdings. While at 31 December 2004 investments in West Bank and Gaza were only one-quarter of total investments, this

[52] Investments totalled some $633 million at that date. The Standard and Poor report along with PIF by-laws are published on the PIF website, www.pa-inv-fund.com/lasse.asp

proportion is now increasing following the sale of the Orascom Telecommunications holdings program using PIF funds.

In 2004 PIF paid a dividend of $74.5 million to the budget (compared with a budget provision of $35 million), compared with $31 million in 2003 and nothing in 2002. In 2005, according to the former Minister of Finance, some $120 million ($60 million more than the proposed dividend set out in the PIF 2004 financial statements) was transferred from PIF to the PA budget by way of dividend, reflecting in part the high level of PIF profits in 2004. A further $156 million went to support the social care program included in the 2005 budget,[53] leaving net equity in PIF of $858 million at end-2005. In addition, the former Minister states that $443 million of PIF assets were used as collateral for borrowing from commercial banks for 2005 budget (Fayyad 2006).

It has not been possible to verify these figures as no financial statements for PIF have been presented since March 2005. This disappointing decline in fiscal transparency reflects in part recent difficulties in West Bank and Gaza as well as the change in PIF's governance and management arrangements and some apparent lack of documentation of key PIF board decisions made in 2005. Audited financial statements for 2005 were expected to be available in early June 2006.

The new PIF board is proposing a change in investment strategy which would see greater involvement in longer term strategic PA development needs, such as investment in the Gaza off-shore gas project, a second broadband license for West Bank and Gaza, a guarantee fund for Palestinian entrepreneurs and Gaza housing. While it is intended to at least partly offset the lower shorter-term returns from such investments by a change to higher return (and thus higher risk) investments outside West Bank and Gaza, the net result is likely to be some decline in the value of the PIF portfolio and in PIF profits in the medium term. The PIF board has also recently agreed to transfer some $100 million to the President's Office to cover urgent PA expenditures.

5. Policy Recommendations

Drawing upon the discussion in the chapter above, box 2.2 provides a detailed set of policy recommendations for the broader PFM reform agenda.

[53] Although this would mean transfers to the budget in 2005 exceeded realized PIF profits for the year, running down net equity is permissible provided net equity does not go below the level of authorized equity capital and statutory reserve of $580 million.

Box 2.2: Public Financial Management Policy Recommendations

Donor Practices:

- When circumstances allow, donors should resume channeling their assistance through the Central Treasury Account and the PA accounting system as soon as possible and close all accounts with the Office of the President.
- Donors should move to meet international commitments to harmonize project financial management requirements.
- All donors should respect the MOP's mandate to endorse all projects and programs and provide accurate and comprehensive information on their activities to the MOP's database.
- Donors should fully and actively support the MOP's efforts in the formulation and implementation of a Palestinian Harmonization and Aid Effectiveness Action Plan.
- Ensure that PECDAR becomes accountable to the executive branch of government, with its financial transactions being part of the Central Treasury Account.

Scope of the Budget:

- Consider transferring responsibility for approval of all external financial assistance grants to the MOF.

Nature of Budget Appropriations:

- Ensure separate reporting on the use of the budget contingency reserve in the aggregate financial statements, to be thus audited and then reviewed by the Palestinian Legislative Council.

Budget Classification and Establishing Line Ministry Accountability for Expenditure Control:

- Revise the chart of accounts to make it consistent with international classification systems and to provide for reporting by spending unit and program in the redevelopment of the accounting system.
- Review the current system of the MOF directly paying much of the operating expenditures for line ministries and departments.

Budget Documentation:

- Improve budget documentation by including narrative information on the role, responsibilities and activities of budget entities and by providing explanations of previous year's out-turns against budget.
- Provide the full budget documents on the MOF website to ensure wide availability.

Budget Development Dialogue:

- Deepen the level of discussion with MOI on the security service budgets.

Improving Expenditure Prioritization:

- Continue with the development of the MTDP, paying close attention to the full involvement and collaboration of the MOF, MOP, line ministries, PECDAR and the donor community.
- Over the medium term, consider merging MOP into MOF so as to more fully integrate the planning and budgeting functions.

Role of the Palestinian Legislative Council in Budget Development and Execution:

- Review the budget timetable to allow for more effective review of the proposed budget.
- Formally involve the Committee in reviewing reports on the budget contingency reserve.

Budget Execution and Enhancing Predictability of Funding to Line Ministries:

- Increase the predictability of funding for line ministries from the MOF budget department operating expenditures by establishing a transparent system for the release of funds, both for items paid by MOF and those paid by line ministries from their own bank accounts.
- Develop a formal commitment control system as part of the redevelopment of the accounting systems and consider a formal role for financial controllers in approving commitments as well as payments.

Budget Execution and Cash Management:

- MOF should sweep all bank accounts on a daily basis, with consideration being given in the longer term to consolidating all banking arrangements into one account with sub-accounts as necessary for ministry and agency operations. MOF should ensure that all ministries (MOF and line ministries) regularly carry out bank reconciliation.
- MOF should also ensure that line ministries do not issue payment orders until funds are available.

Continued…

- A system of cash forecasting (involving a Cash Management Committee comprising different parts of MOF) should be developed, in order to alleviate the current short-term (day by day) approach to funds release and to provide a basis for monitoring the extent to which the budget (both revenues and expenditures) is on track.
- Provisions governing limits on borrowing should be incorporated into the Organic Budget Law. These provisions should include appropriate reporting on actual levels of borrowing to the Palestinian Legislative Council.

Managing Palestinian Authority Debt and Liabilities:

- Develop regular (quarterly) production of aggregate financial statements which will enable the overall financial position of the PA to be monitored on a regular basis.
- Improve financial accountability of GPIC, including the presentation of timely and audited financial statements, and ensure that these are reviewed by MOF and Palestinian Legislative Council.

The Accounting System:

- Using appropriate external technical resources undertake a review of the existing accounting systems strategy. This review would examine:
  - The appropriateness of the "in house" approach to the current redevelopment of the central system operated by MOF.
  - Possible strategies to ensure the management information needs of line ministries are met, while avoiding the proliferation of separate ministry systems which may become increasingly difficult to operate and maintain.
  - The system implications of moving to a more detailed process of budget development and assignment of budgets to spending units.
  - Ensure that the redevelopment of the accounting system includes a commitment control module.

Payroll Issues:

- Bring security services payroll under the direct control of MOF.
- Accelerate work on the integration of the payroll and personnel systems.
- As part of the redevelopment of the accounting system, provide for a direct link between the payroll and MOF central accounting systems.

Internal Audit:

- Develop a collaborative relationship with the new external audit institution as it becomes established on a sound footing.
- Proceed with the proposed decentralized arrangement for the internal audit function.

Financial Control and Reporting:

- Amend the Organic Budget Law to require financial statements to be finalized and presented for audit within six months of the end of the financial year, and for audited statements to be presented to the Palestinian Legislative Council within nine months of the end of the year.
- Adhere to this timeframe for the production and audit of these statements.
- Improve the form and content of the financial statements so that they comply with the International Public Sector Accounting Standard (cash basis).
- Seek the external technical assistance necessary for MOF to improve both the timeliness and form and content of the statements.

External Audit:

- Proceed expeditiously to make the new Financial and Administrative Control Bureau operational, developing a detailed action plan as discussed above and seeking external assistance from another national audit institution in doing this and in ongoing capacity development.
- Ensure that particular emphasis is placed on developing the Bureau's capacity to audit financial statements.

Palestinian Authority Commercial Investments:

- Ensure the previous standards of timely financial reporting by the PIF are reestablished.
- Ensure timely audited financial statements are produced by the Petroleum Corporation.

Ensure the publication of separate timely audited financial statements by the Cement Company.

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CHAPTER 3: THE CHALLENGE OF CIVIL SERVICE REFORM

1. Key Issues and Challenges

Since the Oslo Accords, the Palestinian Authority (PA) has become both the main service provider for the Palestinian population and the largest employer in the West Bank and Gaza. But its long-term viability has been sorely tested as public sector salaries have largely gone unpaid throughout most of 2006 and wage arrears owed to PA employees from March to October exceeding $572 million. Several partial salary payments were made by the PA and the Arab League through the Office of the President (OOP), but only amount to about 40 percent of the total. Until August 2006, ministries were operating with around 70 percent of their staff in attendance, absenteeism higher in the West Bank than in Gaza. In September 2006, a crippling public sector strike broke out. No official data is available on the number of workers striking, but informal estimates place it higher than 75 percent in the West Bank and much lower in Gaza. A recent poll by the Center for Policy and Survey Research revealed that nearly half (48.2 percent) of Palestinian respondents believe the PA must be dissolved if it fails to pay the salaries (2006).

The implosion of revenues after March 2006 would have thrown any government into turmoil, and little could have been done technically or administratively to cushion the blow. That so many employees continued to work even though they had not been paid in months is a credit to the PA. But the seeds of the current crisis were laid more than a decade ago, as both the PA and the donor community repeatedly failed to address core issues of public administration reform, resulting in a civil service establishment that is an excessive burden upon PA finances and does not provide services worth the considerable resources invested in it. While the current crisis was unavoidable, policies pursued over time have made the PA vulnerable to any disruption in external aid flows and exacerbated the depth and impact of the crisis.

In the six years since the start of the second Palestinian uprising, total public sector employment grew by nearly 70 percent. Public sector salaries increased significantly, particularly after the substantial 2005 pay increases awarded to both security and civil service employees. In the last quarter of 2005, the wage bill averaged $93.4 million a month, almost a 20 percent increase from the first two quarters, according to Ministry of Finance data. By early 2006, formal spending on public sector salaries represented more than 91 percent of the PA's total revenue and about two-thirds of current expenditures. (Informally, senior PA officials have indicated that the wage bill was actually $112 to $120 million a month.) Given that the PA's net revenues were approximately $108 million a month in the last quarter of 2005, its revenues were unsustainable even prior to the election of Hamas in January 2006. As the public sector has expanded, it has reduced the resources available for non-wage expenditures, degraded the quality of service delivery and made the PA particularly vulnerable to disruptions in the flow of clearance revenues and external assistance.

This wage expansion has not occurred in a vacuum. Powerful pressures were at work that would have been difficult for any government to resist. Difficulties in transportation and restraints on movement make it hard to rationalize and optimize the distribution of staff. Heavy demographic pressures, combined with the private sector's limited capacity to absorb new entrants into the labor market, have pressured the PA to provide employment. In the past five years, the public sector served as a buffer against the loss of jobs in Israel due to movement restrictions following the *intifada*. The deteriorating security situation and rise of private militias have pressured the security services to expand.

In spite of the fiscal shortcomings, a number of concerted efforts at civil service reform have been made. The government passed a Civil Service Law in 2005, which identified stricter recruitment rules and outlined measures for non-compliance. The law rationalized the number of allowances and reduced managerial discretion. The role of the General Personnel Council (GPC), the chief body responsible for oversight of civil service statutes, was strengthened and much of the alleged corruption and lax administrative practices prevalent earlier cleaned up. The role of the Ministry of Finance (MOF) in monitoring fiscal flows and controlling the payroll has reduced fraud. Some administrative structures have been rationalized, and the security services have begun important reforms. The institutional infrastructure to manage the reform process is in place, and these efforts should provide the foundation for future reforms.

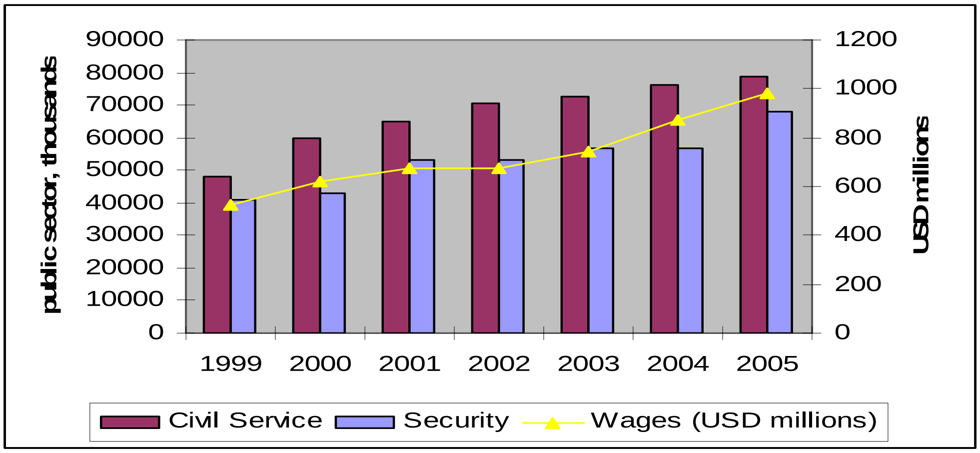
Ultimately, the PA's success depends on its ability to pursue a sustainable fiscal policy, which in turn depends on controlling the wage bill, far and away the largest single item of expenditure. Generating employment through the public sector may have worked episodically in the past, but such days are over. Even after donor funding resumes, the PA has exhausted its capacity to absorb any additional excess labor. It cannot, in fact, afford the establishment it currently has. Because existing commitments cannot be fully honored, the PA and donor community have two choices. They may either address this problem directly in a sophisticated, equitable, and comprehensive fashion. Or they may continue to act on an informal and ad hoc basis by simply paying a portion of salaries owed as resources become available and hoping that adequate resources will materialize and the day of fiscal reckoning be postponed.

2. Evolution of Employment Policy in the PA

When formed in 1993, the PA had 20,000 employees, largely from the Israeli Civil Administration. The majority were doctors and teachers. Some who assumed largely managerial positions in the PA came from the PLO. Between 1995 and 2000, the number of PA employees more than doubled, equivalent to an annual growth rate of 12.3 percent. In the early years, this expansion could be justified as the PA was acquiring new responsibilities and assuming greater control over services and security in the Palestinian territories. Overtime, the rate of hiring was clearly outpacing the PA's capacity to provide improved public services. By 1998–1999, the Bank and other donors began expressing serious concerns of fiscal sustainability.

The situation grew worse with the second *intifada*, when the PA created jobs to soften the blow on the private sector. In the first year, public sector employment grew by 12.8 percent. In 2002 and 2003 the public sector grew an additional 10 percent a year.[54] In 2004 public employment continued to grow but generally remained within the general proportions imposed by agreement with the international donors. The civil service added 3,924 new employees, just 424 employees over the number stipulated in the budget. The bulk of the civil service hiring was in Health, Education and the Ministry of Social Affairs. The security services, however, added an additional 3,443 employees even though the budget stipulated a freeze on more hiring.

Figure 3.1: Public Sector Hiring and Wage Bill Growth, 1999–2005



Source: MOF and GPC.

The PA granted significant salary increases, averaging more than 20 percent, to civil servants in 2003 when the new civil service legislation was implemented. However, a clear tipping point occurred in 2005 when the PA was found in violation of the ongoing Public Financial Management Reform Program tied to the Reform Trust Fund. Donors were particularly concerned with PA's performance against the Wage Bill Containment Plan targets and pension reform. Wage increases at the end of the year exceeded projections by an additional $300 million. Neither the higher revenue increases nor anticipated levels of donor support were likely to cover the wage bill (See Table 3.2 below).

The MOF initially estimated that retrenchment and retirements would offset the budget impact of the salary increases. It identified 8,000 non-performing security service employees and about 2,000 non-performing civil service staff. Eliminating these employees would have saved an estimated $85 million a year. But despite the repeated promises to take action, none of the identified non-performing personnel were removed from the payroll. Additionally, the implementation of the Unified Pension Law (UPL) in September 2005 did not lead to significant retirements in civil service personnel. The Pension Law passed for the security services did not lead to substantial savings because

[54] Meanwhile, unemployment in the Palestinian territories rose to 25.5 percent in 2002 and 30 percent in 2003, reflecting the increasing uncertainty of job prospects in Israel and declining economic opportunities in the Palestinian territories.

the pension payments were equivalent to or even exceeded the salaries of active employees.

In 2005, the wage bill increased significantly following implementation of the new Civil Service Law and additional hiring into the security services. The civil service added 3,666 employees, almost 90 percent for the Ministries of Education and Health. The security services added an additional 13,852 new recruits funded from the transfer budget of the Ministry of the Interior (MOI). The security service recruits do not appear on the payroll of the MOI and are paid a stipend of NIS 1,065 a month. Some government bodies such as the MOF, the President's Office and the GPC witnessed reductions in total staffing levels, but most reductions were due to the reallocation of staff to different agencies and Ministries.[55]

Average wages increased by 28 percent for security and by 13 percent for civil service personnel in 2005, eclipsing the rate of inflation and the average wages for the private sector and workers employed in Israel. As a result of hiring and wage increases, the total security and civil service wage bill eclipsed $1 billion in 2005, up from $870 million in 2004. By the end of the year, the wage bill swallowed up nearly 23 percent of the West Bank & Gaza's annual GDP and 82 percent of gross government revenues—nearly three times the equivalent MENA average.[56] Wage bill payments reached 55.1 percent of current expenditure in 2005, slightly lower than in the past several years due to improved revenue performance and strong donor support. In the last quarter of 2005, the wage bill was formally averaging $93 million a month (although as noted above, informal assessments by authoritative PA sources place it significantly higher), with net revenues at approximately $115 million a month (see Table 3.1 below).

Table 3.1: Average Monthly Expenditures and Revenue for 2005, in Million USD

PA Revenues and Expenditures	2005 Budget	Q1 Jan–March	Q2 Apr–June	Q3 July–Sept	Q4 Oct–Dec
Gross wages	78	79	78	84	93
Civilian	47	49	50	51	55
Security	31	29	29	33	38
Transfers	52	15	48	20	42
Non-wage operating expenditure	20	12	24	19	18
PA development expenditure	2	1	6	5	3
Total expenditure*	153	107	136	148	155
Net revenue	88	85	114	97	115

Source: International Monetary Fund.
Figures on total expenditure do not include spending on net lending.

[55] The GPC used to carry some 2,000–2,500 surplus staff on its payroll. These were largely political appointees and staff working for the security services. The current head of the GPC vowed to end the practice of seconded employees and it appears that the problem has been largely fixed.
[56] The recent World Bank estimates indicate that civil service wages for MENA range from 6 to 19 percent of GDP (Bulmer 2000).

This wage bill increase has left little room for non-wage operating expenditures and transfers. Transfers were reduced from the budgeted $52 million a month to an average of $31 million. (Transfers include social security payments—the government's contribution of 12.5 percent as employer to the civil service pension fund, members of the Gaza Pension and Insurance Corporation and West Bank pensions.) PA non-wage operating expenditures were also reduced, albeit less severely. The budget anticipated $20 million in monthly expenditures but actually averaged $18 million. PA spending on development projects is almost entirely depended upon donors.

The impact of these shifting expenditure patterns is particularly pronounced at the sectoral level. A recent assessment of the Ministry of Health, for example, showed that its salary budget had risen by more than 70 percent in 2000–2005; in contrast, budget funding for non-salary expenditures was flat or declining for much of this period. In 1997–2001 allocations for health declined from 14 to 9 percent of budgetary expenditures, and allocation for education fell from 22 to 17 percent. The PA was able to survive this diminished support for non-salary expenditure only through a large increase in donor funding. This in turn severely reduced budget predictability and increased vulnerability to exogenous shocks, such as the withdrawal of donor support in early 2006.

Recent Developments. Before the new government took over in March 2006, a number of policy measures were put on the table to reduce the wage bill. The MOF proposed in December 2005 to form a presidential committee to remove 5,000 civil service and security employees "not at post;" retire an additional 5,000 personnel and offer 500 people early retirement; impose a complete freeze on any renewal or extension of contracts of persons over the retirement age of 60; and review all security service appointments in 2005, which included 15,000 new recruits. Other proposed measures included elimination of all overtime payments except those for doctors and border guards and an audit of all oversees posts.

The estimated fiscal impact of these measures is approximately $85 million a year, or 5 percent of PA expenditures. The estimated savings could close roughly half of the gap between the projected wage bill in 2006 and the original target of the Wage Bill Containment plan proposed under the Reform Trust Fund. However, only a few measures were implemented, including the formation of the presidential committee to review all new appointments and the suspension of all overtime payments to civil servants.

In the first quarter of 2006, PA finances further deteriorated following the withdrawal of donor support and Israel's refusal to transfer clearance revenues. The PA initially expressed interest in rationalizing public employment, but so far has been reticent to take drastic steps. Despite the fiscal squeeze, the PA managed to add 1,388 additional civil service employees (including 1,186 in the Ministry of Education). Some replacement hiring has also occurred under the new government. On the security services side, PA hiring brought the total number of new recruits since August 2005 to 17,021. This is in addition to some 3,984 permanent security service personnel added to the payroll of the Ministry of Interior. Reports indicate that a corresponding increase in the president's executive forces also took place during the same period, putting the total number of security service personnel at 65,000.

The additional hiring took place during a paralyzing general public sector strike. Nearly all staff in the MOF and the Ministry of Planning were on strike, and most other central government ministries operated with fewer than half their employees. Widespread absenteeism, disintegration of financial and managerial controls, delays and reductions in social support payments, and electricity shortages compromised the work of those frontline providers, such teachers and doctors, who continued to come to work despite the adverse circumstances.

Table 3.2: Growth of PA Wages and Salaries, 1996–2005

Year	Salaries (USD million)	Growth rate in percent	Salaries (percent of current expenditure)	Salaries (percent of GDP)
1996	403	-	57	10.9
1997	471	14	54	10.7
1998	467	0	55	9.9
1999	523	10	56	10.8
2000	619	15	51.9	13.1
2001	678	8	62	18.4
2002	642	-5	69.6	25.7
2003	743	10	66.7	26.5
2004	870	9	64.4	21.8
2005	1001	15	55.1	23.3

Source: Ministry of Finance.

3. Description of PA Employment

Aggregate Staffing Levels. When compared with the size of the population, PA employment is not significantly out of line with international comparators. At the end of 2005, the PA employed 45,691 government employees in the West Bank and 31,747 in Gaza. At approximately 80,000 employees, the civil service constitutes about 35 percent of total labor force and about 3 percent of population. In comparison, the average for the Middle East and North Africa (MENA) is 30 and 9 percent, respectively. The PA's immediate neighbors, Lebanon, Egypt, Jordan and Syria, have larger ratios of civil service to population and labor force, although the MENA region has large public sectors in comparison to other regions.[57] Compared with Latin America and Eastern Europe, however, the Palestinian public sector is overstaffed, particularly considering the PA is not yet a state and does not provide the full range of services that come with statehood.

Most PA employees are concentrated in the West Bank, with some key departments and institutions based in Gaza. For example, the majority of health professionals work in Gaza, while the overwhelming number of teachers and support staff are located in the

[57] The central government wage bill in Egypt is 31.2 percent of current expenditures, 22 percent in Jordan, 54 percent in Syria and 25 percent in Lebanon.

West Bank, in large part because of the education services the UN Refugees and Works Agency (UNRWA) provides to the refugees in Gaza. Table 3.3 presents a selective geographic distribution of employees.

Table 3.3: Geographic Distribution of Government Workforce, 2005

Sector	West Bank	Gaza	Total	Percent of Total
Presidential Office	499	57	556	0.7
Health (MOH)	4,393	7,658	12,051	15
Education (MOE, Youth and Sports, Science)	28,918	11,607	40,525	51
Labor and Social Protection	918	1,053	1,957	2.5
(MOL, Detainees, MOSP)	486	860	1,346	1.7
Media (WAFA, Broadcasting, Radio and Television)	1,590	1,357	2,947	3.7
Finance and Economic Development (MOF, MOP, MOE)				
Infrastructure (MOT, Public Works)	781	1,018	1,799	2.3
Other (Justice, Autonomous Agencies, etc.)	11,182	7,537	18,799	23

Source: General Personnel Council.

UNRWA supplies education and health services, as well as emergency services and basic social support programs, to some 40 percent of registered refugees. UNRWA employs 26,000 workers, approximately 5,000 in the West Bank and 21,000 in Gaza. Other bilateral and multilateral aid agencies and international NGOs provide a wide range of services for the population. Taking alternative providers into account, PA employment ratios appear less favorable vis-à-vis other Middle Eastern countries. The PA may indeed be overstaffed in social and education sectors.[58]

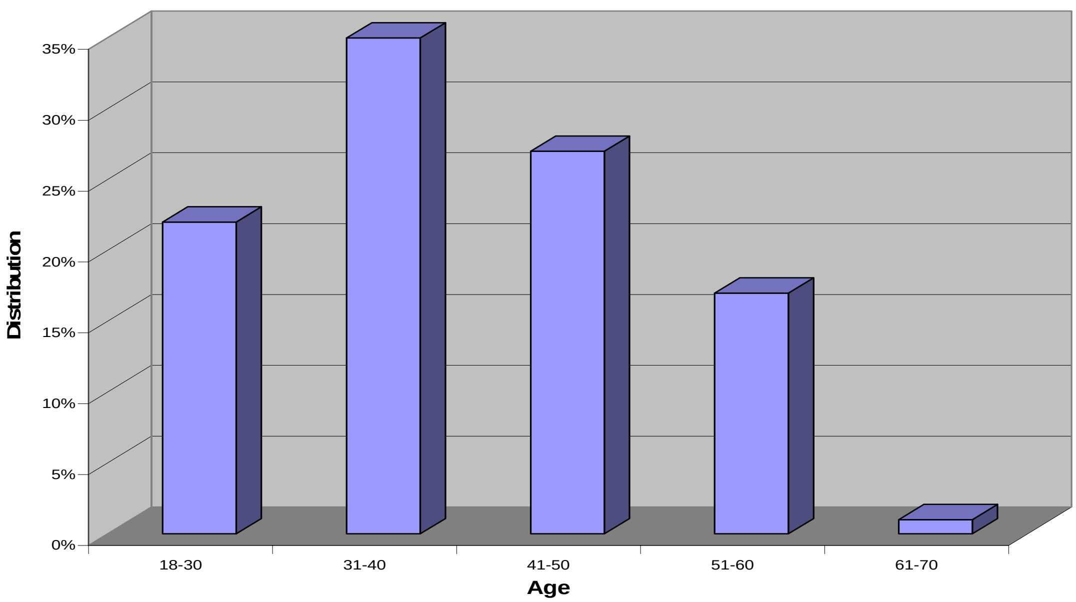
Gender and Age Profile. Palestine Central Bureau of Statistics (PCBS) data shows that public sector employees are on average older and better educated, are more likely to be married and professional but less likely to be male than the Palestinian private sector. Approximately 31 percent of public sector employees are women. The ratio is higher in social sectors—health and education—where the female employees are the majority. Compared with other countries in the Middle East, Palestinian women have greater access to public sector jobs, but still face gender bias in wages—although it is not high compared with other countries in the region.[59]

[58] The total student population between 2000 and 2004 increased on average by 4.5 percent a year. The number of teachers during the same period increased by 5 percent a year, and the number of non-teaching support staff in the Ministry of Education and Higher Education increased by a further 5.35 percent. This is all in addition to scaled up UNRWA operations during the same period.

[59] The analysis of PCBS data shows that in 2000 all males earned a wage premium compared with their female counterparts, especially in the lower income percentiles. In the past six years, this gender bias decreased over the income distribution except at the top percentiles where the gender bias increased. By the

The age distribution of public sector employment is relatively well balanced. Thirty-five percent of public sector employees are between ages 31 and 40 and 22 percent are young people between ages 18 and 31 (see figure 3.1). The PA civil service regulations limit employment for people over 60, and only under exceptional circumstances can a person past the age of retirement of 60 remain at her post. This stipulation was not fully enforced in the past. On average, more than 500 exemptions a year were issued to employees past their age of retirement. The number of workers working past the age of 60 was reduced significantly in 2005 with only 66 employees over the age of 60 in their positions at the end of the year. There are 7,667 people over the age of 50 and 3,208 over the age of 55 who may be eligible for early retirement.

Figure 3.2: Age Distribution for PA Employees, 2005



Source: General Personnel Council.

The PA employs daily and contractual workers. Although the GPC does not closely track their employment, anecdotal evidence suggests their number fluctuates between 2,000 and 3,000 on a yearly basis. The wages of contractual employees in the civil service come from either foreign donor support or the operational budgets of the ministries. In cases where the operational budgets do not allow additional contractual employees, the ministry often adds employees on a permanent basis, leaving contractual employees on the ministry payroll long after the project is completed. Standardizing the employment of contractual workers through secondary legislation would allow fixed-term appointments to mitigate under-staffing in key positions.

last quarter of 2005, though still positive, the gender bias had decreased significantly, particularly at the lower income levels. It dropped slightly at the higher income percentiles and remained more or less flat across the middle-income distribution.

Attrition Levels. The attrition rate for the PA civil servants is quite low, at about 1.8 percent annually (see table 3.4). The majority is due to retirement; the GPC reports that 470 employees retired in 2005. These relatively low attrition rates work against using a hiring freeze as the principal method for reducing the wage bill, although it may be useful combined with other measures.

Only a small number of civil servants are dismissed for non-compliance. According to the most recent data for 2005, 28 people in the West Bank and 92 employees in Gaza were dismissed for lack of attendance and other violations of civil service law in 2005.

Table 3.4: Public Employment Attrition for West Bank and Gaza, 2005

Termination of service for 2005	West Bank	Gaza	Total
Total yearly attrition	707	719	1426
Retirement	215	255	470
Resignation	151	170	321
Dismissal for noncompliance	28	92	120
Other (not specified)	300	215	515

Source: General Personnel Council.

PA civil service legislation does not directly address redundancy and termination of service, nor does it envision any early retirement schemes. Removal of poorly performing employees is a cumbersome and politically sensitive process. While the Civil Service Law mentions attendance, the secondary legislation is too weak to ensure compliance. For example, violations of civil service legislation are specified (15 days absence from duty station, for example), but disciplinary actions such as suspending salary payments or terminating an employee are difficult.[60] The law does require a one-year probation period for employees entering the civil service, however, and probation and evaluation procedures can be tightened to ensure that only the best civil servants become permanent employees.

Neither by-laws nor the Civil Service Law include detailed criteria regarding the evaluation process. According to the new regulations, an existing employee has to be evaluated once a year with a secret appraisal report issued by his superior. The reports are forwarded to the GPC, which is tasked with reviewing the files and imposing penalties for unsatisfactory performance. However, despite regular evaluations, there is little

[60] Currently the impetus for removing an employee from the payroll for misconduct comes from the senior staff in the employing agency. For example, in the Ministry of Labor, the direct supervisor monitors the compliance of the employees. If an employee is in a serious violation, an internal directorate may apply administrative sanctions, such as administrative notice, deduction of pay and reduction of yearly paid holidays. Only in cases of serious non-compliance will the GPC intervene. But even the GPC is not fully empowered to weed out non-performing personnel. The ministries have their own internal supervision departments whose quality varies from ministry to ministry. Often, departments in charge of oversight are not willing to challenge politically connected personnel fearing financial and social reprimand.

follow up except in exceptional cases of abuse. The GPC does not have the capacity to enforce the law and investigate cases on its own. Even simple administrative reprimands are difficult to implement.

Another significant problem of the current civil service framework is the lack of an appeals system. Employees do not have formal means of redress against a decision of a disciplinary committee. The employee accused of misconduct may take the case to the court, but the judicial system is already slow and overburdened and does not provide a good venue for administrative hearings. The GPC initiated a temporary appeals board composed of retired judges and members of the academic community to deal with the process of appeals, but a permanent means for administrative redress is needed. The GPC has started developing a code of conduct for civil servants and plans to introduce it into all ministries.

Security Services. The security services have grown rapidly in the recent years. Founded in 1994, they were initially grouped into the Civil Police, Public Security, Intelligence, Emergency Services and Rescue and the Coastal Police. The interim agreement between the GOI and the PA added two additional branches: Preventive Security (which deals with internal political threats) and the Presidential Security Force. By 2004, the security apparatus had expanded to 13 branches, including military intelligence and the military police.

The Ministry of the Interior (MOI) had 59,207 security service employees on the payroll at the end of 2005. Some 13,852 trainees were receiving a modest stipend from the transfer budget of the MOI. An additional 3,000 Hamas recruits and nearly 7,000 new trainees were added to the security forces in early 2006. The total number of Palestinian security forces nearly equals the total of civil service employees.

PA police and security services reform has received extensive attention from a handful of donors, including the European Union and the United States. Work was under way to reduce the number of services from 13 to 3, to rationalize staffing and to integrate operations and deployment. Broader goals included bringing police force under civilian authority and making it subject to political oversight by the legislature. The European Commission also had a program on police training and equipment support.

An audit of security service employment would go a long way towards identifying the most serious abuses by non-performing staff. While the MOF has control over employment in the civil service, its powers are greatly circumscribed when it comes to security service appointments. The Finance Minister may refuse to release the payment of salaries for new staff, but the MOF cannot block the initial recruitment into the security services.

Increasing oversight of the security services payroll is critical to bringing fiscal stability to the PA budget. The security forces absorb one-third of all PA government expenditure, and more than all operating expenditures and all non-wage education and health expenditures combined. By the end of 2005, the PA was spending nearly $44 million on

MOI wages. The distribution of the security service wages is slightly different than for the civil service. A large portion of the security service salaries went to the lower income brackets as the proportion of low-ranking police and security personnel is higher than the lower grade mix for the civil service.

The Palestinian Civil Police represents some 30 percent of total forces, smaller groups like the Preventive Security and General Intelligence 20 percent, and the military 50 percent. Of the over 58,000 security personnel, around 11,000 provide various type of support for the 48,000 security forces. Of this 48,000 only 36,000 directly contribute to preserving law and order. Several elements of the police and security forces, such as honorary officers or political officers, are clearly redundant.

In 2005, the MOI initially identified 14,000 non-compliant personnel but later reduced this number to 8,000. The number of non-performing personnel varies widely by source. In one estimate, 40 to 50 percent of total security service employees do not show up for work. This is a "soft" estimate as attendance records are not systematized across the security services. The rate of absenteeism increased dramatically in recent months as salaries are not paid regularly and the security infrastructure (cars, weapons) is in short supply.

The current size of the PA security forces is more than twice the figure stipulated under the Oslo II Agreement, which proposed a baseline of 30,000 personnel spread across seven services.[61] International comparisons also find PA security staffing high. The ratio of police to population in Palestine is estimated at 1:191 in the West Bank and 1:84 in Gaza, whereas the United States and Turkey average 1:400 and 1:192 respectively (Rand Corporation 2005). The PA falls somewhat in the middle relative to its neighbors (see table 3.5). It has more policemen per citizen than Lebanon but fewer than Jordan and Egypt. In terms of military strength, the PA's staffing levels are similar to Syria and Morocco, but lower than Jordan and Lebanon. The optimal staffing ratio for the police and military services in the PA is difficult to determine because the PA does not operate under normal circumstances—when size of the security forces can be determined through analyzing the security situation and the available funding. Both security and funding have deteriorated rapidly in the recent year.

[61] The report prepared for the U.K. Department for International Development on security sector reform in 2005 also estimates staffing needs by using the Oslo levels plus population growth (DFID 2006). The consultants estimate that with the assumption of 30 percent overall growth and the civilian staff ratio of 25 percent, a staffing level of 52,000 security personnel should be expected.

Table 3.5: Comparative Military and Police Staffing, 2005

Country	Military spending, percent of GDP	Population, million	Military personnel	Cost per soldier, USD	Police personnel	Cost per policeman, USD	Military to population ratio	Police to population ratio
Georgia	0.6	4,667	15,000	1,533	52,000	8,290	1:312	1:90
Jordan	14.6	5,760	85,000	17,647	61,000	21,428	1:67	1:94
Yemen	7.8	20,727	67,000	13,208	88,000	3,887	1:309	1:235
Romania	2.5	22,330	66,000	14,924	94,000	18,551	1:338	1:238
Turkey	5.0	69,600	402,000	29,850	321,000	22,095	1:173	1:216
Lebanon	3.1	3,826	72,100	7,489	16,000	8,832	1:53	1:239
Albania	1.5	3,563	10,000	5,600	128,000	18,800	1:356	1:28
West Bank	5.6	2,385	12,000	8,333	12,400	8,333	1:198	1:192
Gaza	15.0	1,376	15,800	7,278	16,400	7,278	1:87	1:84

Source: Ward Group, 2005.

Broader Pressures to Increase Public Employment in West Bank and Gaza. For the better part of a decade, the size and wage structure of the public sector has received considerable attention from donors and policymakers, with a variety of explanations for the PA's perceived inability to contain the rise in wage expenditure. Some focus on persistent shocks to the economy and the lack of available private sector alternatives—factors that have been exacerbated by frequent border closures and the precipitous decline of work in Israel. Others focus on patronage and the creation of jobs within the PA to bolster political legitimacy. Still others see a general lack of accountability of the executive branch, the prevalence of prevailing social norms such as nepotism and favouritism (i.e. wasta) or weak mechanisms for establishment control. Donor failure to rigorously enforce benchmarks on prudent fiscal policy, combined with large inflows of foreign aid, is also a contributing factor to the continued growth of the wage bill.

At a political economy level, the pressures on public sector employment are understandable. The public sector was seen as a buffer against the private sector loss of jobs owing to increased closures and movement restrictions following the *intifada*. Employment in the public sector expanded as the economic situation worsened. During the height of the *intifada* and the Israeli security responses, total private sector employment within Gaza and the West Bank had declined by 25 percent. Before September 2000, Palestinian workers were generally free to enter or exit Israel without interference and around 146,000 were working in Israel (23 percent of the labor force). This figure has subsequently declined by 90 percent. In 2005, unemployment in the West Bank was at 30 percent, and unemployment in Gaza was close to 40 percent. With such high rates of joblessness, the public sector became an extremely attractive source of income for the population.

Another pressure on public employment is the high birth rate and the large number of youth entering the labor market. With estimated overall population growth of 3.3 percent a year, around 45,000 new employees enter the labor market each year. For people between ages 21 to 24 the estimated unemployment rate is 50 percent. The problem of youth unemployment was especially evident in 2005 when scores of armed young militiamen assaulted PA institutions demanding jobs. Although the bulk of public sector salaries went to middle income groups, young people entering the security services mainly came from low income households with few prospects for jobs in the private sector.

The PA's propensity to expand public employment goes beyond the very real pressures of border closures, an anemic private sector and sheer demographics, however. Employment within the civil and security services has long been used by leading Palestinian politicians to consolidate informal political networks of patronage and clientilism. Jobs were offered as political favors to placate supporters or to co-opt members of competing groups. Many PA positions were filled by under-qualified personnel, often through patronage appointments which rewarded political loyalty. Positions of deputy ministers, general directors and heads of agencies were predominantly awarded to Fatah party loyalists.[62] As the anecdotal evidence in box 3.1 indicates, expansion in public employment was often driven more by political connections than administrative necessity. These perceptions are so strong among Palestinians that a public opinion poll by the Palestinian Center for Policy and Survey Research in June 2005 revealed that 95 percent of the population believed that wasta or "connections" are necessary to secure a job in the public sector.

Box 3.1: Institutional Planning under Yasser Arafat

"Nafiz had worked for many years as a physics teacher but was fed up with his low wages. He had gone to the Director General of the Ministry of Transport, a former friend of his father, and asked for a job. The Director General told Nafiz that he would like to employ him, but that he had no money to do so. Nafiz then wrote a letter to President Yasser Arafat, explaining that his father had worked for the PLO in Syria before his *ightiyal* (assassination) in the 1970s. A few weeks later Nafiz received a letter signed by Yasser Arafat instructing the Ministry of Finance to pay his wages. As a result Nafiz was made a *mudir* (director) in the Ministry of Transport."

Nafiz's story was fairly typical of the people who received senior positions in the PA during Yasser Arafat's tenure. A senior official within the Palestinian Legislative Council commented that the president's policy was to employ as many people as possible to create dependency and limit political opposition. The irregular appointment of civil personnel became known as the "Fatah Bonus," the practice by which individuals connected to the ruling coalition would get preferential treatment in getting the civil service jobs.

Political patronage permeated not only the process of appointments but also extended more broadly to public administration. It was not uncommon to find ad hoc departments and even agencies created for specific individuals or groups. As one official put it, legal niceties had often fallen by the wayside in the process of institutional creation:
"If Arafat was told 'this Ministry does not need people, it is filled,' he'd say, 'OK' and then create another ministry. In this he built the main basis for the state."

Sources: Samuels 2005; interviews with PA staff.

[62] For an elaboration of this view, see *State Formation in Palestine,* edited by Mushtaq Husain Khan, George Giacaman and Inge Amundsen (London: Routledge Press, 2004).

4. Remuneration

Base Salaries and Grade Distribution. As part of the new civil service law, in 2005 the government adopted a uniform wage structure for civil servants with five regular grades and a superior grade that includes political appointees and high level managerial staff (see table 3.6). The starting salary for support level staff is about $300 a month, not including allowances, although many people in the lower category earn less. Skilled professionals in Grade 2 usually earn $400 to $500 dollars a month. In the case of professional medical and educational staff, the average salaries are $600 dollars a month. Director General level staff are expected to receive a gross salary of $1,500 dollars a month. Salaries for high-level managerial staff, Grade 1 and above, are on average lower than comparative professional salaries in the private sector. Reports of difficulties in recruiting and retaining high caliber level professional staff are confirmed by comparative public-private pay analysis (see figure 3.3). The compression ratio is around 4.4:1, which is higher than regional countries with extremely compressed salary structures (such as Yemen) but below target norms of 7:1.

Table 3.6: Grade Distribution and Salaries, 2005

Category	Total employment	Average base salary, USD	Average gross salary, USD
Senior	927	940	1,750
Grade 1	4,616	633	1,093
Grade 2	34,615	396	612
Grade 3	22,180	385	547
Grade 4	2,756	306	471
Grade 5	6,812	290	394
Daily/Contractuals	3,106	521	825

Source: Ministry of Finance.

The distribution of grades is in line with modern civil service standards. The bulk of the employment is in Grades 2 and 3, and the level of support staff is fairly low at only 11 percent. The share of top managerial personnel, Grade 1 and Senior, is around 6 percent. However, a more detailed look at individual ministries reveals a much greater discrepancy in the distribution of grades. In some ministries, high-level managerial staff are more than one-third of the total staff. For example, in the Ministry of Youth and Sports and the Environmental Authority, the top managerial staff exceeds 30 percent. The top-heavy nature of some of the PA ministries is a serious fiscal burden for the government. Job descriptions need to be incorporated into the ministerial development plans to avoid grade inflation in the future. In the near future, caps on future promotions need to be instituted in a number of government agencies.

The absence of clear regulations and lack of direction over distribution of salaries and allowances led to widespread abuses—irregular appointments, granting of special allowances and even the creation of departments to fit specific individuals for purely political purposes—creating a large body of personnel who receive salaries disproportionate to their experience and qualification. Even in the wake of the recent Civil Service Law in 2005, ministries and agencies have been able to bypass the scrutiny of the GPC and MOF and appoint people to higher positions than would otherwise be allowed if the regulations were better defined.[63]

Just prior to 2006, the MOF began to play a more central role in all promotion and recruitment decisions. According to the new regulations, every agency must inform the payroll directorate at the MOF and the GPC before initiating a recruitment request. The MOF certifies the availability of funds for the position and only then can the recruitment process begin. Following the completion of competitive recruitment, the MOF again has to clear all appointments through certification of the Director General of Financial Control and then finally sign off on the appointments.

Allowances. Allowances on average represent 35 percent of total pay. According to the MOF, six allowances are available for PA employees. These include specialist allowance, social (family) allowance, transportation allowance, rarity allowance, job hazard and job type allowance, and an administrative allowance for high level staff. In addition to the allowances listed in the Civil Service Law, every employee is entitled to receive an automatic pay increase of 1.25 percent a year. These automatic pay increases, even if small, need to be avoided during a fiscal crisis. The civil service pay increases should be tied to changes in the standard of living and prevailing inflation rates as well as to overall revenues and expenditures in a given year.

Overtime pay presents a serious issue for the PA budget. In the past, poor record-keeping and lack of central oversight allowed employees in non-essential sectors to claim overtime for hours not spent at work. The internal payroll audit revealed serious violations by conducting spot checks during the summer of 2005. Based on the audit recommendations, the MOF proposed suspending overtime pay for all employees except for essential health services and border patrol. This recommendation and others were approved by President Abbas in January 2006 and later confirmed by the Council of Ministers. The current freeze on overtime should be kept until the GPC builds capacity to monitor attendance.

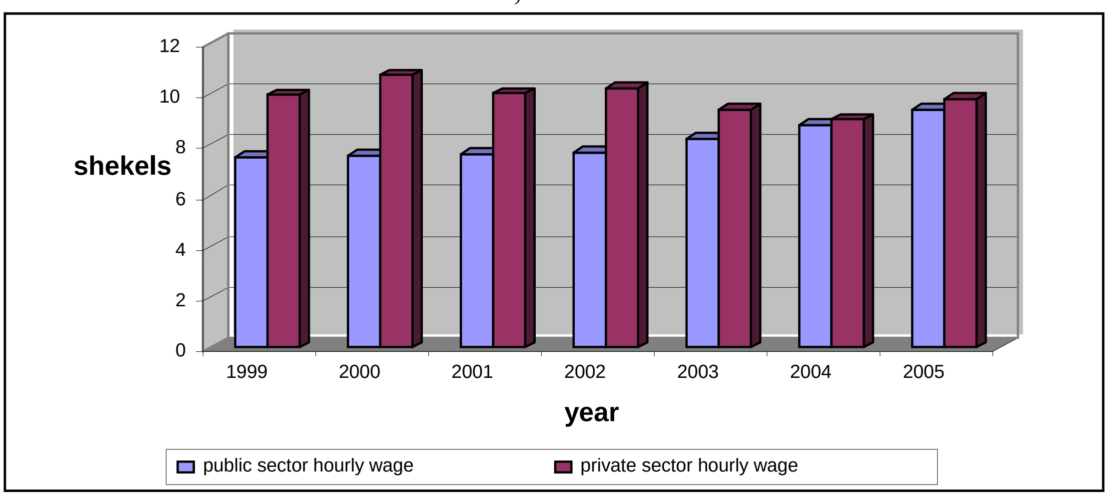
The new Civil Service Law and accompanying secondary legislation goes a long way in rationalizing the distribution of allowances. The law eliminated some of the older discretionary off-budget allowances previously provided through ministries and departments. The share of allowances in the total pay also decreased from an average of 55 percent to 35 percent. But there is room for further merging allowances into base pay, such as those for area of specialty and job type. Allowances where the internal audit of the MOF finds serious instances of abuse (transportation allowances, for example) should be suspended until proper monitoring is established.

[63] A ministerial management committee was formed at the end of 2005 to assess, recommend and approve candidates for senior positions within the PA ministries and governmental agencies. The committee is composed of the Minister of Finance, the Minister of Planning, the Cabinet Secretary and the Head of GPC. The work of the committee has been compromised by the internal political wrangling between Hamas and Fatah in the aftermath of the parliamentary elections.

Public-Private Wage Comparisons. Understanding how public sector and private sector salaries vary across the wage distribution in the West Bank & Gaza can greatly assist the PA in setting the proper wage and employment policies. Historically, estimation techniques distorted the gap between the public and private sector and led many civil servants to believe they are not adequately compensated for the services they provide. Figure 3.3, for example, reports information on nominal hourly wages for public and private sector employees. It reveals a gap between the mean hourly wages of public sector employees and their private sector counterparts, albeit one that was reduced from NIS 2.5 in 1999 to NIS 0.5 in 2005. This reduction occurred as private sector wages stagnated and public sector wages continued to increase.

A focus on mean salary levels in the two sectors can be misleading because the distribution of salaries in the public sector differs from the private sector due to wage compression. Recent regression techniques allow the comparison of workers with similar educational and professional backgrounds and enable researchers to probe the wage differential at different points along the distribution of salaries. This allows for a much richer, nuanced and more accurate analysis. Table 3.7 summarizes the results of such analysis. For all rounds of calculations between 1999 and 2005, the estimated coefficients are highly significant at the 95 percent confidence level and increase over time. These estimates suggest that in earlier years, particularly in the pre-*intifada* period, individuals with similar education, gender and age characteristics did on average earn less when they worked for the public sector. But this differential subsequently disappears and then reverses over time. In the first quarter of 2000 the public-private wage differential was estimated to be 13.3 percent in favor of private sector. However, from 2003, a clear public sector premium emerges and rises significantly in the last quarter of 2005, just prior to national elections.

Figure 3.3: Comparative Public and Private Sector Hourly Wages in West Bank and Gaza, 1999-2005



Source: Palestine Central Bureau of Statistics.

After controlling for differences in age, the level of education, marital status and skills, workers in public sector in the West Bank & Gaza on average earn a significant premium of around 15 percent over their private sector counterparts. The PA has fostered this development through a series of large salary increases in 2004 and 2005. These findings have serious policy implications in terms of the future sustainability of the wage bill and persistent arguments that public sector workers are underpaid. Compared to the private sector, they are not.

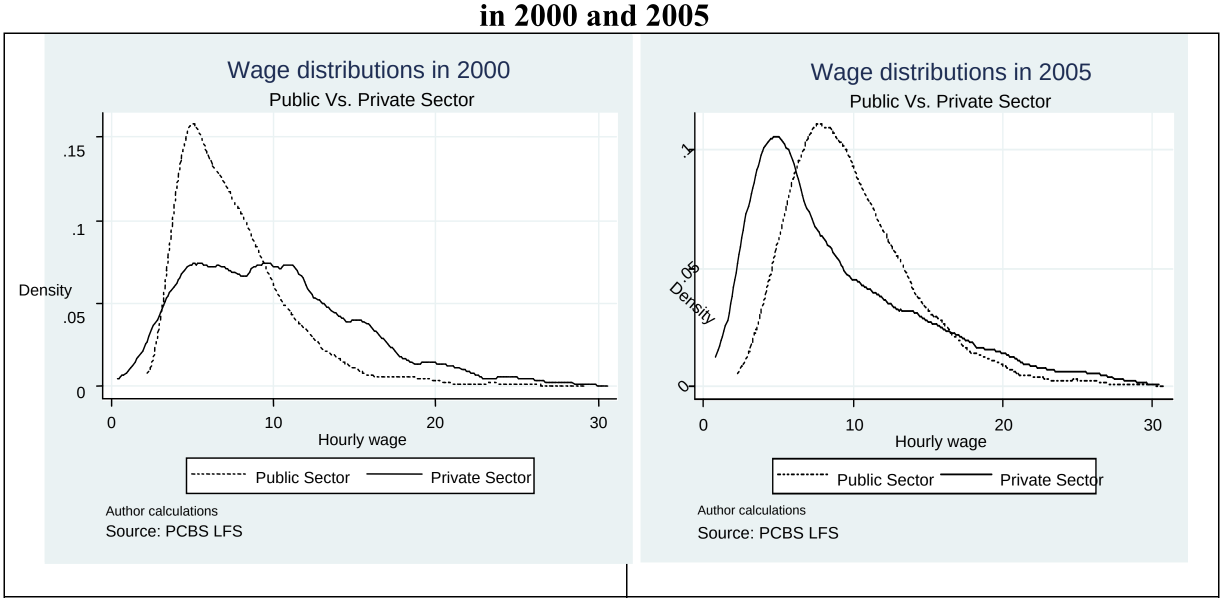
Table 3.7: Summary of Regression Statistics for Private and Public Wage Differentials, 2000–2005

Coefficients	2000 Q1	2000 Q4	2001 Q4	2002 Q4	2003 Q4	2004 Q4	2005 Q4
Age	0.021	0.019	-0.007	0.021	0.015	0.021	0.031
Yrs. school	0.023	0.028	0.023	0.026	0.033	0.032	0.034
Tenure	0.001	0.001	0.001	0.001	0.001	0.001	0.000
Male	0.226	0.299	0.130	0.240	0.252	0.202	0.201
Married	0.111	0.099	0.088	0.090	0.128	0.111	0.114
Professional	0.130	0.163	0.184	0.200	0.235	0.192	0.184
Public Sector	**-0.133**	**-0.262**	**-0.206**	**-0.131**	**0.046**	**0.014**	**0.154**

Source: World Bank calculations.

As figure 3.4 indicates, the public sector wage premium is highest for low-wage earners and diminishes for high-wage earners. From an administrative vantage point, such an arrangement is the inverse of what is desired. Governments typically want to ensure that the public sector has access to staff with skills in high demand areas such as information technology or financial management, and to do so requires paying salaries that are broadly competitive with the private sector. The across-the-board pay increases recently granted are both unnecessary (given that attrition rates within the PA are very low) and inefficient (given that, to the extent that they do take place, pay increases should be targeted towards staff with skills in heavy demand in the public sector.)

Figure 3.4: Comparing Public and Private Sector Wage Distributions in 2000 and 2005



Source: World Bank calculations.

This analysis has important policy implications. Because most PA civil servants are not underpaid vis-à-vis their private sector counterparts, the PA should impose a moratorium on all future salary increases for the next two to three years. Beyond that point, increases should be carefully crafted and narrowly targeted towards employees with particular sets of skills that are in short supply. A second implication is that the sizeable public sector wage premium has led to perverse labor market incentives, with individuals preferring to wait in unemployment for a public sector job than accept lower paid jobs in the private sector. In an environment of acute fiscal crisis, the PA cannot afford to be the employer of first resort.

5. Improving Establishment Control and Human Resource Management

Since mid-2006, a number of ad hoc arrangements have been put in place to pay civil service salaries, such as the Temporary International Mechanism (TIM) endorsed by the Quartet in May 2006 or the World Bank–administered Emergency Services Support Program (ESSP). This analysis is focused upon medium- and long-term measures for improving the quality of Palestinian practices and does not address the adequacy of these temporary measures.

From 2003 to 2005, a number of important initiatives improved payroll oversight and regularized the process of promotions and appointments in the civil service. The most significant have been in expanding the role of the MOF in overseeing civil servant salary payments. Payroll control was brought fully under the purview of the MOF, which operated a unified payroll management system covering all security and civil service employees in West Bank and Gaza.

Promotions and Recruitment. The process of promotions and recruitment in the PA has become both more routine and transparent and more cumbersome—the latter being the unfortunate byproduct of stemming unauthorized appointments. Requests for new appointments are initiated by the relevant ministry, and the Minister of Finance and Chairman of the GPC are involved in the recruitment process from beginning to end. After putting forward the initial request, the agency receives a signed authorization from the MOF confirming sufficient budget for the position. The request is forwarded to the GPC to initiate recruitment through open search and examination. The positions are advertised in the official gazette, and an exam committee composed jointly of the GPC and the relevant ministry administers the test. (All candidates below the deputy minister level are a subject to examination.) The candidate is evaluated on a point system according to his or her years of experience, level of education and performance on the exam. The system is fairly transparent but needs greater standardization. For example, the rules governing what is included in the civil service examination are not readily available and vary by agency and ministry.

Once the person is selected, the budget directorate at the MOF again certifies that there are sufficient funds for the position. After the approval from the Minister of Finance, the payroll department receives an order to include the new employee in the payroll. Following the completion of the recruitment process, the procedures are reviewed by the

Internal Audit Department of the MOF. Finally, all new appointments are subject to the signature of the Minister of Finance. The detailed day-to-day management of the civil service by the MOF provides formal checks on the public sector growth and is a regrettable necessity given the PA's legacy of unrestrained recruitment. Eventually, the MOF should cede operational controls to the GPC and the line ministries and focus instead on indirect financial controls. Decentralizing control over the civil service would improve responsiveness and lead to efficiency gains. Specific recommendations include consolidating civil service and security service payroll under the MOF and clarifying the roles of the GPC and the MOF in managing human resources under the new civil service legislation.

Oversight of Wage Bill Expenditure and Payroll Systems. Each month the payroll and audit department review reports generated by the payroll system on the exceptional number of new employees added and compare monthly totals of current to previous payroll expenditures. The reports are reviewed by the internal control and payroll directorate before the new payments are released. The current system is set up to track the aggregate changes but does not preclude systemic manipulations. For example, positions for each ministry are identified in terms of a set of budgetary appropriations and cumulative totals for staff. Ministries and agencies lack manning tables, which allows for easy transfer of employees within the ministry. While sometimes this practice allows flexibility for task managers, in the West Bank & Gaza it has often been abused.

The system does not oversee "frozen" posts—posts that were previously authorized but are currently held vacant for financial reasons. Salaries are distributed according to authorized posts and not according to the actual number of staff, so ministries tend to overbid for salaries. The current civil service legislation also does not provide for fixed contract employment. Many contractual employees who are hired on donor-financed projects often remain with the PA long after the project has ended.

The MOF operates an electronic payroll system that tracks all MOF-approved civil service and security services personnel in the West Bank and Gaza. The GPC system operates an Access-based personnel management database that covers all civil service employees except for the Ministry of Education and the Ministry of the Interior. The GPC has no clear provisions for intra and interministry electronic communications, so data management remains a labor-intensive manual process. The Ministry of the Interior maintains its own filing system that it regularly sends to the MOF. The payroll records of the MOF and the personnel files of the GPC and the MOI are not reconciled.

Without the integrated system, all exchanges between the GPC, MOF and MOI relating to promotions, recruitment and terminations remain paper-based, which gives ample room for tampering. The 2005 internal audit of the payroll found that some people are receiving salaries even though they have been absent from their job for more than two years, as well as a number of other violations. Near-term recommendations include ensuring that the payments for salaries are released according to actual staff numbers and not to the total number of positions in each ministry. They would also include providing greater security over access to the payroll and personnel database. (For example, until recently it was possible to manually change the date of recruitment without authorization from a manager.) When the current political crisis is resolved, the GPC and MOF need to resume efforts integrate their payroll and personnel records between their systems in West Bank and Gaza, along with those of the Ministry of Education, and the Ministry of Interior.

Irregularities in Salary Payments. All government employees, including security services, receive their salaries via direct transfer to their bank accounts. The banks are required to validate the bank account against the employee name before releasing the payment. The payroll system is also supposed to automatically identify multiple payments to one bank account. However, multiple payments are common. For example, the internal audit revealed a number of employees who receive several salaries from within the civil service and from both the civil service and the security services.

Tracking double dippers is complicated by the existing irregularities in the system. The internal audit revealed employees on the payroll who have no file in the GPC and were apparently brought on without the explicit approval of the GPC chairman. Some actions have been taken to correct the abuse, and the GPC and the Internal Audit Department at the MOF began a review of seconded employees in other agencies and ministries. Their internal audit found a number of employees who receive a salary while working outside the country. The practice of seconding employees became popular in the mid-1990s when numerous staff were on the payroll of one ministry but were overseas or working elsewhere. The GPC payroll, for example, listed some 2,000 employees working elsewhere in the civil service.

The lack of detailed job descriptions intensifies the already tenuous link between civil service headcount and ministerial budgets. The GPC has had difficulty containing exceptional promotions, which are often granted without the approval either of the Minister of Finance or the GPC chairman. Exceptional appointments increased during the transfer to the new salary scale, which coincided with the election year. Most of the promotions were in higher echelons of the civil service corps. Between May and October 2005, nearly 14 percent of Grade 2 employees were promoted and around 10 percent of Grade 1 employees received a higher rank.

Without a comprehensive external payroll audit, estimating the financial cost of irregularities is difficult. Occasional spot checks on the part of the MOF and the GPC, such as sending out a list of all employees on each ministry’s payroll for confirmation that the person is actually working, are ineffective. The previous Fatah government created an Administrative Affairs committee to review cases of irregular promotions. The new Hamas cabinet also called for a review of all new appointments granted between November 2005 and March 2006. The decision reflects a concern that many of the new appointments at the end of the year were politically motivated, and many new civil servants entered the ranks without a proper review of their qualification. The outcome of the appointment review and the total number of irregular staff is not clear, but it does not appear to be large.

A comprehensive external audit of the payroll to identify double-dippers and ghost employees, can be a joint exercise between the government and an external audit consultancy firm. It would further identify redundant political appointees not assigned a specific task, employees whose professional qualifications can be better utilized elsewhere and workers who regularly do not show up for work. The GPC may also consider creating a pool of surplus employees who could undergo targeted training programs and reassignment to other units.

Note that the tracking of payroll records may deteriorate if the current fiscal crisis is not resolved quickly. If civil servants are paid irregularly or not at all, individual agencies may resort to setting up alternative payroll systems. In spring 2006, reports revealed that some agencies are paying their employees in cash or finding alternative sources of financing. The lack of regular oversight may lead to serious problems down the road, which may take time to reverse.

Legal Framework for HR Management. One of the most significant recent developments has been the adoption of Civil Service Law No. 4 in July 2005. The law was first developed in 1998, but it was not passed until 2005 due to the internal disagreements within the Cabinet. It replaced a collection of old Egyptian, British mandate, Jordanian and Israeli military laws and represents a significant step forward in rationalizing the management of the civil service.

The new Civil Service Law is fairly detailed. On the one hand, the broad reach of the law limits discretion in interpretation; on the other, it requires legislative approval for small changes. In many Organization for Economic Cooperation and Development (OECD) countries, the civil service law would focus on fundamental principles and practices and leave more detailed implementation procedures for secondary legislation or regulations. The new employment regulations developed by the GPC may help to modify some of the law's rigidity, but the extent to which the law's central principles can be modified is limited. As the interpreter and enforcer of this legislation, the GPC is given little scope and definition. The law should further clarify the GPC's responsibilities, as well as those of individual ministries and agencies, and allow such agencies to take responsibility for developing secondary legislation and common standards for civil service management.

The GPC approves the general description for each group or position within the civil service. For each position, the GPC specifies the required minimum degree, work history and experience. The current law bases promotions almost solely on the number of years in service. The law also specifies life-time employment, with only passing reference to contractual employment. The law is not well equipped to deal with exceptional appointments, which have become a common staple of PA politics in the past two years. Even when the Civil Service Law was passed in July, it was not specific enough to identify manning tables, which allowed ministries and agencies to bypass the scrutiny of the MOF and appoint people to higher positions than they would have otherwise been allowed if the regulations were stricter. The PA needs to develop clear organizational charts for ministries, which include job descriptions to avoid undue promotions and appointments in the future.

6. Organizational Structure of the PA

The number of institutions of the Palestinian Authority (PA) expanded along with the PA civil service staff. When the PA took over the Israeli-imposed Civil Administration, some 20,000 Palestinians were spread across 14 agencies. By 1996, the number of major ministries in the PA increased to 23. At its peak in early 2002, the PA had some 84 different agencies and 33 ministries (some ministers were without a portfolio). Currently 25 ministries operate across 114 regional offices. (The OECD average is around 14.) In addition there are a number of semi-independent public authorities (for example, the Tobacco Authority, Civil Aviation Authority and the Ports Authority) and 14 district governors with overlapping jurisdictions. In total, the PA budget lists some 63 budget entities.[64] The sheer number of institutions in the PA makes policy coordination difficult.[65]

Competing mandates and duplication of function are legacies of the ad hoc institutional planning in the mid-1990s and threaten coherent policymaking. Examples abound. The Ministry of Local Government and the Ministry of Planning compete over urban planning and zoning. The Ministry of Detainees, the Ministry of Social Affairs and the Ministry of Labor offer competing and overlapping social protection programs. Another example is the separation of the Ministry of Education and Higher Education and Science and the Ministry of Youth and Sports. And in addition to a separate Ministry of Information, the President's office maintains three departments in charge of information dissemination: public relations department, foreign information department and a department for Arab press and local media.

Table 3.8: Duplication of Selective PA Functions

Education and Youth	Ministry of Education and Higher Education	Ministry of Youth and Sports	
Economic Planning	Ministry of Finance	Ministry of Economy	Ministry of Planning
Social Protection	Ministry of Labor	Ministry of Social Affairs	Ministry of Detainees
Public Works	Ministry of Public Works and Housing	Ministry of Transportation	

Source: General Personnel Council.

[64] The section does not consider the relationship between the PA and the PLO institutions. A number of PLO agencies duplicate the functions of PA institutions but a thorough review of these institutional arrangements was not completed.

[65] Policy formulation is also complicated by the restrictions of travel between West Bank and Gaza and the resulting inability to formulate policy in a centralized way. Meeting irregularly and generating policy decisions through video and teleconferencing puts a serious strain on the PA's ability to act as a coherent body. It also strains Palestinian finances because of the extra staff (especially at the higher level) necessary for policy coordination and guidance.

Institutional Restructuring. One of the first priorities of the PA since 2004 has been eliminating redundant agencies. In the past two years, the government has reduced the number of autonomous agencies to 47 and greater reductions are planned. Some agencies have been incorporated under a flagship ministry. For example, the MOF incorporated previously self-standing tobacco, petroleum and natural resources agencies. Other agencies are waiting to be restructured.

Whether the recent restructuring has actually led to increased efficiency and fiscal savings is debatable. Many of the units subsumed in 2004 and 2005 had only 20 to 40 employees. Care also needs to be taken in reforming agencies made non-operational by conflict. One example is the Civil Aviation Authority (CAA), which was founded in 1999 to prepare for the reopening of the Gaza airport. The agency continues to employ pilots and air traffic controllers even though many have second jobs or work overseas. At the end of 2005, the GPC listed 415 employees working for the Civil Aviation Authority in Gaza, even though 50 were employed in its West Bank branch.

There is significant scope for rationalization and realignment of functions among the PA institutions. Detailed functional reviews should provide a basis for reorganization and elimination of duplication. For dormant but necessary agencies like the CAA temporary re-assignment of staff to other government institutions where the demand for staff is greater should be considered. The design of PA institutions should reflect the Palestinian aspirations for a viable, comprehensive state apparatus capable of providing a wide range of public services.

Rationalizing government ministries and agencies should be subject to a thorough review that establishes the guidelines for institutional planning in the medium term. As part of the streamlining process, the government commissioned Birzeit University Law Center to develop a library of the legislation that establishes the mandates for all government ministries and agencies. Once the legal database is completed, the government may be ready to take steps to reduce the number of government agencies and streamlining functions.

Reorganization within Ministries. The number of ministries in the PA was reduced by three to 25 at the end of 2005 to include 23 ministries and two ministries of state. As part of the internal streamlining process, the previous cabinet approved the Organizational Development Plans (ODP) for 22 ministries and a few key government agencies. The ODPs present the detailed structure for every department and unit within a ministry. They clarify the scope of activity of each department within the ministry and limit the expansive recruitment patterns employed in the past. This clarification of ministerial mandates and establishment of new patterns of recruitment are important positive steps in developing more detailed organizational descriptions for civil service jobs.

However, the ODPs were drafted without an integrated functional framework that looks at government institutions as an organic whole. The ministerial plans do not include detailed manning tables and a description of posts. The ministries still can hire above their official headcount if they stay below the budget provided by the MOF. There are still very few incentives for the line ministries to economize on staff because any payroll savings cannot be transferred to non-wage expenditures.

Ministries and agencies should be rewarded for reducing non-performing staff by allowing the ministries to keep a part of their budgetary savings for other operational expenditures. Ministers and sector managers should have incentives and appropriate authority to ensure that staff numbers and skills are appropriate for actual needs, and they should be held accountable for using that authority effectively. Ministerial restructuring plans need to be integrated into a comprehensive framework so that redundant functions can be phased out and operational effectiveness improved.

7. Anticorruption

Public Opinion and International Comparators. During the January 2006 elections, the Palestinian public rated the PA's weak performance and perceived corruption as their most important concerns following unemployment and the Israeli closures. Anticorruption themes were also prominent in the local and presidential elections (Palestinian Center for Policy and Survey Research, 2005). The polls did note regional variation in the results, with residents in Gaza more likely to complain about corruption than those in the West Bank. Public perceptions of the integrity, honesty and performance of the PA remain largely negative, with corruption and nepotism considered significant problems. According to a PCPSR poll in 2004, 77 percent of Palestinians in the West Bank and Gaza believed that public sector jobs were largely obtained through "connections" (wasta), 84 percent believed that there is a widespread corruption in the PA, and 87 percent strongly supported calls for reforms.

Palestine also does not fair well in global surveys of integrity and anticorruption. In 2005, it ranked 112th on Transparency International's Global Corruption Perceptions Index, worse than Lebanon (83rd) and Yemen (104th). Only Iraq and Libya have lower scores among the Arab countries. On the World Bank Institute governance indicators, which include control of corruption, the West Bank and Gaza scores significantly below the regional average. The share of Palestinians who believe that the PA has significant corruption increased from approximately 50 percent in 1996 to 91 percent in late 2005 (PCPSR 2005). Concerns with corruption relate mostly to the lack of transparency within the PA and the belief that it caters to insiders and the politically well connected, while traditional problems such as bribery or petty corruption are given relatively less weight (World Bank 2002). In one World Bank study, Palestinian businesspeople pointed to corruption as the second greatest impediment to private sector activity (after political instability and uncertainty), although only 21 percent reported having to pay bribes regularly (2001).

The PA faces two significant challenges in addressing corruption in a comprehensive manner—a weak legal framework and a lack of enforcement measures. No special anticorruption law exists, and the applicable framework has many gaps, particularly in identifying certain forms of corruption. Enforcement measures are even weaker—due to the lack of political will to combat corruption, a general breakdown in law and order and inefficient judicial and prosecutorial systems. Bodies established to monitor corruption remain weak and without the necessary resources to achieve their mandates. And the occupation has stunted the development of judiciary and public prosecution, presenting difficulties not only in addressing corruption, but also in deferring attention to conflict-related problems.

Until now the PA has not adopted a comprehensive national anticorruption strategy, and the limited anticorruption activities undertaken have been ad hoc rather than part of a systematic approach to combating corruption. However, the January 2006 election victory of Hamas in the Palestinian Legislative Council (PLC) elections may provide a new political impetus for addressing corruption. Civil society has filled some of this gap by proposing anticorruption measures. In particular, Aman—the Coalition for Accountability and Integrity, the local counterpart of Transparency International—issued a comprehensive three-year action plan to combat corruption in all branches of government and civil society. But this plan is dependent on donor funding.

Legislative Framework. The primary legislation that addresses anticorruption issues include the Basic Law, the Law on Illicit Gains, the Law on Duties and Rights of the Members of the Legislative Council, the Civil Service Law and the Criminal Code. And although these laws together cover a number of activities and various higher-level public officials, there are still gaps in the legislation. For example, these laws are mostly silent on nepotism and conflict of interest, two of the most prominent forms of corruption in West Bank and Gaza. There is no freedom of information legislation, although a draft law is presently before the PLC. The highlights of the legislative framework are laid out in box 3.2.

Enforcement. There is no specific enforcement body covering all aspects of anticorruption. The Office of the Commissioner established pursuant to the *Law on Illicit Gains* is responsible for investigating allegations of illicit wealth involving higher-level public officials. But while a Commissioner has been appointed, the office is not yet functional. The Auditor General also has a limited role in addressing corruption. A number of laws, including the Law on Illicit Gains and the Law on Duties and Rights of Members of the Legislative Council, require PA officials to provide financial disclosure forms, but compliance with requirements is weak at best.

Equally important to addressing corruption is the Office of the Attorney General. The Attorney General and public prosecutors are responsible for both investigating and prosecuting cases of corruption. In general, the Office of the Attorney General has been slow to launch investigations. In January of 2006, the Attorney General announced that roughly 50 investigations of high-level PA officials were currently underway. However, these cases do not appear, as of yet, to be part of a larger systematic approach to combating corruption. The general inefficiency of the court system also hampers enforcement.

Box 3.2: Anticorruption Legislation in the West Bank & Gaza

Basic Law: The Basic Law requires the prime minister, ministers and PLC members to provide a financial disclosure statement, including property of spouses and dependent minor children. The disclosure must include all movable and immovable property including securities and cash owned in Palestine or abroad. The statement must be submitted to the President's office.

Law on Illicit Gains: This Law defines "illicit gains" as any gain in personal wealth from sources other than what the civil service post provides from the moment the civil servant is appointed. It provides for the establishment of an independent authority to ensure implementation—the Office of the Commissioner. The Law covers, inter alia, the president; prime minister; ministers; PLC members; members of the judiciary and public prosecution; heads and directors of the security forces and the police; members of local government structures; chairs, board members and CEOs of public shareholding companies; civil service staff in Grades 1 and 2; staff of entities that receive financing from the national PA Budget; and any other person that the Council of Ministers decides to should come under the scope of this Law. The Law provides for fines, imprisonment and restrictions on future public employment.

Law on Duties and Rights of the Members of the Legislative Council: This Law prohibits Legislative Council members from engaging in any business or holding posts at the PA besides that of a parliament member. Each member must provide a financial statement of their assets, as well as the assets of spouses and minor children, including real property and debt.

Civil Service Law: The Civil Service Law prohibits civil servants from taking advantage of their posts for personal gain or profit, or to accept directly or indirectly any gift, reward, grant or commission for carrying out their duties. The Law provides penalties that include suspension, downgrading and termination.

Criminal Codes: Both the West Bank and Gaza Criminal Codes criminalize bribes, receipt of gifts or personal gain by public servants from their posts. The Gaza Code also includes abuse of public position. Penalties include fines and imprisonment.

Recommended Next Steps. In April 2005, the World Bank funded a mission of an anticorruption expert to the West Bank and Gaza. Given the current climate of reform and the public perception that corruption remains a problem, the PA should take a proactive approach to resolving corruption problems. Undertaking quick and comprehensive assessments of corruption would provide the PA with the necessary information to mount an effective anticorruption campaign and dispel any public misperceptions as to the extent of corruption. Steps that need to be taken include:

Adoption of a National Integrity Strategy: As a matter of priority, the PA should develop a comprehensive anticorruption strategy. The first step would be adopting a brief policy paper emphasizing the three key components of the strategy: enforcement, prevention and public education. This policy paper should include the next steps to be taken, a timetable and a breakdown of the resources necessary for strategy preparation. The paper should be produced in several months. The anticorruption strategy can be finalized after completion of the analytical work and public consultations.

Analytical Work: The PA should facilitate an assessment of where corruption is located and how it should be addressed. This assessment should include: identification of corruption-related concerns inside and outside the government; analysis of the current legal framework related to anticorruption; detailed information of the efficacy of current agencies involved in anticorruption work; and identification of selected agencies perceived to be at risk for corruption. This analytical work can begin immediately, and should take into account the analytical work already conducted by Aman and other civil society organizations.

Public Consultation: Because public consultation is a key component of an effective anticorruption strategy, the PA should commission a survey of public views on specific questions of anticorruption. A civil society organization, such as the Palestinian Independent Commission for Civil Rights (PICCR) or Aman, should carry out the survey. The PA could then produce a paper detailing PA polices to combat anticorruption based on the specific issues raised in the public survey. Public feedback will be instrumental in developing the anticorruption strategy, so the public survey should be conducted immediately.

Consideration of an Independent Anticorruption Agency: The PA should consider the establishment of an anticorruption agency: either develop a new agency or expand the mandate of an already existing agency, such as PICCR or the Office of the Commissioner created by the Law on Illicit Gains. Any such body needs the ability to fully investigate all claims of corruption. Since special anticorruption agencies have proven beneficial in other countries, immediate attention should be given to this issue.

Parallel Activities: In addition to specific anticorruption activities the PA should ensure other activities related to anticorruption and good governance are furthered, including: strengthening governmental record keeping, reporting and disclosure; supporting the PLC and groups of parliamentarians; and adoption and implementation of freedom of information legislation. These activities can begin immediately.

8. Establishing the Institutional Infrastructure for Reform

On paper, several important agencies and offices exist for advancing the public sector reform agenda in the West Bank & Gaza. In practice, the institutional infrastructure is ill equipped for such a complex and politically sensitive task and has further been compromised by the fiscal and political isolation imposed on the PA. In the past five years, a Ministerial Reform Committee (MRC) has been established to oversee the broader reform agenda throughout the PA, and a Reform Coordination and Support Unit (RCSU) under the office of the Prime Minister and the Minister of Planning exists to help manage the reform. The MRC met infrequently and had little logistical support. The RCSU has a broad remit but limited staff, and it has been bounced around institutionally between the Prime Minister's Office and the Ministry of Planning.

Before the new Hamas government took over, the necessary leadership by the Prime Minister (who was responsible for the entire reform agenda) was largely absent. The Minister of Planning (who has a specific responsibility for civil service reform) played a more active role but was not able to ensure that the public sector reform agenda was consistently pursued. The MRC would be strengthened by meeting much more frequently. The RSCU's current agenda has effectively been put on hold. If the RCSU is to perform an effective secretariat function for the MRC and other PA bodies in the future, its capacity will need to be significantly strengthened. It may need to increase staff and secretarial support. So far, much of the public sector reform agenda is donor-driven. For any future success of the reform program, the government needs to take more ownership over the agenda and define actionable targets and ensure their implementation.

In terms of day-to day management of the civil service, the GPC has begun to implement a series of important internal reforms. The council issues regulations for implementing the Civil Service Law and oversees compliance with the legislation. It is also responsible for confirming appointments, maintaining database on civil servants and advising Cabinet on proposed HR management changes. The GPC's mandate covers both oversight and policy formulation. But for years, the GPC had little independence from the President's Office and acted as the de facto agency for implementing what were essentially patronage-driven decisions regarding recruitment.

With the death of Chairman Arafat, the council has begun transforming itself into a modern civil service office by adopting a medium-term development plan and taking a lead on implementing an integrated human resource management system. Yet the GPC lacks the capacity and the political clout to push through an overarching civil service reform agenda. It is generally overloaded with tasks, and the separation of the GPC offices in the West Bank and Gaza creates significant bottlenecks and delays. The new Civil Service Law expands the GPC's mandate to manage the civil service. The organizational development plan put together with RSCU further strengthens the capacity of its departments, but building up capacity of the GPC to effectively manage the reform effort will require time and effort.

The PLC, through its budget committee and other channels, has been one of the strongest proponents of civil service reform. The cooperation of the executive and legislative branches will be critical for any future overhaul of the civil service. As noted above, a number of NGOs are also active on the good governance and anticorruption agenda. The involvement of civil society groups will be critical in any future effort to establish efficient and responsive Palestinian institutions. Just as the effort to strengthen coordination of the reform agenda should be supported from the top, so should the empowerment of civil society groups to track the implementation of this agenda from the bottom.

Box 3.3: Civil Service Reform Policy Recommendations

Wage Bill:

- Ensure the long-term affordability of the public sector by committing to a donor-supported action plan for a fixed monthly wage bill to be allocated across employees at a fixed rate, with the understanding that any savings through staff reductions will increase the proportion of PA wages allocated to other PA employees.
- Eliminate automatic yearly salary raises and impose a moratorium on all future increases, which should be based only on the implementation of ministerial restructuring plans and job descriptions.
- Create a surplus labor pool under the General Personnel Council or the Ministry of Social Affairs where employees made redundant by ministerial restructuring can either take a retirement package or continue receiving a fraction of their salaries.

Civil Service Size:

- Implement comprehensive external audit of the payroll to identify redundancies as a joint exercise between the PA and an external audit consultancy firm.
- Take action (including termination) against various categories of employees who have in one way or another been abusing the system, including employees working abroad or out of post for more than two years, those working past retirement age, double dippers and ghost workers.
- Impose a blanket freeze on recruitment for the next two years, except for replacement-related recruitment in education and health.

Reform of Security Services:

- To ensure transparency, place all security service personnel (including trainees) formally on the MOI payroll. Ensure all security services are incorporated in the PA comprehensive personnel audit.
- Integrate MOI payroll under the purview of the MOF and empower the MOF to veto security service recruitment as needed.
- Achieve the Ward/Dayton mission objective of reducing the number of security services from 13 to 3. Eliminate units within the security services that are no longer needed, such as honorary or political cadres.
- Bring the total number of security service employment down to the original Oslo estimates, taking into account population growth rates and (to a limited extent) broader strategic considerations regarding eliminating private militias.
- Retract the January 2005 Security Services Pension Law and prepare new legislation that is affordable and in line with international practices with regard to contributions and benefits.

Donor Practices:

- Donors must give top priority to helping the PA develop a sustainable wage strategy for the civil and security services. This objective in turn will require: (1) a joint plan to address overstaffing in a comprehensive and systematic manner through a combination of budget support and targeted incentive packages; and (2) avoiding dysfunctional practices that are likely to increase the wage bill in the long term (such as paying salary top-ups or the recruitment of project-specific staff).
- Donors should support MOP and GPC efforts in the formulation and implementation of ministerial restructuring plans and in the strengthening of establishment controls.

Establishment Control:

- Eliminate paper-based exchanges between the GPC, MOI and the MOF related to recruitment and promotions. Strengthen efforts by the GPC to develop a computerized human resource database covering all PA employees to and develop an integrated human resource management information system (MIS) (that includes a biometric identification system) linking the databases of the GPC, MOF and MOI.
- Develop clear organizational charts for ministries, including manning charts and job descriptions, to avoid irregular promotions and appointments.

Continued…

- Disallow hiring above the official agency headcount by preparing detailed job descriptions; reward agencies for staying below their payroll budget by allowing them to obtain greater resources for operating expenses.

Organizational Restructuring:

- Complete the legal database that establishes mandates for all government ministries and agencies.
- Reform the PA organizational structure by combining or merging functions and institutions to attain target of approximately 22 ministries; reduce the number of independent agencies by approximately one-third.
- Implement previously approved organizational development plans (ODP) for ministries and government agencies; add detailed job descriptions.
- Create a competitive organizational restructuring program that rewards individual agencies with gradual wage increases based on clearly verifiable reform criteria.

Payroll Management:

- Restore all payments to employee bank accounts when political conditions allow; eliminate payments of salaries in cash; ensure that bank verify employee name before releasing the payment.
- Ensure that salaries are released according to the actual staff numbers and not to the total number of positions within each ministry.

Allowances:

- Impose strict restrictions on overtime pay except for essential services where life and property are at risk.
- Merge allowances for job type and specialty into base pay.
- Suspend the transportation allowance and other allowances where auditors find substantial abuses until corrective measures are taken.

Civil Service Legislation:

- Continue with the development of secondary legislation and regulations supporting the new Civil Service Law, with emphasis upon clarifying the responsibilities of the GPC and individual ministries and departments.
- Address the issues of redundancy and termination of service directly through secondary legislation.

Performance Management and Recruitment:

- Standardize entrance exams across the civil service.
- Eliminate exceptional promotions and ensure that no promotions are granted without the explicit agreement of the GPC and the MOF.
- Review all past exceptional promotions and demote persons promoted illegally.
- Reward ministries for reducing non-performing staff by allowing the ministries to keep a part of the budgetary savings for non-wage expenses.

Anticorruption:

- Conduct analytic work to identify the extent to which corruption exists and the areas where it is particularly problematic.
- Develop a comprehensive anticorruption strategy emphasizing enforcement, prevention and public education, and assess the feasibility of establishing an independent anticorruption agency.
- Equip the Office of the Commissioner established pursuant to the Law on Illicit Gains.

Strengthen Institutions Involved in Reform Coordination:

- Reactivate the Ministerial Reform Committee (MRC) under the chairmanship of the Prime Minister.
- Strengthen the capacity of the Reform Coordination and Support Unit (RCSU) to serve as MRC secretariat and help guide the reform agenda; pursue a limited increase in its staffing and budget.
- Involve PLC budget committee and other key players within the PLC in the civil service reform agenda.

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CHAPTER 4: REFORMING INTERGOVERNMENTAL FISCAL RELATIONS

1. Key Issues and Challenges

The Palestinian intergovernmental system was not created by design. Rather, it has been shaped over time by a variety of factors, including legal ordinances issued by various administrative regimes pre-dating the Palestinian Authority (PA), ongoing practices, adopted policies and, eventually, an overarching legal framework reflected in the Law on Local Authorities (LLA 1997). This piecemeal evolution of the system has left many legal and policy gaps and contradictions, particularly relating to the way local governments understand and perform their functions and authorities. For instance, in the West Bank, many practices carried over from the period of Jordanian control derive from that legal system. In Gaza, municipalities often continue practices more in line with the Egyptian legal ordinances applied prior to the emergence of the PA.

Despite such obstacles, the system must be improved to ensure that Palestinian local governments adhere to basic standards and sound financial management practices to improve public expenditure management. As entities authorized to raise revenues and manage public funds, local governments have as much an obligation as other public agencies to ensure that funds are managed effectively and accountably.

This chapter reviews the intergovernmental fiscal system with particular focus on public expenditure management. It considers legal and policy issues, expenditure and revenue assignment authorities, structural and functional relationships within the system, and the effect of these factors on policy outcomes and service delivery. A key recommendation is the need to realign and consolidate the legal and administrative framework to ensure greater coordination among national and local agencies. Inconsistency in laws and divergence in practices will continue to undermine effective public expenditure management system if not addressed in the near term.

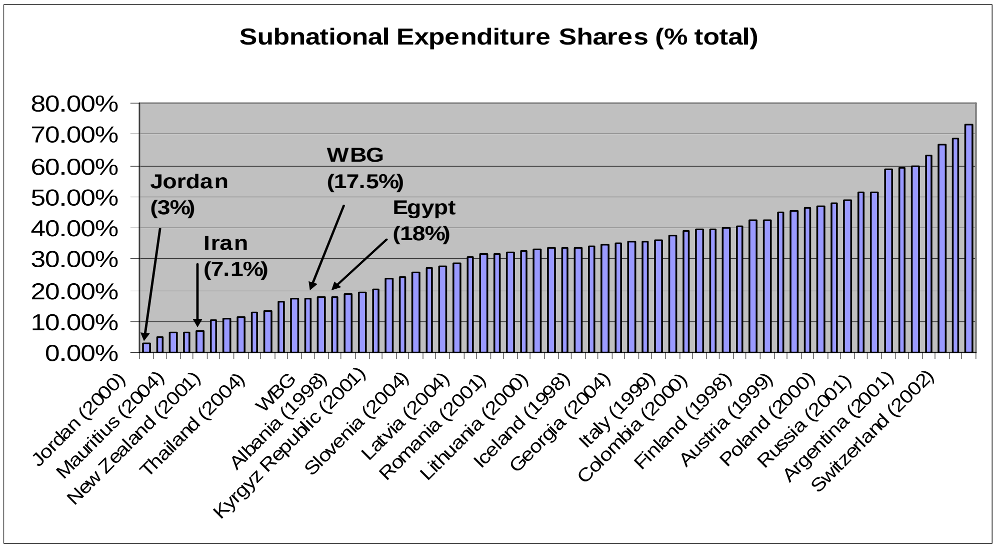
To its credit, the Ministry of Local Government (MOLG) began reviewing such issues in 2004 in its Local Government Sector Diagnostic Report and Local Government Reform Strategy. The local government elections of December 2004—the first in 30 years—were a cornerstone of this strategy. Aimed at making local governments more responsive and accountable, this reform process has stalled. It must be reactivated. Particularly at a time when economic contraction has reduced municipal revenues, local officials must manage expenditure as efficiently as possible.

The Local Government Sector within the Broader Fiscal Context. In comparison to federal states and other decentralized countries, the size of local government in the West Bank and Gaza (WBG) is relatively small—its share of public expenditure about 17.5percent (figure 4.1).[66] In a region of unitary states with central control over most

[66] Palestine's municipal share of public expenditure represents a pre-*intifada* four-year average (1996–99). By comparison, Egypt represents Governorate expenditures, whereas municipal expenditures are negligible.

aspects of government, however, Palestinian local governments are among the most autonomous. WBG average per capita subnational expenditure ($75 in 2002) is well above that of Jordan ($15 in 2000), yet behind other comparator countries, such as Brazil ($931 in 1998), Iran ($109 in 2004) and Egypt ($83 in 2005).

Figure 4.1: Subnational Share of Total Public Expenditures, Selected Countries



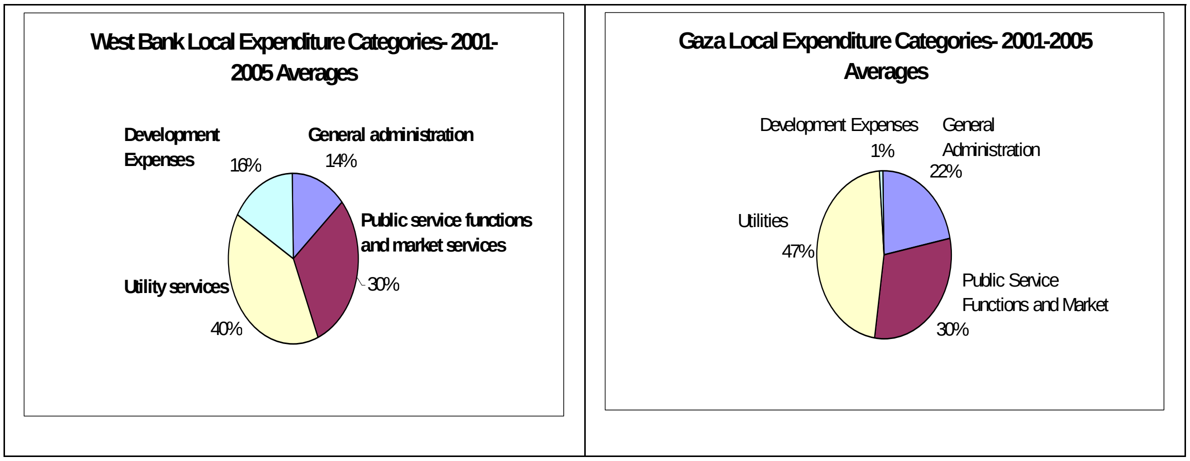
Source: Government Finance Statistics Yearbook, IMF, March 2006; selected World Bank Country Studies.

Palestinian Local Government Fiscal Autonomy. Palestinian local government autonomy is illustrated by a low dependency ratio on central government financial support. World Bank survey data indicate that even when the *intifada* increased municipal dependency transfers to West Bank local governments never exceeded 2 percent of revenue. Even Gaza's higher 17 percent is still modest by regional standards. Utility and public service and market expenditures make up the bulk of expenditures in the West Bank and Gaza (70 and 77 percent respectively), figures which correspond closely to revenues from these sources (figure 4.2).

This regional anomaly can be explained by Palestine's historical evolution. The PA arose out of the Oslo peace process in 1993, but many Palestinian municipalities have existed for a century or more, long providing many services to their citizens—at high levels of satisfaction. This experience differs from that of other MENA countries, where local governments merely represent the centralized state. Despite the West Bank & Gaza's different heritage, few concrete actions have been taken to improve coordination and ensure effective delivery of local services.

These indicators mask areas of concern that have emerged during the second *intifada*: spiraling arrears in municipal finance, troubling reliance on utility surcharges as a source of revenue and growing shares of local expenditures for general administration and wages. Capital expenditures have declined in relative terms, raising questions about service quality and coverage, especially with high population growth.

Figure 4.2: Composition of Local Government Expenditure in West Bank and Gaza, 2001–2005



2. Intergovernmental Fiscal System—Structural Issues

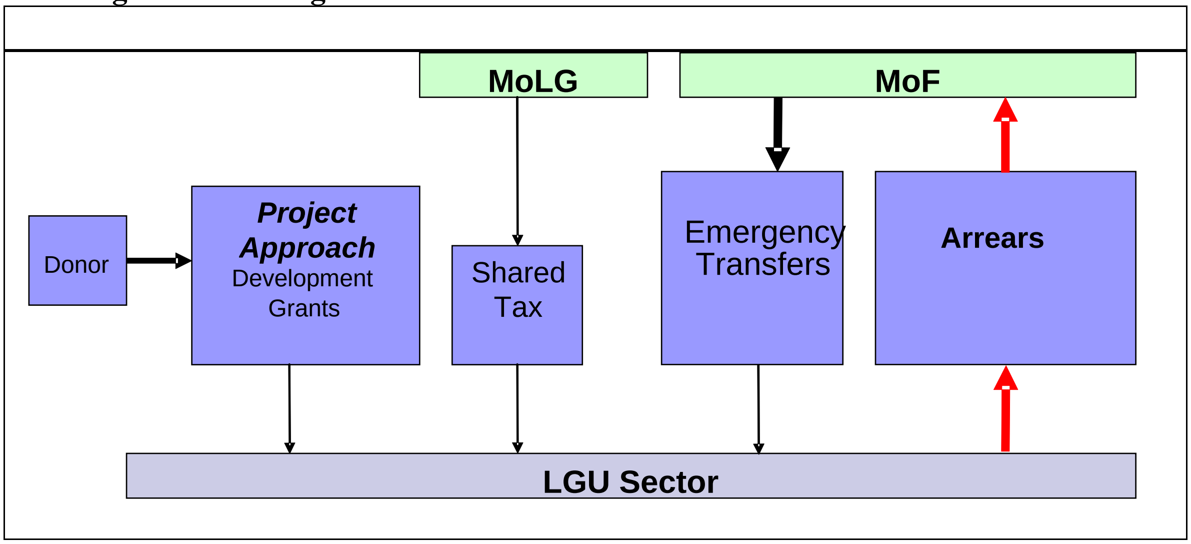
Gaps, Inconsistencies and Structural Flaws in the Intergovernmental Fiscal System. The flaws of the intergovernmental fiscal system are not surprising given the rapid emergence of the PA. Little attention was devoted to harmonizing facts on the ground with principles of governance and fiscal policy. Although the same law, the Law on Local Authorities (1997), applies to local governments in West Bank and Gaza, fiscal management differs between the two—and remains largely outside the purview of the PA. For example, Gaza municipalities collect property taxes directly while those in the West Bank rely on the Ministry of Finance (MOF) to do so.

Financial accounting and reporting is uneven and does not conform to international standards. A unified chart of accounts has not been adopted to provide common accounting for revenues and expenditures. Budget preparation and review takes place with little central government oversight. Irregular and ineffective audits do not prevent financial distress.

Structural and Functional Problems. In the West Bank and Gaza, parallel processes take place with limited coordination among agencies (figure 4.3). One agency sometimes undermines another. Emergency transfers to municipalities, authorized by the President's office, have undermined the MOF's withholding of shared tax revenues to penalize nonpayment of water and electricity utilities. Such transfers, though highly irregular in volume from year to year, represented about 20 percent of aggregate local expenditures in 2004.

Many donors' focus on project-specific outcomes, though understandable, is inadequate for institution building. Bilateral arrangements between donors and select municipalities have undermined PA efforts to restore stability. Strengthening recurrent cost budgeting for needed operations and maintenance of donor investments is a particular priority.

Figure 4.3: Intergovernmental Fiscal Structure in the West Bank and Gaza



Intergovernmental Fiscal Policy Coordination. This report recommends establishing an Intergovernmental Fiscal Policy Commission, including the Ministries of Finance, Local Government and Planning, the Palestinian Central Bureau of Statistics, the Municipal Development Fund and possibly the Association of Palestinian Local Authorities (or direct local government representation). Such a commission would provide needed follow up to the recommendations of this report, ensuring that policy coordination is institutionalized. The Commission's agenda should address issues that have relevance across agencies, including municipal arrears, intergovernmental transfers (both equalization and performance-based grants), revenue and expenditure assignment, and donor aid coordination to local governments. The Commission should seek better ways to integrate local government budgets and finances into national systems, while maintaining local autonomy and better defining it within the law.

Proliferation of Palestinian Local Governments. The decision to expand the number local governments, taken in the early years of the PA, complicated the fiscal system. Through ambiguities in the law, all local units—nearly 500 of them—have the same role in providing services, reporting finances, preparing and implementing budgets, and so on. This arrangement has created a sense of entitlement while limiting resources for larger municipalities. The PA has recognized the importance of this issue and initial steps have been promising. One initiative has limited financing to local governments of a particular size (many donors are focusing their efforts on the 118 municipalities). The remaining local governments, mainly village councils, are encouraged to submit joint funding proposals. Such initiatives consolidate budgetary resource management without canceling mechanisms for political representation. They merit further exploration.

Table 4.1: Categorization of Local Government Units in the West Bank and Gaza

Category	Number	Criteria
Class A Municipality	14	Governorate Centers (major cities)
Class B Municipality	24	Established before 1994
Class C Municipality	41	Established after 1994, with a population of more than 15,000
Class D Municipality	40	Established after 1994, with a population of between 5,000 and 15,000
Village Councils	251	Population of less than 5,000
Project Communities	127	Very small communities
TOTAL	**497**	

Source: The Ministry of Local Government Report 2003.

Palestinian Municipal Development Fund as a Policy Instrument. The Emergency Municipal Services Rehabilitation Project (EMSRP), a pilot program financed by the World Bank, showed the effectiveness of performance-based grants as tools of reform. In its second round of financing in 2004, EMSRP payments were conditioned on local governments' adherence to financial management standards. This conditionality improved submission and disclosure from 20 percent to more than 80 percent. The PA then established the Palestinian Municipal Development Fund (MDF) to induce local governments to increase revenue collection, adopt sound accounting practices, improve spending management and boost accountability and reporting. The MDF also includes a capacity-building program to help local governments meet objectives. If these measures help local governments access market-based finance, it would reduce the burden on the central government (box 4.1).

3. Expenditure Assignment Issues

Government Responsibilities and the Local Authorities Law. Under the law, local expenditure authority encompasses at least 22 areas. Health and education are notably missing, although West Bank governments often build schools and health clinics. Local governments in both the West Bank and Gaza rely on the PA for staffing, curriculum development and health care policies. Table 4.2 outlines the differences between formal legal responsibilities and local practices.

Table 4.2: Expenditure Responsibility in Law and Practice

	WB	Gaza
1997 LGL Assignments for Local Governments	**Current Practice**	
Town planning and road construction	Yes	Yes
Building licensing and control	Yes	Yes
Electricity supply, construction and management	Yes	No
Water supply, construction and management	Yes	Yes
Sewage supply, construction and management	Yes	Yes
Public markets management	Yes	Yes
Cultural and sport activities	Yes	Yes
Building demolition	No	No
Advertisement control	Yes	Yes
Hotel operation control	No	No
Public entertainment control	Yes	Yes
Sale of closed roads	Yes	Yes
Control of beggars	No	No
Public transport	No	No
Public health including collection and disposal of solid waste and slaughterhouse	Yes	Yes
Canine control	Yes	Yes
Weights and measures control	No	No
Control of peddlers and open markets	Yes	Yes
Cemeteries	Yes	Yes
Public parks	Yes	Yes
Budget and LGU Personnel	Yes	Yes
Management of LGU Assets	Yes	Yes

Source: Local Government Law 1997; Interviews with central and local government representatives; UNDP Report 2004.

Box 4.1: The Palestinian Municipal Development Fund

Established in 2003, the Municipal Development Fund (MDF) advances several goals. It channels reliable, rule-based funding to local governments. It builds financial management capacity by creating local credit markets. It moves from emergency assistance to more effective donor mobilization and coordination.

A review of several other "first stage" municipal development funds around the world showed that "rationalizing the ad hoc, arbitrary and sometimes politically guided process of resource transfers from central to local governments, an MDF can introduce criteria based funding (reliant on the strong technical capacity of MDF management) that can strengthen local capacity, provide incentives for good financial performance, improve the selection of investment priorities, and markedly enhance the quality of local project finance" (El-Daher 2000).

The Palestinian MDF pools donor aid and PA financing in a multiyear financing mechanism. Specific institutional development criteria drive eligibility. As local governments "graduate" to creditworthy status, they will become more independent and begin to access market finance. Once the institutional development performance criteria have been met, all projects will be screened against investment impact criteria, applying standard cost-benefit analysis.

The municipal development fund (not itself a lender) will bridge the gap between local governments and commercial financial institutions. If it succeeds in its first mission, it will introduce new financial tools—guarantee instruments, bond issuance, and so on—that can leveraging private capital. At present, local commercial banks offer only very short term finance (2–3 years), wholly inadequate for infrastructure investments. Success in the first stage would lay the groundwork for more sustainable finance and greater fiscal decentralization.

Unclear Expenditure and Service Responsibilities. Despite efforts to define municipal service responsibilities in the law, ambiguities remain. Municipalities have different capacities to deliver assigned services. Conflicts arise between local and national mandates, and the ambiguities create gaps in local services. Expenditure assignment should be based on rational considerations—economies of scale or the proximity of users and service providers. Services with large local effects, such as health, education, social services and fire fighting are not legally assigned to municipalities. In many countries, at least certain aspects of such services are assigned locally. In the absence of a reliable public administration system, some WBG municipalities have felt compelled to extend services beyond the provisions of the law, particularly those that matter most to their constituencies. Hebron, for instance, builds schools and fights fires. The debate on expenditure assignment and service delivery needs to take place through a consultative process that informs any effort to reform the intergovernmental fiscal system.

Asymmetries in Capacity. The Local Government Law does not recognize asymmetries in service delivery capacity, treating the smallest village councils and the largest cities the same.[67] This system requires revision. Responsibilities are too broadly defined for small local government units (LGUs) but too narrowly defined for large municipalities. Older and larger municipalities have well-established service and regulatory mechanisms—roads, water, electricity, sanitation, markets, libraries, fire abatement, slaughter houses, land use planning, solid waste management, parks and recreation and business and professional licensing (World Bank 2000). These functions are mandatory, but most

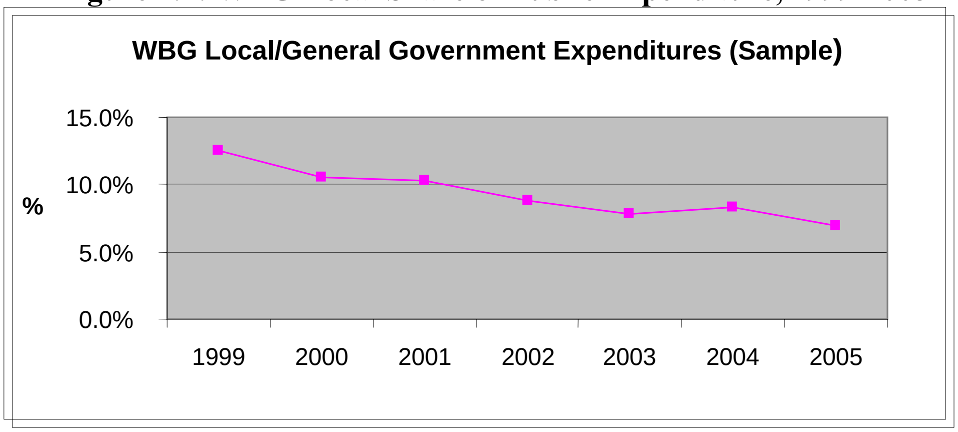
[67] The Local Authorities Law refers to "local authorities", which may include municipalities, local councils, village councils, administrative committees, project committees, or other types of councils. None of these terms is further defined or explained (MOLG 2004 and World Bank 2000).

villages are not able to fulfill them. Regulations are needed to address the asymmetries between larger and smaller LGUs. These regulations would then drive budgeting.

4. Expenditure Trends

Expenditure After the Intifada. Though still large, the local government share of public expenditure is shrinking. After the second *intifada*, WBG municipalities cut expenditures to match declining revenues (figure 4.4). The West Bank's post-*intifada* (2001–2005) average per capita expenditure fell 18 percent below the pre-*intifada* (1999–2000) average. The decline is more severe in Gaza—an estimated 29 percent.

Figure 4.4: WBG Local Share of Public Expenditure, 1999-2005



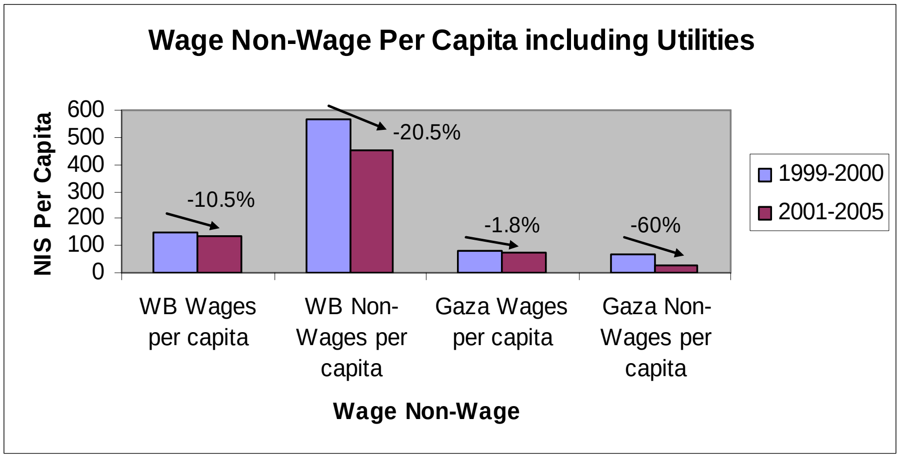
Source: Figures derived from World Bank Municipal Finance Survey and IMF Central Government Budget figures.

The wage share of expenditure is increasing, eroding the resources available for services and capital expenditures, especially in Gaza. While WBG municipalities cut wages after the *intifada*, they cuts non-wage expenditures more—60 percent in Gaza. Anecdotal evidence suggests that many municipalities had to cut their capital expenditures because they were unable or unwilling to cut wages.

Trend analysis highlights changing local expenditures. Public functions, market services, and capital and development expenditures have increased while utility expenditures have declined. Moderate general administrative expenditures continue. This analysis shows the importance of efficiency, effectiveness and capacity issues in public service functions and market services. Such expenditures are a major source of difference in expenditure needs and fiscal capacities across West Bank and Gaza municipalities.

The utility share of expenditure in the post-*intifada* period is well below pre-*intifada* levels in both the West Bank and Gaza, despite a rebound after 2003. Although utility expenditures dropped, utility salaries rose, raising suspicions that the utility infrastructure is not getting the attention it needs. Anecdotal evidence supports this diagnosis: Services and infrastructure are deteriorating in many municipalities. One remedial measure could involve encouraging smaller municipalities to use Joint Service Councils. Benefiting from economies of scale, towns could cut expenditure without sacrificing quality.

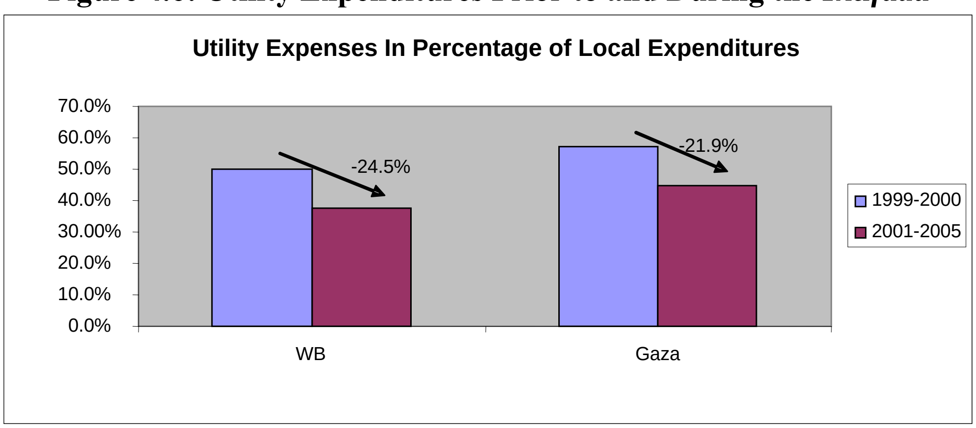
Figure 4.5: WBG Wage and Non-wage Expenditures in Pre- and *Intifada* Periods



Source: World Bank Municipal Finance Survey 2006.

Municipal Utility Services and the "Free Rider" Problem. Nonpayment of utility bills threatens the intergovernmental system in the West Bank and Gaza. In prior years, shared revenues were withheld by MOF to pay utility service debts, which were deducted by Israeli suppliers from the monthly clearance revenue that it collects and is expected to transfer to the PA. In 2002, the MOF introduced a new policy. Debts had become a critical issue—they rose from about NIS 68 million in 2000 to nearly NIS 170 million in 2002. The ministry announced that it would reinstate central transfers, but that it would intercept the funds of municipalities in arrears. The intercept provided an incentive for payment in smaller municipalities where transfers were greater than or equal to debt (see Figure 4.6). In larger municipalities, however, transfers represented only a fraction of their debts and the intercept failed. The ministry was only able to recover about NIS 18 million in 2004, a figured dwarfed by the mounting debts. Today, the suspension of clearance transfers from the Israeli government has left the PA without any such policy instrument.

Figure 4.6: Utility Expenditures Prior to and During the *Intifada*



Source: World Bank Municipal Finance Survey 2006.

Declining Utility Revenues. With the decline of revenue from utilities, public service functions and market services require other funding**.** West Bank and Gaza municipalities have met this challenge in different ways in response to local conditions. This situation indicates local flexibility, but it also creates inconsistencies. Differing practices in revenue collection lead to many fees in the marketplace. Practices must be standardized as this expenditure grows.

Box 4.2: Pre-paid Metering Systems: A Way to Address Arrears?

Pre-paid metering (PPM) systems operate in more than 40 countries around the world. In the United Kingdom and South Africa, this new approach covers 3 million and 2 million users respectively. Other countries are in the pilot phases, with between 100 and 100,000 meters in place. PPM systems are now mature (we know their advantages and disadvantages through testing experiences) and PPM markets are growing internationally. PPM systems have been applied to electricity, water, gas, telephone, and cell phone services. Locally, the Jerusalem Electricity Company (JEC) introduced a successful pilot program.

Why introduce pre-paid metering? Pre-paid metering systems have been introduced for a variety of reasons, revenue recovery first among them. Many sources also cite improved customer service. Elimination of billing, mailing, and meter readings lowers costs. Other payment systems also give inherent subsidies to some while raising the costs to all. Removing these subsidies would allow providers to pass on savings. For example, PPM systems eliminate the need for credit control, provisioning for bad debt and legal and technical services for disconnection and reconnection—costs built into recovery charges and tariff rates.

Improved energy and water conservation. From an energy conservation and household expenditure perspective, PPM systems encourage users to manage consumption better—a benefit in a resource-scarce region. Customers control their usage and can save money through monitoring consumption. Initially, PPM systems lead to revenue declines due to lower consumption, but system losses decrease as well, allowing greater coverage.

Reduction of bad debts. Providers have noted dramatic declines in bad debts where they have introduced PPM systems. They also note improved cash flow. Payment in advance leads to improved relations with customers. Customers prefer pre-paid metering's flexibility and open system approach—they can purchase electricity at any time and in any quantity. No deposits are required.

Improved means of targeting the poor through the elimination of costs and subsidies. Through a range of new payment options and smart technologies, PPM helps central or local governments provide targeted subsidies (in-kind support for electricity service to the poorest). Magnetic cards, smart cards, memory cards, keypad tokens and smart tokens—all convert payments into service.

Implementation. A pilot strategy, initially involving no more than three municipalities, would draw on lessons learned from the Jerusalem District Electric Utility Company. The strategy would consider the most appropriate technologies, customer preferences, technical specifications, public awareness requirements and so on. Policy issues will arise, such as whether to make pre-paid metering free choice or forced use. Most successful PPM pilots have included external and internal marketing campaigns to raise awareness. They also require training, restructuring of management processes, and installing new meters, all of which are included in the proposed pilot budget.

5. Accountability Measures and Sector Oversight

Weaknesses in the Regulatory Framework. Due to its informal beginnings, the local government sector operates without a guiding framework for accounting and financial management. Local governments operate without a unified chart of accounts. With revenues and expenditures recorded in a different manner at different municipalities, data aggregation at the sector level becomes impractical and unreliable. This shortcoming compromises regulatory oversight. In addition, while the General Accounting Office of MOLG carries out audits, no reports are prepared and their findings remain undisclosed. Guidelines for local budgeting and financial management are desperately needed to define common management principles: planned/executed budget formats, standard balance sheets and revenue-expense and cash-flow statement templates.

Need for Accountability in Local Government. Accountability at the local level has been nearly non-existent. In response to donor requests, the PA held local elections for the first time in over 30 years. Elections place checks on public officials—they can be replaced or removed if they are not responsive to their constituencies. However, other measures are needed. A recent special purpose audit revealed irregularities in local accounting and financial management.

Box 4.3: 2005 Special Purpose Audit of Local Governments

With World Bank support, the Ministry of Local Governments carried out a special purpose audit of five municipalities. The aim was to observe financial practices and internal control procedures to assess accounting standards. The audit was carried out by a reputable local firm.

The audit sheds light on shortcomings in the accounting, budgeting and financial reporting practices of local governments, even the more advanced ones. No formal financial procedures have been established in any of the municipalities, nor are standard procurement procedures applied. In the absence of a standard, unified chart of accounts, each municipality records its transactions differently, making it difficult to aggregate data and implement policy. Accounts from past years—some dating back five years or more—remain open and have been modified well after the standard period. Some accounts did not reconcile with existing records. Standard control procedures, including segregation of duties, are not commonly observed.

Local governments have continued to suffer from their informal, piecemeal beginnings, even after the establishment of the PA and the Ministry of Local Governments. The absence of a unified chart of accounts and standard financial and procurement policies represents a serious gap that needs to be addressed soon to improve local financial management.

Using Service Delivery Surveys to Improve Accountability and Expenditure Management. Service delivery surveys (SDSs) could improve accountability in the relationship between the service provider and the end user, leading to better investment planning and expenditure management. Nationally, such surveys can inform decisionmakers about user views on coverage, services and provider choices. Locally, they can provide vital information about service delivery and local priorities.

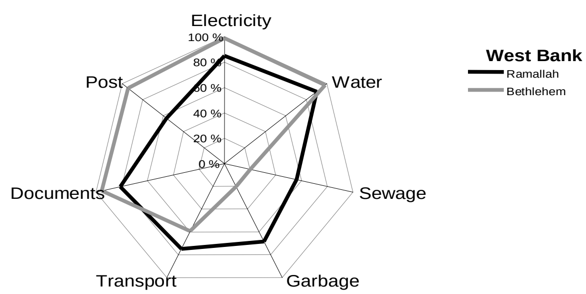
The World Bank, with the assistance of the Norwegian Social Science Research Institute, carried out a service delivery survey in the West Bank between March and June of 2005. The survey consisted of a series of focus groups in Ramallah and Bethlehem. Sixty providers and users were interviewed in each city. The survey assessed satisfaction with local services and service providers. Complementing these discussions, a transect survey—100 interviewers from a random selection of city residents—verified key findings.

The surveys suggested that Palestinians are more satisfied than those queried in Egypt, Iran, Morocco and Yemen—perhaps an implicit acknowledgement that providers do their best in a difficult environment. Findings confirm acceptance of current institutional arrangements where postal, water and sanitation services are provided through national agencies, while electricity and solid waste collection are provided through the private sector and local governments respectively. Public transport, provided solely through the private sector, is generally deemed acceptable. Respondents were open to private services in other areas, but price remained the dominant consideration.

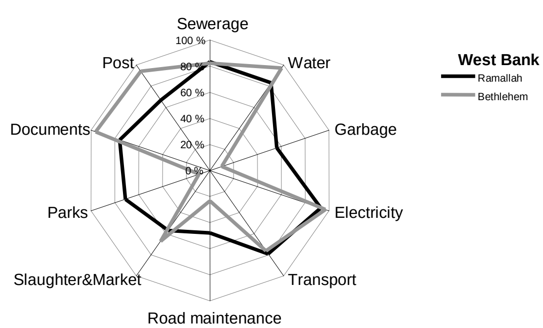
Road maintenance, a local responsibility, received significant negative responses. Respondents acknowledged that roads have been exposed to damage in the ongoing conflict (particularly tank treads). But respondents also wanted greater local engagement in maintenance (figure 4.7).

Figure 4.7: Satisfaction with Service Providers, Type of Service and City

Percent of respondents who say personnel are well informed, competent, polite and easily accessible



Percent of respondents who are very or somewhat satisfied with service provision by service area.



6. Conclusion

Palestinian municipalities have many impressive accomplishments, especially in customer satisfaction. Yet much work remains to improve efficiency and reduce the burden of municipal finances on the broader PA budget. Specific steps will aid this process (box 4.4).

Box 4.4: Policy Recommendations for Reforming Intergovernmental Fiscal Relations

Legal and Regulatory Framework

- Revise laws on fiscal relations and eliminate "claw back" clauses that limit local autonomy. (medium term)
- Institute a classification system that recognizes asymmetries in local capacity and realigns assignments accordingly. (medium term)

Policy Formulation and Coordination

- Create an intergovernmental fiscal policy commission comprising the Ministry of Local Government, Ministry of Finance, Ministry of Planning, MDLF and other relevant bodies to coordinate fiscal policy, transfer implementation and take necessary remedial measures. (short term)
- Develop a new equalization grant system to address horizontal imbalances in local tax base and resources. (medium term)

Budget Preparation and Review

- Adopt guidelines for local budgets to standardize preparation and reporting formats and institutionalize local process in the national cycle. (short term)
- Encourage the Ministry of Local Government to review budget plans and report its findings. (short term)

Central Government Oversight

- Establish a local government finance database to monitor sector performance to improve policy responsiveness. (short term)
- Issue an annual public domain report that reviews local fiscal performance. The report should include annual trends, expenditure and revenue data and standard monitoring ratios. (short term)

Local Revenue Collection

- Assess tax administration to develop reliable revenue sources for local governments. (medium term)
- Review the pilot pre-paid metering schemes and consider expansion into other municipalities. (short term)
- Transform the MDLF's emergency assistance grants into performance-based grants conditioned on improvements in revenue collection. (medium term)

Governance and Accountability

- Publish executed and planned local budgets in print and online.
- Institute external auditing of municipal accounts and monitor implementation.

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CHAPTER 5: THE EDUCATION SECTOR

1. Key Issues and Challenges

The education sector in the West Bank and Gaza is at an important turning point. In spite of the harsh conditions in which schools have had to operate, impressive achievements have been made during the past five years. The system has experienced massive expansion and attained equitable access, reaching a level of development that by most accounts is comparable with middle-income countries. Enrollment in basic education is universal, and the enrollment rate for secondary education is above 80 percent. These figures put the West Bank and Gaza in the lead in the MENA region. Equally important is the high enrollment rate in tertiary education—above 40 percent for the 18−24 age group—which is even high when compared with middle-income countries. To the Palestinian Authority's credit, access to basic and secondary is highly equitable with respect to gender, location, refugee status and household income.

The introduction of a new curriculum in a short period of time and the availability of the corresponding textbooks for all children in all schools has also been a remarkable achievement. The fact that for the first time in 2003 Palestinian children participated in international tests and scored above the average for MENA countries is another major accomplishment. In terms of teacher training, there have also been impressive results. Since 2000 almost every teacher in West Bank and Gaza has been provided with opportunities for training.

A major challenge lies ahead in building on these achievements and consolidating recent gains. Although almost all children up to the age of 12 are attending school, the quality of education is variable. This is to a certain extent expected, as the regular pattern is to move from reaching massive levels of participation (which West Bank and Gaza has clearly achieved) to addressing concerns about quality and equitable access.

To achieve these new qualitative goals, it will be necessary to introduce key policy changes. Education spending will need to shift from classroom construction, textbook procurement and the recruitment of more teachers towards a more sophisticated set of policies aimed at implementing more modern pedagogical methods and practices, introducing improved monitoring and evaluation and developing a comprehensive strategy for human resource management.

There are also areas where education spending can be made more efficient. A closer look at the demographic profile, for example, reveals that it may no longer be necessary for the PA to recruit thousands of teachers each year to keep up with population growth. The profile of staff recruited into education should place more emphasis on front line service delivery staff and less on administrative and support staff.

2. Public Funding of Education

Education expenditures have been increasing in the past five years. Although unit costs for the provision of basic schooling in West Bank and Gaza are high compared to neighboring countries, government funding for education as a share of national income is low by regional and international standards (table 5.2). Total education expenditure as a percentage of GDP has increased in the past three years, from 7.5 percent in 2000 to 11.5 percent in 2003. However, the government's share of total education expenditure fell from 42 percent in 2000 to just 34 percent in 2003. Private funding has been increasing and has reached 46 percent of all education expenditure (including tertiary education). The United Nations Relief and Works Agency (UNRWA) accounts for 20 percent of total expenditure and enrolls 25 percent of students in basic education.

Recurrent Expenditure. Most public funding for education and training is allocated to the Ministry of Education and Higher Education (MOEHE). Other ministries also provide education and training services, most notably the Ministries of Social Welfare, Labor and Ex-Prisoners. MOEHE's share of total public funding is high by international comparisons. PA expenditures for education increased from 15 percent in 2000 to 17.9 percent in 2003. The total recurrent budget for the MOEHE was NIS1306.3 million ($290.3 million) in 2004.

The bulk of these resources—around 90 percent—are allocated for salaries, which are paid directly by the Ministry of Finance. In nominal terms, the MOEHE salary budget has increased by nearly 80 percent since 2000. The number of government teachers increased by 36 percent between 1999/2000 and 2004/05.

The functional breakdown was 89.3 percent salaries, 5.3 percent school operational expenditures, and 5.4 percent university support. Around two-thirds of non-salary recurrent expenditure is allocated to textbooks and examinations. The MOEHE non-salary operational budget allocated by the Ministry of Finance was halved in 2005, severely limiting their capacity to provide the educational system with the resources needed for the provision of quality services. The rapidly increasing wage bill for government teachers has crowded out operational funding for schools.

Investment Expenditure. MOEHE's donor partners have funded the bulk of capital expenditure since 2000. A total of 266 schools and 7,350 classrooms were constructed between 1994/95 and 2005. The MOEHE was directly responsible for the construction of 118 new schools, 44 percent of them in the West Bank, and 2,675 classrooms (36 percent in the West Bank). NGOs and local communities built the remainder. In contrast, UNRWA construction expenditure on schools has been minimal in the past five years. Unit costs for school construction are 60 percent higher in the West Bank than in the Gaza Strip (averaging $350 per square meter versus $220), which points to regional inequities in school infrastructure expenditure. Schools in Gaza are generally cheaper to build because they are constructed on flat land from concrete rather than stone, and labor costs are appreciably lower.

Table 5.1: National Expenditure Indicators for Education, 2000–03

	2000	2001	2002	2003
Government expenditure on education as a percent of total expenditure on education	42.3	32.2	34.5	33.9
Government expenditure on education as a percent of total government expenditure	15	12.4	11.6	17.9
Education expenditure as a percent of Gross National Income	6.3	9.7	7.4	10.7
Education expenditure as a percent of Gross Domestic Product	7.5	9.8	9	11.5
Household expenditure on education as a percent of total annual household expenditure	3.3	5.8	6	6.1

Source: Palestinian Central Bureau of Statistics, National Accounts Department.

Table 5.2: International Comparisons of Public Expenditure on Education, 2001

	As a percent of total government spending	As a percent of GNP
Country/region		
West Bank & Gaza	17.9	3.6
Israel	n.a	7.6
Jordan	20.6	4.6
Lebanon	11.1	2.8
Morocco	n.a	5.2
Syria	11.1	4.2
Tunisia	17.4	7.2
Median values		
Developed countries	11.6	5.1
Developing countries	14.8	4.2
Arab region	n.a	n.a
East Asia and Pacific	15.3	3.6
Latin America	13.4	4.6
North America and Europe	11.6	5.6
South and West Asia	13.4	3.3
Sub-Saharan Africa	n.a	3.4

n.a: not available

Note: West Bank & Gaza figures are for 2004.

Table 5.3: Ministry of Finance Non-Salary Recurrent Budget Allocations
(NIS millions)

Ministry	2003	2004	2005
Education	122	142	60
Health	180	293	190
Ex-detainees	82	123	75
Social Welfare	198	275	113
President's Office	322	120	53
Interior	137	191	102
Finance	26	24	9
NGOs	30	37	7
All PA	1,461	1,993	1,026
Education as a percentage of total	8.3	7.1	5.8

Source: Ministry of Finance.

Table 5.4: MOEHE Recurrent Expenditure, 2000–05
(NIS millions)

	2000	2001	2002	2003	2004	2005
Salaries	690	758.5	817.8	922.5	1,118	1,226.7
School operational expenditure						
Textbook printing	21.2	2.4	34.2	31.8	32.2	35.1
Examinations	9.1	10.7	11.3	12.9	13.8	15.5
Rent	4.6	5.5	5.6	5.6	5.7	7.7
Transportation	1.6	1.1	0.7	1.8	2.4	2.4
Water and electricity	4.8	5.2	2.7	6.2	6.1	7
Telephone	2	2.3	1.1	2.6	2.3	2.5
Maintenance	1.6	0.2	0.3	0.5	3.2	0.5
Illiteracy	0.5	0.6	0	0	0	0
Subtotal	47.7	53.8	57.2	64.4	68.6	73.5
Other recurrent expenditure						
Social welfare	17.7	18.7	24.8	37.7	46.9	61.6
Universities support	7.5	8.5	8.5	63.4	71.1	100
Presidential awards	0	0	1.5	1.5	1.8	2
Subtotal	17.7	18.7	26.3	102.5	119.5	163.6
Total	755.4	831.1	901.3	1,089.4	1,306.3	1,463.8
Percentage breakdowns						
Salaries	91.3	91.3	90.7	84.7	85.6	83.8
School operational	6.3	6.5	6.4	5.9	5.3	5.0
University support	1.0	1.0	0.9	5.8	5.4	6.8
Pensions	2.3	2.3	2.8	3.5	3.6	4.2

Note: Figures for 2000–04 are actual expenditures, figures for 2005 are budgeted expenditures.
Source: Department of Finance, MOEHE.

Sources of Funding. There are three main sources of donor funding for public education provision in the West Bank & Gaza, namely the UNRWA education program, and budget and project support for MOEHE and other PA education and training programs provided by donors. UNRWA accounted for 20 percent of total (public plus private) expenditure and 25 percent of public education expenditure in 2003, and enrolls 25 percent of children in the basic cycle (grades 1–10).

Despite sizeable annual fluctuations, donor assistance has remained relatively constant at around $23–$24 million per annum during the periods 1995–99 and 2000–05. School building and other construction activities absorbed nearly 80 percent of donor support during the 1990s. Since then, however, it has declined to only one-third of total commitments. The share of "other" commitments, which include support to individual projects as well as targeted budget support for the education sector, has increased from just 6 percent during the 1990s to 45 percent since 2000. This has increased the proliferation of uncoordinated expenditure and reduced incentives for the PA to introduce efficiency gains. Curriculum development and textbook production are also a major component of donor assistance, amounting to 21 percent of commitments since 2000 (table 5.5).

Table 5.5: Financial Commitments of Donor Partners to the Ministry of Education, 1995–2005

(millions of dollars)

	Cons-truction	Material	Curri-culum	Capacity	Training	Other inc.	Totals	Percent	Percent	Percent
Year		**Equip-ment**	**Text-books**	**Building**		**Budget support**		**Construction**	**Text-books**	**Other**
1995	22.6	0.1	0.8	0	0.2	0.1	23.8	95.1	3.2	0.6
1996	5.4	0.3	9.6	0.3	0.3	0.9	16.8	31.9	57.5	5.2
1997	53.0	1.8	0	0.7	0	0.5	56.0	94.6	0	0.8
1998	12.1	1.0	0	0	0.1	5.9	19.1	63.3	0	30.9
1999	7.5	0	1.7	0	2.3	0.4	11.9	34.9	25.2	6.3
Sub-total	**100.6**	**3.2**	**12.1**	**1.0**	**2.9**	**7.8**	**127.6**	**77.9**	**9.9**	**6.4**
2000	5.5	0	3.0	0	0	3.0	11.5	47.8	25.7	26.5
2001	27.2	1.5	1.1	0	0.5	13.1	43.4	57.8	3.0	34.2
2002	6.9	0	12.4	0	0.1	9.2	28.6	23.2	44.2	32.3
2003	3.3	0.1	2.9	0	0	37.0	43.2	n.a	n.a	n.a
2004	0	0	0	0	0	0	0	0	0	0
2005	6.7	0	12.2	0	0.1	0.5	19.5	34.4	62.8	2.4
Sub-total	**49.6**	**1.6**	**31.6**	**0**	**0.6**	**62.8**	**146.2**	**31.9**	**21.1**	**45.4**
Total	**150.2**	**4.8**	**43.7**	**1**	**3.5**	**70.6**	**273.8**	**57.2**	**15.1**	**24.4**

Source: Project Department, MOEHE.
n.a.:data are not available

Household Expenditure. The share of private expenditures is high, at 46 percent of all education (including tertiary) expenditures. While education access inequities with regard to income appear to be relatively small, household expenditure on education varies enormously. The poorest households, with total consumption of less than $284 per month, spend only $10 per annum on education, while the richest households, with monthly consumption of more than $1,400, spend over 80 times this amount.

Expenditure by Type of Education. The education system in West Bank and Gaza is structured to provide 10 years of basic education and 2 years of secondary. The first cycle is sub-divided. Grades 1 to 4 are designated as the preparation stage and grades 5 to 10 are the empowerment stage. Secondary education comprises two grades, 11 and 12. Absence of a clear separation between basic and secondary among government schools in the West Bank & Gaza makes it difficult to precisely estimate the expenditure breakdown between these two types of schools. Around 77 percent of the MOEHE recurrent budget was allocated to basic and 18 percent to secondary education in 2004/05. Given the relatively long basic schooling cycles and very short secondary schooling cycles in Palestine, international comparisons of sub-sector expenditure breakdowns are not meaningful. Public expenditure on higher education accounts for only 5.6 percent of total MOEHE expenditure on education, which is very low compared to 30 percent for MENA countries and 26.3 percent for OECD countries.

Most tertiary education institutions (TEIs) in Palestine are in serious financial crises. They have had to rely increasingly on cost recovery from student tuition fees, which currently account for around 60 percent of total expenditure. Public funding for tertiary education is of two types: annual subventions to public universities by the Ministry of Finance and direct funding of six government TEIs, which is channeled through MOEHE. The MOF has made a formal commitment to provide $20 million of core support each year to the TE sector. However, fiscal constraints have meant that only slightly more than one-half of this amount was disbursed between 2002/03 and 2004/05, which amounts to around 5 percent of university recurrent expenditure during this period.

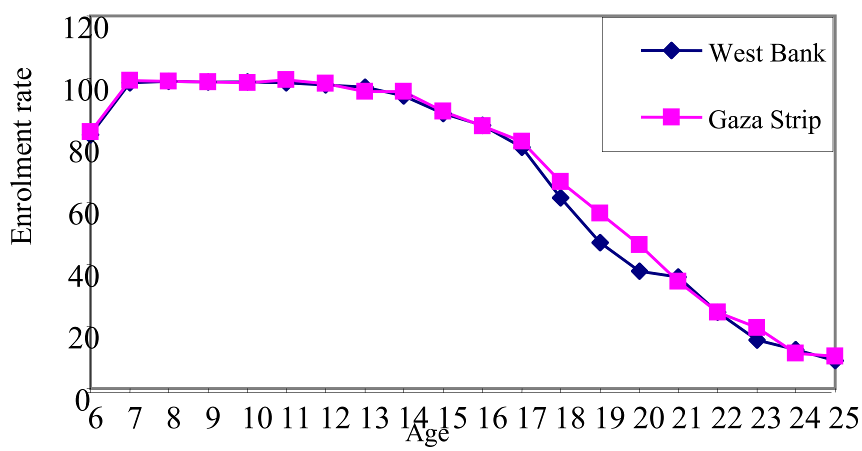
Education expenditure has been expanding very rapidly over the last five years. Private expenditure accounts for almost half of all total expenditure on education, which is a concern given the diminishing capacity of families to pay for services. The MOEHE is heavily reliant on financial support from donors for both budget and project support. In order to keep services running, such arrangements will need to continue for the foreseeable future. A positive point is that the incidence of public expenditure is quite equitable because the share of basic and secondary education is very high compared to tertiary. However, the resource allocation inequities between the Gaza Strip and the West Bank are large.

3. Enrollment Trends

The total population of West Bank and Gaza was estimated by the Palestinian Central Bureau of Statistics (PCBS) to be 3.7 million in 2005, with 52 percent under 18 years of age. However, population projections have recently been adjusted downwards to take into account much lower than expected inward migration of Palestinians due to the second *intifada*. The latest population growth figure is 3.3 percent per annum, down from 3.8 percent in 1997.[68]

Access to basic and secondary is highly equitable with respect to gender, location (rural and urban), refugee status and household income. According to the 2005 Demographic and Health Survey, enrollment rate profiles are virtually identical in the Gaza Strip and in the West Bank (figure 5.1). Almost all children attend school up until the age of 12. The main enrollment targets set for the 2000–05 MOEHE Education Five-Year Development Plan have been met for both basic and secondary schooling. But this is not the case for the vocational education targets. The goal was to reach 15 percent of the secondary enrollment in the vocational streams, which amounted to only 3 percent in 2005, down from a slight peak of 5 percent in 2003.

Figure 5.1: Education Enrollment by Age



Enrollment growth across the 12 school grades has not been even. Enrollments were actually lower in grades 1–3 in 2005/06 than they were in 1999/2000.[69] In contrast, enrollment in grades 10–12 increased by well over 60 percent during the same period. With annual population growth expected to be nearly 4 percent, the 2000–05 education plan projected that the age six population would increase by 24 percent between 1999/2000 and 2004/05. In reality, primary grade enrollments fell by 8 percent compared to a 34 percent increase for the preparatory grades (5–10) and a 55 percent increase for the secondary grades.

[68] Some questions remain about the accuracy of these population projections. A recent demographic study by the Harvard School of Public Health estimates that the population of the Gaza Strip was 1.29 million in late 2005, which is almost exactly 100,000 less than the PCBS projection for this year (Harvard 2005).

[69] It should be pointed out that grade 1 intakes in 1999 were slightly higher than normal due to a change in regulations that enabled children to enroll two months earlier than in previous years.

More research is needed, but there are probably two main reasons for this unexpected fall in enrollment intakes for basic schooling. First, fertility rates may have declined due to the social and economic upheaval of the second *intifada*. Second, emigration rates may have been much higher than expected. A Demographic Survey in Palestine (DSP) reports that, between 2000 and 2004, at least one person had permanently emigrated in 5 percent of households and temporarily migrated in 11 percent of households (2004).

Transition rates from basic to secondary education have been consistently in excess of 90 percent over the last five years, which is high by international standards. If Gross enrollment rate (GER) is calculated using Labor Force Survey (LFS) (2005) and Demographic and household survey (DHS) (2004) data for this age group, then it was 83 to 85 percent. Secondary enrollment rates have increased by 13 percentage points for both females and males since 2000, reaching gender parity for this age group.

Enrollment in Vocational Schools and Tertiary Education. School-based vocational training in the West Bank & Gaza has five streams: industrial, agricultural, commercial, hotel and home economics. Total enrollment for the five streams increased from around 3,000 in 1999/2000 to 5,561 in 2004/05, which is considerably lower than the MOEHE 2000–05 target enrollment figure of 9,000. Part of the reason is that this type of training remains unpopular among most students and parents/guardians.

There is a strong societal expectation in the West Bank & Gaza that all young people have a right to tertiary education. The MOEHE 2000–05 education plan had no explicit access targets for this level of education. The lack of sufficiently detailed survey data makes it difficult to accurately calculate transition rates for students successfully completing secondary education and proceeding to tertiary education. It is estimated that over 80 percent of grade 12 graduates who pass the *Tawjihi* go on to some kind of post-secondary education or training. DHS data indicate that 44 percent of 18–21 year olds were still in full-time education in 2004, which is a very high rate by international comparisons. In 2003 the average found in other Arab states was 15 percent, and in other middle income countries was 21 percent (in Mexico and Costa Rica) and 27 percent (in Malaysia).

4. Equity in the Provision of Education Services

A close look at allocation of resources shows that there are important regional differences, mainly between West Bank and Gaza, but also among districts. These differences are observed in the number of schools operating double shifts, in student-teacher ratios, and in the availability of libraries and computers in schools, among other things. One of the main factors in how resources are allocated differently between the West Bank and Gaza is population density, though this does not in itself sufficiently explain the considerable regional differences.

Refugee Status. PCBS estimates that 42 percent of the population under 18 years old are refugees. Around two-thirds of children from refugee households attended UNRWA schools (225,000 out of 342,000 in 2001/02), with the remainder attending PA and private schools. Ten percent of the total enrollment at UNRWA schools is non-refugee children. There are virtually no differences in enrollment rates between children from refugee and non-refugee households. UNRWA schools do not provide services beyond grade 9, but no difficulties are reported in students transferring to government schools to finish their basic cycle.

Location. On the basis of the DHS enrollment profiles, as well as Education Management Information System (EMIS) shown in figure 5.1, there are no differences between either location or gender enrollment profiles for basic and secondary education. The only difference in regional enrollment rates is a noticeably higher proportion of young adults (aged 18−20) living in the Gaza Strip enrolled in full-time education in 2004. With a few exceptions, enrollment rates are relatively uniform across the directorates for the basic school age cohorts. However, among the 16−17 age group, they vary markedly from a low of 66.5 percent in Jericho to 99 percent in Jerusalem. Despite these directorate differences, there appear to be no major enrollment disparities between rural and urban areas in the West Bank & Gaza.

5. Efficiency in the Use of Human and Financial Resources

As noted above, education is divided into the preparation stage (grades 1 to 4), the empowerment stage (grades 5 to 10), and the optional secondary education stage (grades 11 and 12). Under ideal circumstances, a child would complete each stage without having to transfer between schools, especially at the preparation stage, when stability is an important factor. However, this is rarely the case in the West Bank & Gaza. There is remarkable diversity of provision with respect to the grade structure of schools. Among schools that offer only the basic grades, barely one-third of government schools have the complete elementary and preparatory cycles. UNRWA schools offer schooling only up to grade 9 and students must shift to government schools to finish their basic cycle.

The lack of correspondence between the schooling cycles, which form the basis for the curriculum and the grade structure of schools, is not only likely to be inefficient from pedagogical and learning perspectives (particularly with so many children having to move schools mid-cycle), but is also likely to raise unit costs.

School Size. Government schools in the West Bank & Gaza are quite small by international standards, which has important implications for resource utilization and efficiency. Table 5.6 shows that nearly 20 percent of government schools have fewer than 200 students, compared to only 3 percent among UNRWA schools. Part of the reason for this difference in school size profiles is that UNRWA schools are mainly located in refugee camps with high population densities.

Table 5.6: School Size Variation by School Ownership and Region, 2004–05
(percent of total number of schools)

Region	Less than 100 students	101–200 students	201–500 students	501–1000 student	More than 1,000 students	Number of schools
West Bank						
Government	5.5	12.8	57.2	24.3	0.1	1,339
UNRWA	4.3	3.2	31.2	44.1	17.2	93
Private	35.6	23.2	30.9	8.6	1.7	233
Total	7.0	37.6	37.6	16.8	1.0	1,665
Gaza Strip						
Government	0.9	0.3	18.3	69.9	10.6	322
UNRWA	0	0	1.7	35.6	62.8	180
Private	20.0	32.0	20.0	24.0	4.0	25
Total	1.5	1.7	12.7	56.0	28.1	527
Total						
Government	4.6	10.4	49.7	33.1	2.2	1,661
UNRWA	1.5	1.1	11.7	38.5	47.3	273
Private	34.1	24.0	29.8	10.1	1.9	258
Total	7.7	10.9	42.6	31.1	7.8	2,192

Source: EMIS.

Population densities are very different in the West Bank and Gaza Strip. There are 640 population concentrations in the West Bank, compared to only 40 in the Gaza Strip. The number of individuals per square kilometer is 300 and 5,000, respectively. In addition, the impact of the occupation and closures has meant that de facto school catchment areas have become much smaller, since parents are reluctant to allow their children to attend schools outside their immediate localities (especially when it involves crossing Israeli checkpoints). The predominance of single-sex schools is another important factor contributing to small schools, as only 31 percent of schools are coeducational.

Class Size. Relatively small class size is a key feature of government schools in the West Bank. In 2004/05, 41 percent of classes had 30 students or less and only 18 percent had more than 40 students. By contrast, the Gaza Strip had 6 percent of classes with 30 students or less and 56 percent with more than 40 students. As expected given the differences in school size, smaller classes are much less common in UNRWA schools in the West Bank and are virtually non-existent in the Gaza Strip.

Student-Teacher Ratios. The complex pattern of school grade profiles makes it difficult to analyze student-teacher ratios in Palestine. The student-teacher ratio for government schools that have only grades 1–10 is 28. It is slightly higher, at 30, for elementary only schools (grades 1–4). Student-teacher ratios at both types of basic schools are appreciably higher in Gaza than in the West Bank. Student-teacher ratios in secondary schools offering only grades 11 and 12 were much lower—around 19 in the West Bank and 24 in the Gaza Strip. As shown in table 5.7, primary school student-teacher ratios in the West Bank & Gaza are relatively high compared to MENA, which has a low average, but are relatively low compared to low-income countries.

Table 5.7: Ratio of Students to Teachers in Primary Global Data

	Weighted average
West Bank & Gaza, 2004	28.0
Low and middle income	27.9
Low income	42.6
Lower middle income	21.9
Upper middle income	18.7
High income	14.0
Region, 2003	
Sub-Saharan Africa	44.7
East Asia and Pacific	30.6
Europe and Central Asia	17.5
Latin America and Caribbean	25.1
Middle East and North Africa	21.9
South Asia	40.9

Note: West Bank & Gaza, grades 1–4, 2004.
Source: EdStats 2003.

Analysis of Unit Costs-Salary Expenditures. The main education expenditure is salaries. MOEHE EMIS defines teachers as, “all teaching and non-teaching staff in school except service employees and janitors.” According to this definition, a total of 45,892 teachers were employed in 2004/05 throughout Palestine, with 73 percent employed in the PA, 17 percent in UNRWA, and 10 percent in private schools. The number of government teachers has increased considerably in the past five years, growing 36 percent between 1999/2000 and 2004/05; UNRWA and private schools also registered increases of 25 percent and 17 percent, respectively. MOF payroll data indicates that 29,763 teachers were working at government schools in August 2005 supported by 1,518 school managers and 5,135 other support staff. The number of support staff (for which there is no clear definition of roles) has increased by almost four times in the past four years.

Table 5.8 shows that the number of administrative and support staff at PA schools is much higher than at UNRWA schools. In fact, viewed in proportion to front line service providers, the PA employs twice as many support staff as UNRWA.

Given the current situation, every effort is made to post teachers in or very near to their home areas. Teacher attrition is minimal. Transfers of teachers between districts are also reported to be negligible, but intra-district transfers are more common. As a result of closures and other travel restrictions, senior MOEHE planners report that more than half the teachers at government schools have had to be relocated. The downside is that many of them have to teach subjects for which they are not qualified. However, the practice has benefits, in that it has probably enhanced informal social accountability. Education is reported to have encountered the least problems with absenteeism in the midst of the severe fiscal crisis in 2006. Where necessary, teachers are shared among schools, but multi-grade teaching is not practiced.

Table 5.8: Total School Employment by Ownership and Region, 2004/05

Region	Administrative Staff	Teachers	Others
West Bank			
Government	3,783	20,558	1,846
UNRWA	121	1,957	133
Private	554	3,272	678
Gaza Strip			
Government	998	9,031	691
UNRWA	298	5,629	288
Private	68	522	120
Total			
Government	4,781	28,589	2,536
UNRWA	419	7,586	421
Private	622	3,793	798

Note: Head office and directorate staff are not included in these figures.
Source: EMIS.

Unit Costs for Basic Education. Student-teacher ratios in the West Bank & Gaza are likely to be reasonably good indicators of recurrent unit costs. This is because salary costs account for 90 percent of total recurrent costs, other MOEHE resources are equitably distributed to all schools regardless of location and school income (principally from fees) only accounts for a very small proportion of total school expenditures.

Table 5.9: Annual Expenditure per Student (unit costs) by Type of Education
(dollars)

	Average teacher salary	Teacher unit costs	Personnel unit cost	Operational unit cost	Overall unit cost
Government schools (mid-2005)	6,882	281	343	27	370
UNRWA teaching staff (2004)	9,917	n.a	329	16	345
Government TVET	10,312	n.a	n.a	n.a	n.a
UNRWA TVET	n.a	n.a	2,438	1,468	3,906

n.a: not available
Source: MOEHE and MOF.

According to the MOEHE 2000–05 education plan, average annual expenditure per student (in other words, the overall unit cost) at government schools was $283 in 1999/2000 and was projected to rise to $370 in 2004/05 in 1999 prices. Table 5.9 shows that, even though UNRWA teacher salaries are over 40 percent higher than PA teacher salaries, there is little difference in personnel unit costs at government and UNRWA schools, mainly because of the much larger numbers of support staff employed by MOEHE.[70] The unit student costs at government schools need to be adjusted downwards slightly, although probably by no more than 2–3 percent, taking into consideration that

[70] Expenditure per student at UNRWA schools in the West Bank and Gaza Strip were $393 and $331 respectively in 2004.

MOEHE staff perform functions (most notably curriculum development and examinations) that are not undertaken by UNRWA education personnel.

Comparison between United Nations Relief and Works Agency and Palestinian Authority Basic Schools Unit Costs. Overall unit costs were $370 in 2005/06. For UNRWA schools, they were $345 in 2004 and $391 (provisionally) in 2005. Unit costs for government schools have increased by 32 percent since 1999/2000, a figure largely consistent with the 30 percent increase for UNRWA schools between 2002 and 2005. Up to date information on unit costs in MENA countries is not available. However, 2001 UNESCO data tentatively indicate that unit costs are higher in Palestine than in Jordan, Morocco and Tunisia, but considerably lower than in Syria. In summary, with better learning outcomes and lower unit costs, UNRWA schooling could be more cost-effective.

Table 5.10: Key Input Efficiency Parameters by School Ownership

School owner	2000/01	2001/02	2002/03	2003/04	2004/05
PA					
Student-teacher ratio	23.3	23.2	22.3	22.7	26.3
Average class size	37.7	36.5	35.1	34.7	34.3
Average school enrollment	505.8	506.9	500.1	505.8	n.
Average school shift enrollment	455.0	456.9	444.7	455.5	n.a
UNRWA					
Student-teacher ratio	35.8	34.9	32.2	33.6	33.4
Average class size	39.4	40.8	44.6	43.4	42.4
Average school enrollment	1,208.1	1,199.3	1,261.3	1,246.6	n.a
Average school shift enrollment	832.8	842.4	878.9	859.7	n.a
Private					
Student-teacher ratio	15.3	14.2	14	13.7	16.7
Average class size	25.7	23.8	23.6	23.9	23.9
Average school size	153.4	237.2	225.2	232.2	n.a

n.a: not available

Cost Efficiency of Technical and Vocational Education and Training Institutions. Vocational schools present an important challenge in terms of cost-efficiency and effectiveness. Since their costs are 10 times more than traditional schools, there is limited demand for them, and their graduates often do not find jobs. The activity profiles every month of secondary industrial school graduates between the beginning of 2002 and the end of 2005 shows that, for 56 percent of secondary industrial school and 31 percent of technical college graduates, their current employment is “completely unrelated” to their training specialization. These percentages are particularly high for some specializations, notably computer maintenance, automotive mechanics, industrial electronics and automotive electrics. The most striking feature of this profile is that around one-half of all graduates enroll in full-time degree and diploma level courses at higher education institutions for two to three years rather than finding training-related employment. On graduating from college, over 70 percent of female graduates were unable to find jobs during their first six months in the labor market. While this figure declined over time, over half were still unemployed during the latter half of 2005. In contrast, unemployment rates among male college graduates have been much lower; only 11 percent were unemployed in late 2005. Nearly 85 percent of males were in some kind of employment (either waged or self-employed) compared to only slightly more than 40 percent among the female graduates.

The Directorate of Technical and Vocational Education and Training estimates that the annual operational unit cost for secondary industrial schools is currently $1,707, which is 4.6 times higher than for academic schools. Inclusive of building and equipment depreciation, this sum increases to $2,510. The average unit cost for the four UNRWA vocational and teacher training colleges that are located in Palestine was $3,906 in 2005, which is 10 times greater than the unit costs at UNRWA basic schools.[71]

6. Quality and Relevance of Education Outcomes

The combination of very rapid expansion of basic and secondary education with the effects of the ongoing conflict on the school system has led to a widespread perception that the quality of education is declining in the West Bank & Gaza. If learning outcomes are taken as a measure of educational quality, then on the basis of national test results this seems to be the case. To a certain extent this is not surprising, considering the difficult environment in which schools must to operate. A decline in the quality of services is observed in most countries when education policies focus on expansion without taking into account the need to sustain and improve quality. The Palestinian education system has reached a turning point in which it is critical to introduce policy changes geared towards building on the achievements of the earlier rapid expansion and focusing on quality improvement.

Relevance of Education. In addition to the uneven achievements, there are critical issues related to the relevance of education. There is serious imbalance among the three streams in upper secondary education. The shrinking student participation in the scientific stream is especially worrying due both to supply and demand factors and constraints. Conversely, the literary stream continues to grow in terms of student enrollments, which raises serious doubts in terms of both quality and relevance. The growing imbalance in secondary enrollments has two important consequences. First, it reduces the size of the potential pool of candidates entering science and technology programs in higher education, thus “exporting” the imbalance to that sector of the education system. Second, it increases the percentage of students in the literary stream who leave secondary school with no qualification or skills. These problems become even more serious when considering that vocational education is not a real option for secondary school students (its enrollment share was down to 3 percent in 2005). Therefore, tackling the imbalance and its effects requires changes in the curriculum policy of basic and secondary education and the—already planned—reform of vocational education at the secondary and tertiary levels. It would also demand reviewing the current admission system to higher education, the courses of study offered at both universities and community colleges and student financial aid policies.

[71] The Gaza Vocational Training Centers (VTC) has unit costs of $2,261 and the average unit cost for the three post-secondary training institutions in the West Bank is $5,261.

With a high (91 percent) adult literacy rate, Palestinians are the most educated population in the MENA region. However, as in other countries in the region, an educated workforce is not correlated with economic productivity. There are important mismatches between education profiles and the labor market, with substantive gender differences. Female participation in the skilled labor force is low, even though women represent about 50 percent of enrollments in tertiary education. Unemployment among male university graduates is lower than for those with only elementary or secondary school, showing that for males there are substantial private rates of return to higher education. However, unemployment for women with university degrees is 34 percent. It is obvious that to obtain wage employment, university graduates have an advantage, regardless of the relevance of their knowledge or skills to the job profile. With public service being the main source of employment, and very limited possibilities for private sector development, the high rates of enrollment in higher education, in particular in education sciences, are understandable, as the Ministry of Education is the largest employer in the PA. However, this leads to an oversupply of graduates; for example, there were over 25,000 graduate applicants for 2,200 new teaching jobs advertised by the MOEHE in 2005.

7. Education Funding Requirements

This section examines the funding requirements for the education sector and the likely availability of government and other funding to meet these needs. This represents an attempt to estimate the funding requirements based on the assumption that the current levels of expansion of the sector will be maintained, and that increased enrollments in secondary education would be a main goal for the upcoming years.

Given current enrollment patterns in the West Bank & Gaza, the key parameters that will determine future school enrollments are the growth in the intake population for basic schools, grade repetition and dropout rates and the target enrollment rate for the secondary school grades. In view of the considerable uncertainty that exists concerning future population growth rates, school enrollment projections have been modeled under two scenarios. The first is that the school intake population grows annually at an average rate of 4 percent over the next five years and the other that this rate of intake growth is half this level at only 2 percent a year.[72] The grade 1 net intake rate is assumed to remain at 100 percent for the foreseeable future. A reasonable target for the next five year plan is to achieve universal basic education for all, with 100 percent completion of ten years of education by the end of the plan in 2010. Two scenarios have therefore been adopted with respect to repetition and dropout rates: both rates will remain at their current levels for all grades for the next 10 years; and they will gradually decline to zero by the end of 2009 as a result of more extensive safety nets, better learning outcomes and a marked improvement in the economic and security situation.

[72] According to the revised PCBS population projections, the average annual growth rate for the year-six population will be 3.5 percent between 2005–10.

Projected Enrollments for Primary and Secondary. The enrollment projections for these different scenarios are presented in table 5.11.[73] What is striking is that, regardless of the population growth and repetition/dropout scenario, enrollment growth for basic schooling is only projected to increase by 6–10 percent between 2005/06 and 2010/11. In contrast, secondary grade enrollments are projected to increase by 40–47 percent over this period (these estimates vary little from one scenario to another). The overall increase in school enrollments is only 10–14 percent depending on the projection scenario. Basic school enrollments will only grow slowly because enrollment rates for grades 1–10 are already nearly 100 percent, so it is only intake growth that leads to higher enrollments. For the secondary grades, however, enrollment rates are considerably lower, and therefore enrollments will increase quite rapidly as the target enrollment rate of 100 percent is attained during the next five years.[74]

Table 5.11: Projected Basic and Secondary Grade Enrolments, 2005/06 and 2010/11

	2005/06	2010/11	Increase	Percent increase
Basic schooling				
2% Per Annum Intake Growth				
No change in repetition and dropout	950	104	54	6
Zero repetition and dropout by 2009	938	990	52	6
4% Per Annum Intake Growth				
No change in repetition and dropout	952	1,049	97	10
Zero repetition and dropout by 2009	946	1,035	89	9
Secondary schooling				
2% Per Annum Intake Growth				
No change in repetition and dropout	126	183	57	45
Zero repetition and dropout by 2009	128	187	59	46
4% Per Annum Intake Growth				
No change in repetition and dropout	129	183	54	42
Zero repetition and dropout by 2009	128	187	59	46
Total enrollment				
2% Per Annum Intake Growth				
No change in repetition and dropout	1,076	1,187	111	10
Zero repetition and dropout by 2009	1,066	1,177	111	10
4% Per Annum Intake Growth				
No change in repetition and dropout	1,081	1,232	151	14
Zero repetition and dropout by 2009	1,074	1,222	148	14

Note: Figures are rounded to the nearest thousand.

Funding Requirements for Teachers and Classrooms. Table 5.12 presents total recurrent funding requirements for each scenario for 2005/06 and 2010/11 assuming no changes in current unit costs for basic and secondary education. The average annual rate

[73] The Harvard School of Public Health study models future school enrollments for the Gaza Strip, but these seem to be based on inconsistent population growth estimates. On the one hand, the population aged 0–4 is projected to grow by almost five percent a year between 2005–10 but, on the other hand, the age 6 intake population used to make enrollment projections is projected to increase by only 1.2 percent (from 38,913 to 39,365) during this period.
[74] A study by the Rand Corporation on the future Palestinian state estimates that basic school enrollments will increase by 29 percent and secondary school enrollments will increase by 44 percent between 2005 and 2010.

of recurrent expenditure growth is 2.0−2.5 percent during this period, which is much less than the 11.4 percent rate of annual growth between 1999/2000 and 2004/05. It is important to note that, assuming no changes in the student-teacher ratio, the number of new teaching posts and additional classrooms needed to cater for enrollment growth actually declines appreciably for all but one of the four scenarios. The additional funding requirements for expanding secondary, while maintaining the current enrollments in primary, are $35 million per year, much lower than what the increase in the past five years has been. The good news is that with 2 percent intake growth, between 515−850 fewer teacher posts will be required in 2010/11 than in 2005/06. An average of 213 teachers (0.8 percent of the total in post) will reach the compulsory retirement age of 60 each year over the next four years**.**

Table 5.12: Recurrent Funding Requirements under Four Scenarios
(millions of dollars)

	2005/06	2010/11	Increase	Percent increase
Basic schooling				
2 Percent Per Annum Intake Growth				
No change in repetition and dropout	261.3	276.1	14.9	6
Zero repetition and dropout by 2009	258.0	272.3	14.3	6
4 Percent Per Annum Intake Growth				
No change in repetition and dropout	261.8	288.5	26.7	10
Zero repetition and dropout by 2009	260.2	284.6	24.5	9
Secondary schooling				
2 Percent Per Annum Intake Growth				
No change in repetition and dropout	44.7	65.0	20.2	45
Zero repetition and dropout by 2009	45.4	66.4	20.9	46
4 Percent Per Annum Intake Growth				
No change in repetition and dropout	45.8	65.0	19.2	42
Zero repetition and dropout by 2009	45.4	66.4	20.9	46
Total recurrent expenditure				
2 Percent Per Annum Intake Growth				
No change in repetition and dropout	306.0	341.1	35.1	11
Zero repetition and dropout by 2009	303.4	338.6	35.2	12
4 Percent Per Annum Intake Growth				
No change in repetition and dropout	307.6	353.4	45.8	15
Zero repetition and dropout by 2009	305.6	351.0	45.4	15

Source: calculated for this report.

Capital Expenditure. Assuming no change in the current class size norm of 35, the additional number of classrooms required to accommodate net enrollment growth will decrease from 750−1050 in 2006/07 (depending on scenario) to 430−860 in 2010/11 (see table 5.14). The current average unit cost of adding a classroom to an existing school is $16,000 in the Gaza Strip and $35,000 in the West Bank. The corresponding costs for building a classroom in a new school are $28,000 and $47,000.[75] Given the size of these cost differences, it is not possible to make robust capital expenditure projections without

[75] Further investigation is needed to explain these very large differences in classroom unit costs in Gaza Strip and the West Bank.

more detailed information on the location and type of classroom construction (in old and new schools). A new priority setting process for school construction is needed that is both transparent and equitable. New schools are most urgently needed where there are serious safety concerns about existing buildings and facilities and in order to prevent triple shifting and double shifting (particularly in Gaza).

Table 5.13: Projected Recurrent Expenditure for Basic and Secondary Schooling, 2005/06–2010/11

(millions of dollars)

	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Basic schooling						
2 Percent Per Annum Intake Growth						
No change in repetition and dropout	261.3	265.9	268.7	271.2	272.5	276.1
Zero repetition and dropout by 2009	258.0	261.3	271.4	265.4	268.4	272.3
4 Percent Per Annum Intake Growth						
No change in repetition and dropout	261.8	267.9	272.3	276.7	281.6	288.5
Zero repetition and dropout by 2009	260.2	262.9	266.2	270.9	276.9	284.6
Secondary schooling						
2 Percent Per Annum Intake Growth						
No change in repetition and dropout	44.7	51.1	57.9	61.8	64.3	65.0
Zero repetition and dropout by 2009	45.4	51.1	57.9	62.8	65.7	66.4
4 Percent Per Annum Intake Growth						
No change in repetition and dropout	45.8	51.1	57.5	61.8	64.3	65.0
Zero repetition and dropout by 2009	45.4	51.1	58.2	62.8	65.7	66.4
Total recurrent expenditure						
2 Percent Per Annum Intake Growth						
No change in repetition and dropout	306.0	317.0	326.5	332.9	336.8	341.1
Zero repetition and dropout by 2009	303.4	312.4	329.3	328.2	334.1	338.6
4 Percent Per Annum Intake Growth						
No change in repetition and dropout	307.6	319.0	329.8	338.4	345.9	353.4
Zero repetition and dropout by 2009	305.6	314.0	324.4	333.7	342.6	351.0

Table 5.14: Projected Total Teacher Post-Requirements, 2005/06–2010/11

Per Annum Intake Growth	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
2 Percent Per Annum Intake Growth						
No change in repetition and dropout	46,180	47,682	48,927	49,785	50,300	50,944
Zero repetition and dropout by 2009	45,751	46,953	49,356	49,013	49,828	50,515
4 Percent Per Annum Intake Growth						
No change in repetition and dropout	46,395	47,983	49,442	50,644	51,717	52,876
Zero repetition and dropout by 2009	46,094	47,210	48,584	49,871	51,159	52,446
Extra Posts Required						
2 Percent Per Annum Intake Growth						
No change in repetition and dropout		1,502	1,245	858	515	644
Zero repetition and dropout by 2009		1,202	2,403	–343	815	687
4 Percent Per Annum Intake Growth						
No change in repetition and dropout		1,588	1,459	1,202	1,073	1,159
Zero repetition and dropout by 2009		1,116	1,373	1,288	1,288	1,288

Note: Assumes overall student-teacher ratio of 23.3 (actual 2003/04 latest year available).
Source: calculated for this report

Table 5.15: Projected Classroom Requirements for Basic and Secondary Schooling, 2005/06-2010/11

Per Annum Intake Growth	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
2 Percent Per Annum Intake Growth						
No change in repetition and dropout	30,743	31,743	32,571	33,143	33,486	33,914
Zero repetition and dropout by 2009	30,457	31,257	32,857	32,629	33,171	33,629
4 Percent Per Annum Intake Growth						
No change in repetition and dropout	30,886	31,943	32,914	33,714	34,429	35,200
Zero repetition and dropout by 2009	30,686	31,429	32,343	33,200	34,057	34,914
Additional Classrooms Each Year						
2 Percent Per Annum Intake Growth						
No change in repetition and dropout		1,000	829	571	343	429
Zero repetition and dropout by 2009		800	1,600	–229	543	457
4 Percent Per Annum Intake Growth						
No change in repetition and dropout		1,057	971	800	714	771
Zero repetition and dropout by 2009		743	914	857	857	857

Note: Assumes class size of 35.

Funding Availability. Based on these projections, the average annual rate of recurrent expenditure growth is estimated to be between 2.0 and 2.5 percent over the next five years, which is much less than the 11.4 percent rate of annual growth between 1999/2000 and 2004/05. Assuming no changes in the student-teacher ratio, the number of new teaching posts and additional classrooms needed to cater for enrollment increases declines appreciably for all but one of the four scenarios. With 2 percent intake growth, between 515 and 850 fewer teacher posts will be required in 2010/11 than in 2005/06.

Similarly, assuming no change in the current class size norm of 35, the number of additional classrooms required to accommodate net enrollment growth will decrease from 750–1050 in 2006/07 (depending on scenario) to 430–860 in 2010/11.

8. Conclusions and Challenges Ahead

The progress made on basic educational indicators in the West Bank & Gaza is remarkable—particularly considering the circumstances under which it was achieved. However, the combination of very rapid expansion of basic and secondary education with the effects of the ongoing political conflict on the school system has led to a widespread perception that the quality of education is declining in Palestine. Based on national and international tests results, this seems to be the case. To a certain extent this is not surprising, taking into consideration the difficult environment in which schools have to operate. In many countries, this outcome is also not unusual when education policies focus on expansion without taking into account the need to improve quality. The Palestinian education system has now reached that turning point in which it is critical to introduce policy changes geared towards building on the achievements of the rapid expansion and focusing on quality improvement.

The discussion below summarizes the major issues and tradeoffs emerging from this chapter. Box 5.1 below provides a more condensed summary of the main policy recommendations.

Educational Relevance and Effectiveness. Perhaps the most pressing issues to be addressed are related to the relevance of the education provided in Palestine. The expansion of secondary education has been unbalanced, as almost three out of four students who pass the *Tawjihi* exam are going into the literary stream and those in scientific streams are becoming a minority. This trend has an obvious impact on patterns of student demand for tertiary education and clearly explains the unbalances in tertiary enrollments, (for example, shortage of science and technology students and overcrowding of faculties of humanities, social science and education).

There are also concerns that the PA is over-investing in technical and vocational education. Old-fashioned vocational training, with narrow specialization and extremely low labor insertion for graduates, is obviously not the way forward. Increased emphasis on comprehensive secondary schooling and a diversified tertiary education system with advanced vocational training is a priority. Just as formal basic and secondary schooling should be parts of a unified system, post-secondary school education and training need to be developed as a system. The poor articulation (particularly with respect to learning pathways) between tertiary and TVET institutions needs to be addressed. The challenge is to develop a common framework of skill levels and related qualifications which a diverse range of training and other specialist service institutions are accredited to offer. The primary focus of post-secondary education should be preparation for skilled employment in the formal sector, but given the importance that is attached to private sector development, every effort should be made to encourage higher levels of self-employment in viable enterprises.

Emergency Conditions. The education sector, like all other sectors in the PA, has to cope with the constant fiscal crisis and the fluctuating availability of financial resources. The uncertainty of resource availability leads to a piecemeal approach and a proliferation of uncoordinated projects that have limited impact on the system and do not build the institutional capacity needed to make the interventions sustainable. In addition, the education system has to operate under restrictions imposed by closures, which result in a forced redeployment of teachers.

In the short term, the main challenge for the education system is to meet the financial requirements for keeping the school system operational. Considering that 90 percent of system expenditure is on salaries, finding the mechanisms to guarantee payment of teachers' salaries is the main goal. At the same time, a rationalization of the current high levels of budget and project support for the education sector from external donors is critical. A proliferation of projects and initiatives in recent years is predominantly supply-driven, and their sustainability and potential impact are not aligned with the overall goal of developing the education system. Too often, there is no built-in impact evaluation envisaged in these projects and programs. When evaluations are conducted, they tend to focus on inputs to the school system rather than on student learning outcomes or on the system's institutional capacity. In addition to the lack of performance monitoring, and, therefore, lack of answers regarding the potential impact of such programs, the proliferation of these uncoordinated interventions have also created disincentives for introducing efficiency measures in the use of financial and human resources.

Serious efforts should be made to achieve closer donor coordination and considerably reduced reliance on the project support modality. A sector-wide approach with basket funding should become the main source of external support over the next five years. Appropriate mechanisms to inform policy decision-making must be institutionalized and sustained. Increased political emphasis—and corresponding financial investment—for the impact evaluation of programs and projects will provide the necessary evidence for policymakers to decide what programs to keep or drop, which to scale up, which to adapt or review, and so on. This should apply for government as well as donor initiatives.

Efficiency in the Use of Human and Financial Resources. An analysis of the demographic profile within Palestine may allow the PA to recognize considerable savings. The PA appears to have encountered a demographic bulge rather than a sustained expansion, which will allow it to forgo the recruitment of thousands of new teachers each year. Enrollments were actually lower in grades 1–3 in 2005/06 than they were in 1999/2000. (In contrast, enrollment in grades 10–13 increased by well over 60 percent during the same period.) If such findings are true, the PA could potentially save as much as $17 million per year by reducing its intake from 2,800 new teachers annually and limiting recruitment to replacements only (around 215 per year). More modest decreases projected on 2 and 4 percent a year growth would also yield savings over current practices, albeit at reduced rates. Personnel recruitment for education should not include categories such as administrative and support staff.

A more unified and coherent schooling system with larger schools offering complete elementary, preparatory and secondary cycles would considerably improve the efficiency of service delivery in the education sector. The high proportion of small classes in government schools in the West Bank significantly increases unit costs. Finding ways to ensure that all classes have at least 35–40 students would lead to major efficiency gains, as well as having a more rational deployment of teachers. Larger classes can be achieved through greater teacher flexibility—reliance on class teachers for the lower basic school grades and multi-grade teaching so that small classes can be combined. Effective multi-grade teaching results in both improved learning outcomes (as a result of the introduction of student-centered learning methodologies) and more efficient teacher utilization, and thus significantly lowers unit costs. In addition, class teaching has been found to be more effective than subject teaching among younger aged children in most situations. For this reason, class teachers are the norm in primary schools in most countries. Increased reliance on class teaching, at least up to grade 6, would also substantially improve teacher utilization and overall resource efficiency.

Likewise, the current policy of annual replacement of textbooks is costly and unlikely to be financially sustainable. Increasing the lifetime of textbooks should be seriously considered; three years is the norm in many countries.[76]

Improving the Quality of Basic Education. Quality improvement is clearly the main policy objective for the next five years. Research evidence on determinants of student achievement is consistently pointing to classroom variables and teacher behavior in the classroom as having greater impact than school-wide variables or even system-wide inputs. This means that the emphasis should be on improving pedagogy and methodology, introducing innovations in learning technology, developing classroom management skills in teachers aimed at a more efficient use of time, focusing on school-based monitoring and evaluation and emphasizing the centrality of students in their own learning process.

Towards this end a set of policy reforms should be implemented, including:[77]

- Re-shifting the centrality of textbooks in the curriculum, and the production and dissemination of alternative curriculum materials, teaching aids, school libraries, science laboratories and ICTs.
- Strengthening monitoring and evaluation capabilities at all levels.
- Reform of pre-service and in-service teacher training and development of a national strategy for teacher development.
- Revision by the Agency of Accreditation and Quality Assurance of pre-service teacher training programs, and the technical profiles used for their selection.

[76] Textbooks that are designed to last for three years or more are more costly, but these additional costs are significantly offset by reduced annual replacement expenditure.

[77] A detailed and comprehensive plan to develop such programs is included in the education report: "Impressive Achievements Under Harsh Conditions and the Way Forward to Consolidate a Quality Education System" (World Bank 2006).

- Linking in-service teacher training to decentralized school-improvement policies.
- Developing a system of school indicators of quality improvement.

School Management. Currently, basic schools in the West Bank & Gaza do not face strong incentives to improve quality and learning outcomes. It is important to introduce performance evaluations at the end of the primary cycle to increase the accountability of schools to students and parents and the communities in which they live, as well to create a stronger sense of partnership and ownership. School management committees with significant parental and community representation and considerable decision-making powers could be introduced in order to achieve this. It is important to address government and donor-financed programs and projects directly to strengthening the capacity of schools by enhancing leadership; increasing autonomy for planning and implementation; opening up to the community; favoring partnerships with universities, NGOs and other institutions in the civil society and engaging in school development and improvement projects with the necessary incentives. This necessarily entails a process of political and administrative decentralization and changes in the overall governance and management of the school system.

Box 5.1: Education Policy Recommendations

Broader Strategic Objectives:

- MOEHE's spending pattern should shift from construction, textbooks and increasing the number of teachers to a more sophisticated set of policies to develop pedagogical methods and practices and monitor the quality of service delivery.
- Recruitment should focus exclusively upon areas of critical need (such as secondary school teachers) and avoid categories such as administrative and support staff.

Efficiency in the Use of Human and Financial Resources:

- School size should be increased, particularly in the West Bank.
- MOEHE needs to provide a coherent schooling supply with schools offering complete primary cycles.
- Shifting demographic trends are likely to result in the need to recruit significantly lower numbers of teachers than has been the case previously, curbing the rapid increase in the wage bill.
- On recurrent expenditures, important savings can be made by increasing the lifespan of textbooks and reducing the costs of examinations.
- The introduction of multi-grade teaching will reduce the burden on salaries and improve the quality of teaching.

Providing Equitable Access to Secondary Education:

- Secondary schooling should be the main area of expansion, with enrollments expected to grow over the next five years if all children are accommodated.
- The inequitable distribution of resources between West Bank and Gaza, especially in deployment and training of teachers, computers and library resources, must be addressed.

Improving the Quality of Education:

- Important reforms should be made in the allocation of resources through well-designed policy interventions:
- Shifting the emphasis of textbooks in the curriculum to the production and dissemination of alternative curriculum materials, teaching aids, school libraries, science laboratories and ICTs.
- Reforming pre-service and in-service teacher training and development of a national strategy for teacher development.
- Revising pre-service teacher training programs, and the technical profiles used for their selection, by the Agency of Accreditation and Quality Assurance.
- Linking in-service teacher training to decentralized school-improvement policies.
- Developing a system of school indicators for quality improvement.

Strengthen Monitoring and Evaluation Capabilities at all Levels:

- Emphasize school system results and focus on monitoring student learning outcomes.
- Conduct an impact evaluation of the in-service training provided to teachers through the implementation of the new curriculum.
- Enhance the capacity of universities to monitor and evaluate both students and programs and, in general, perform education research.

Managing the Education System Efficiently and with Transparency:

- Develop donor coordination and harmonization to prevent duplication of actions and waste of resources.
- Use careful impact evaluation of donor and PA programs as the main driver for policy decisions.
- Use a sector-wide approach with basket funding as the main modality for external support over the next five years to increase the potential of achieving impact results and support system-wide development.

Improving Relevance of Education: Reform of Vocational Education at Secondary and Tertiary Level

- Reform vocational education at secondary and tertiary levels to improve employment options for graduates.
- Increase the relevance of education through close collaboration with the private sector and a careful analysis of labor markets.

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CHAPTER 6: THE HEALTH SECTOR

1. Key Issues and Challenges

Over the past decade, the Palestinian population has been able to enjoy a quality of health care that compares favorably with many other middle income countries. This progress is now at risk from a variety of external and internal factors. With a per capita GDP about a third below the pre-*intifada* level, Palestinian society is confronted with a critical challenge in meeting the health needs of the population.[78] The weakened economic situation has been complicated by geographic fragmentation and checkpoint closures, which have hampered the predictable movement of goods and people and diminished access to basic social services, including health care. A rapid expansion in the wage bill, coupled with a major increase in contracting services, has eliminated any discretionary spending that the PA may have enjoyed and made it completely dependent on donors for virtually all non-salary expenditures.

Prior to the *intifada*, the Ministry of Health (MOH), along with the United Nations Relief Works Agency (UNRWA) and the NGOs, provided an extensive and complementary program of public health services and clinical health care. The health system in the West Bank and Gaza achieved high levels of immunization coverage, prenatal care and effective basic health services. Reflecting these achievements, Palestinian health indicators in 2000 compared favorably with countries at similar income levels in terms of child health, child nutrition, maternal health and life expectancy. However, these achievements came at a relatively high cost, with total health spending at about 13 percent of GDP—among the highest rates in the MENA region. The major concerns in the health sector prior to the *intifada* were improving the efficiency and quality of health care services to contain health spending while responding to the changing epidemiological profile of the population.

During the first years of the post-*intifada* period, the PA managed to maintain a pre-*intifada* level of budget for health programs due to generous budget support from the donor community. Between 1994 and 2000 annual donor disbursements averaged around $500 million (or $150 per capita). At the onset of the *intifada* donors significantly stepped up assistance to the Palestinians, doubling it to around $1 billion annually in 2001 and 2002 (World Bank 2004b). Between 2001 and 2003 it is estimated that donor contributions added about 30 percent to the GDP and over 20 percent to the average Palestinian persons' disposable income. Donor spending on humanitarian and welfare assistance peaked in 2003 but has since declined sharply.

Other health service providers besides the PA, like UNRWA (which is mandated to provide basic education, health and social services to some 1.6 million registered refugees in the West Bank and Gaza), have increased their operations in response to the *intifada* and attempted to mobilize additional resources through emergency appeals. But

[78] According to World Bank estimates, real GDP per capita in 2005 was some 35 percent below its pre-*intifada* level of $1,184 in 1999.

UNRWA had difficulty securing adequate funding for its emergency operations despite active campaigns, and its overall budget has declined in recent years. NGOs have historically played a key role in providing health services in the West Bank and Gaza, and they have been financed largely through donor assistance and private contributions. However, with the outbreak of *intifada*, a significant share of the donor funding shifted towards direct support to the PA. According to 2004 data from the Ministry of Planning, NGOs received just 6 percent of overall emergency support. Within the health sector, a number of NGOs have increasingly come to depend on contracts with the PA as an important source of revenue.

Notwithstanding the generous contributions by the donor community, the accessibility and the quality of Palestinian health services has suffered during the *intifada*. Strains on the system are reflected in slowly declining health indicators. Closures and roadblocks have delayed or prevented pregnant women and other patients from reaching hospitals or maternity centers. In May 2004 MOH reported that 106 patients had died at Israeli roadblocks since the beginning of the *intifada* and 55 births occurred at Israeli checkpoints, resulting in the death of 33 newborn infants (Ministry of Health 2004). According to the Health, Development, Information and Policy Institute, prenatal care coverage has declined while homebirths have increased nearly ten-fold, particularly in rural areas, contributing to a rise in the number of stillbirths (2004).

The deterioration in the public health system is also evident in the increased incidence of waterborne communicable diseases, particularly among children. Between 2000–04 gastrointestinal infections in children under five have increased 42 percent, and the prevalence of amoeba and *giardia* increased by 40–60 percent. The Ministry of Health has also reported isolated outbreaks of communicable diseases not normally seen in the West Bank and Gaza, such as bacterial and viral meningitis. Child health has been particularly affected by the *intifada*; according to one study, malnutrition rates have increased from 8 percent stunting in 2000 to 9 percent in 2002, and from 1.4 percent wasting in 2000 to 2.5 percent in 2002 (Zehraoui 2004).[79] Disabilities—a longstanding health problem in the West Bank and Gaza as a result of conflict-related trauma and high rates of congenital conditions—have risen significantly since the start of the *intifada*. Accurate figures are not available, but estimates of permanent disabilities resulting from conflict-related trauma range from 2,500 to 25,000.[80] This newly disabled group, as well as other disabled persons numbering more than 46,000, require special programs for rehabilitation and social support (MOH 2003).

Decreased access to care and to preventive programs contributes to the increased incidence of chronic conditions, such as diabetes, cardiovascular diseases and renal

[79] "Stunting" (low height for age) reflects chronic malnutrition and is a cumulative measure of past nutritional problems and is considered to be the best measure of malnutrition. Chronic malnutrition as measured by height for age is linked to acute malnutrition (weight for height) in that repeated loss of weight in the short term will translate into reduced height in the long term. "Wasting" (low weight for height) reflects recent illness and/or decreased food intake, often due to the anorexia that accompanies an episode of infection or a decline in the availability of food. Wasting, often called acute malnutrition occurs during seasonal fluctuations and in emergencies.

[80] See the Health, Development, Information and Policy Institute website.

failure, and poorer treatment outcomes. Since most patients are not adequately screened by the health system for these conditions, an increase in morbidity rates among the chronic patients is not yet fully reflected in the health surveillance system. Disabilities resulting from these chronic conditions present an additional burden on the overstretched system.

In addition, some of the consequences of the *intifada* undermine the sustainability of the Palestinian health financing system. On the revenue side, the PA depends on supplements from premium contributions and co-payments collected through the Government Health Insurance (GHI) system. The GHI program, established under the MOH in the 1990s, was expected to provide a sustainable financing mechanism in the form of a social health insurance system that would cover the entire Palestinian population. At its peak in 2000, the GHI contributions covered some 51 percent of the MOH expenditures, and the GHI was poised to expand its revenue base in line with the projected economic growth. But a number of important structural reforms to the GHI system initiated in the late 1990s have been halted since 2000, and emergency measures introduced by the PA to cope with the exigencies of the *intifada* have further undermined its financial sustainability. With the outbreak of the *intifada*, GHI contributions declined while the number of GHI beneficiaries exempted from contributing premiums and co-payments increased as a result of the emergency measure decreed by President Arafat. Although the GHI revenues appear to have recovered in recent years—covering about one-third of MOH's expenditures in 2004—this may largely reflect an increase in contributions from the expanded civil service staff, who are receiving salaries heavily subsidized by donor contributions. Hence, the additional GHI revenues may not signify greater diversification of its revenue base.

The recent rise in public health expenditure has been driven by increasing public employment and wage expenditures, along with a lack of fiscal constraint. Since the *intifada*, the PA has essentially used public employment salaries as welfare payments to inject critical demand into the economy. Between 1999 and 2004 expenditures on public sector wages increased by an estimated 64 percent, with a 28 percent increase between 2002 and 2004 (World Bank 2004a). Health expenditure has also been driven by increasing public salary expenditures, with close to zero funding for capital expenditures and a diminishing share allocated to operating costs. Between 2000 and 2005 the number of medical personnel (physicians, dentists and pharmacists) working for the MOH nearly doubled from 1,631 to 2,999 individuals, and the number of administrators increased by 22 percent from 2,457 to 3,158 persons. This has substantially inflated the wage bill within a relatively flat budget envelope, leading to deficit spending in this budget category. While this approach may have been justified as an emergency measure during the early days of *intifada*, the practice of increasing civil service staffing while cutting operating costs is undermining the effectiveness of public health services and programs.

The PA was able to expand the volume and types of contracts with NGO health care providers through the GHI coverage. The expansion of contracting enabled PA to extend the GHI coverage for beneficiaries in areas where the MOH did not have facilities. It also helped to supplement the revenues for NGOs who were suffering from reductions in donor financing and private contributions. However, in the face of current fiscal crisis, the MOH has been unable to fully reimburse the NGOs for services rendered under the existing contracts, and the PA is now accumulating sizeable arrears due to these commitments. While it was the original intention of the GHI program to expand the choice of health providers to the beneficiaries by contracting health services to NGOs and private health care providers, this step would have required a substantial upgrade in the GHI's capacity to design, manage and monitor contracts with external health care providers. Expenditure for specialized treatment ballooned from $8 million in 2002 to $55 million in 2005. Referrals for specialized treatment outside of the MOH, both within and outside of the West Bank and Gaza territories, represented 26 percent of total PA health expenditures and 44 percent of non-salary operating expenditures.

PA's expansive policies on salaries and contracted services has effectively left little fiscal space for critical variable expenditure items such as pharmaceuticals, medical supplies and operating costs for equipment and facilities. Many facilities have capacities that are not fully utilized. Moreover, PA spending on these items appears to be poorly executed—for example, the prices the PA pays for drugs are significantly above both world market prices and those paid by UNRWA. Capital investments have been left largely to donor assistance, but to avoid fragmentation, this will require a well-conceived medium term investment plan that is consistent with sectoral priorities, affordable and conditioned on the availability of an adequate operating and maintenance budget. For example, medical equipment is largely provided by donors, but the coordination of these donations has been limited and the MOH has not been able to estimate and allocate adequate resources for the management and maintenance of equipment.

Similar inefficiency appears to be occurring for UNRWA and NGO providers. There are opportunities for efficiency gains within the sub-sectors (PA, UNRWA and NGO) as well as through better coordination of services and resource allocation across these sub-sectors. This calls for strategic and coordinated support to the Palestinian health system that takes into account the complementarity of all service providers, as well as the allocative efficiency within each set of providers. For the PA, this will also involve a major policy decision on whether to invest in and expand its own MOH-operated services, or to expand services for the GHI beneficiaries by outsourcing and contracting through NGOs and private providers. Since so much of the PA budget depends on donor contributions, donor preferences will also play a key role in determining the direction of PA's budget allocation—though this element should diminish as the PA assumes more direct control over the sector.

Finally, shortcomings in the PA's financial management system, including a lack of transparency in the existing accounting system, severely hamper the MOH's ability to effectively monitor and manage its financial resources. In particular, the reliance on cash accounting prevents the Ministry from having a full and accurate picture of outstanding commitments.

2. Priorities for the Health Sector

In the most recent National Health Strategic Plan (NHSP), for 1999–03, the PA committed itself to provide adequate and affordable health care accessible to all Palestinians in an economically sustainable manner. Considerable achievements were made, reflected in the improvement of health indices, service expansion and broader health insurance coverage. In the first three years of the *intifada*, there was a lapse in the medium term planning process while the PA remained in emergency mode. Prospects for improved economic outlook in 2005 led to the preparation of a new Medium Term Development Plan (MTDP) covering the period 2006–08. This MTDP proposes a set of development priorities for the health sector (described in box 6.1) as a component of the national strategy for sustainable human development.

Box 6.1: Priorities for the Health Sector from 2006–08

- Provide sufficient quantities of medication and treatment, maintain a strategic reserve for contingencies and offer annual vaccines for children.
- Work on developing programs to improve nutrition in Palestinian society, particularly among women and children.
- Support training and continuing education for health sector workers.
- Support and develop existing facilities and resources in the field of capacity building.
- Provide sufficient funds to attract the specialized and efficient technicians and doctors that the health sector needs.
- Work to develop an integrated health insurance system.
- Enhance the health sector's administrative and financial systems.
- Approve and activate health laws and regulations, such as the public health law, health insurance law, trade unions law, Palestinian Medical Board Law and the environmental protection law.
- Develop "Woman and Child" health programs, including reproductive health services, pre-natal care and child care.
- Develop programs for youth on sexual health and reproduction.
- Develop programs to fight social problems such as alcoholism, drug addiction and smoking.

Source: Ministry of Planning, Medium Term Development Plan 2006–08.

The MTDP acknowledges the challenges posed to the Palestinian health sector, especially the reduced access and availability of certain health services and the increased cost of health care provision due to geographic and institutional fragmentation. The MTDP underlines the government's responsibility for providing the population with basic services and recognizes that to realize these service delivery goals, it will be necessary for the health care system's main institutions, the MOH, national and private health institutions, NGOs and UNRWA, to cooperate closely.

3. Overall Trends in Health Spending

Public Expenditure in Health. The MOH budget is a traditional input-output budget with economic categories for expenditure classification. The recurrent budget is divided into salary and non-salary expenditure. Non-salary expenditures include utilities, maintenance, consumables and special treatment referrals. Between 2000 and 2005 public health expenditure increased significantly, mainly due to an expansion in recurrent expenditures (table 6.1). Little to nothing is known about investment expenditure, although given the precarious financial situation in the West Bank & Gaza since the second *intifada*, capital investments have probably been given a lower priority. However, there are investments in new health facilities and maintenance, and upgrades in existing facilities, that take place through specific donor investment projects and do not show up on the MOH balance sheets.

One of the most striking observations in table 6.1 is that public health expenditure has expanded rapidly since 2000 while GDP contracted substantially. Even though GDP has been recovering slowly to pre-*intifada* levels in the last two years, public health expenditure occupies a large and increasing proportion of all public expenditure and GDP. About 8–11 percent of total public funds were allocated to the MOH annually between 2000 and 2006. And since 2003, actual health expenditures have continuously exceeded budget allocations.[81] The difference between budget and actual expenditure was the largest in 2005. The per capita budget increased slightly in nominal terms and, adjusted for inflation, real per capita public health spending has risen steadily since 2002. In all but one of the previous ten years, salary expenditure exceeded the budget allocation—increasingly so since 2003. Non-salary expenditure was usually lower than the budgeted amounts; however, in 2005, non-salary expenditure also exceeded the budget allocation.

For public expenditure in health, the main concern is the growth of salary expenditure as a proportion of total recurrent expenditure. Budget provision for salaries was more or less static between 2000 and 2003, but since then it has increased sharply. Actual salary expenditure rose nearly every year. Salaries as a proportion of budget expenditure increased from 52 percent to 60 percent between 2000 and 2004. In 2005 this trend relaxed slightly, with salary expenditure decreasing to 54 percent of total recurrent expenditure. This was mainly because 2005 was the first year when non-salary expenditure substantially increased. In every year but 2005, the proportion of actual salary expenditure was higher than the proportion of budget salary expenditure, implying low budget discipline. Until recently, there seemed to be only sporadic budget pressure on non-salary expenditure. This is because the majority of the non-salary budget comes from external donor funds, and until recently donors were generally willing to fill this gap.

Similar trends appear to be occurring in UNRWA and other NGO providers of health services. UNRWA has difficulty securing adequate funding to meet all the emergency operations needs, in spite of active campaigns to mobilize additional resources, and its overall budget level has declined in recent years. However, UNRWA's salary

[81] The MOH argues that there were essentially two reasons why actual expenditures exceeded allocations. The first is that the allocations in the budget did not reflect the needs of the ministry, but were determined by the MOF without adequately taking the MOH's needs and priorities into consideration. Second, there was an increase in emergency expenditures as a result of the *intifada*, for which there are no adequate budgetary provisions.

expenditure increased steadily in total and as a proportion of overall expenditure (see box 6.2).

Box 6.2: United Nations Relief Works Agency

UNRWA's mandate is to be a principal agent for the human development of over 4 million Palestinian refugees (22 percent in Gaza and 16 percent in the West Bank). While it has achieved some notable accomplishments, the resource indicators that once symbolized UNRWA's success are now in decline. Education and health facilities are often overcrowded and under-equipped. The intended beneficiaries are increasingly falling through the gaps in service provision (UNRWA 2005). Health resource indicators compare unfavorably with those of the PA (see table 1).

Box table 1 UNRWA's Resource Indicators in Comparison with West Bank and Gaza Host Authority, 2003

Indicators	Palestine	UNRWA	
	Ministry of Health	West Bank	Gaza
Number of Primary Health Care facilities per 100,000 people	29	5.3	1.9
Number of doctors per 100,000 people	84	10.0	9.85
Number of dentists per 100,000 people	8	2.0	1.5
Number of nurses per 100,000 people	141	32.4	27.1
Per capita allocations for health in US dollars	26.9	14.7	12.8

Source: UNRWA 2005.

UNRWA explains this development by noting that the worsening economic situation has forced better-off Palestinian refugees to return to the already overcrowded UNRWA system. In the first months of 2006, for example, the demand for in-patient services increased sharply; it is expected that demand for out-patient services will follow this trend. Other factors may also contribute to this decline. UNRWA's total expenditure in West Bank and Gaza has decreased slightly since 2003. At the same time, salary expenditure increased steadily every year (box table 2). In the health sector, the number of employees increased from 949 in 2002 to 1,139 in 2004 (MOH 2003, 2005). UNRWA confirmed that it is giving priority to staff stability and continued hiring over other efficiency consideration, such as adequate operating expenses. In 2006 UNRWA received record application numbers for their newly advertised positions. While UNRWA's salaries are higher than those of the PA, they are much lower than in other NGOs and UN agencies. In fact, UNRWA is struggling not to lose well-qualified staff. Many doctors and other personnel have to pursue outside employment after their regular working hours at UNRWA.

Box table 2 United Nations Relief Works Agency's Expenditure Trend in the West Bank and Gaza, 2002–05

	2002	2003	2004	2005
Total expenditure	12,710	13,307	12,321	12,997
Salaries (excluding Qalqilia Hospital)	4,401	4,569	4,719	5,166
Medical supplies	2,375	2,515	2,453	1,992

Source: World Bank staff calculations with UNRWA data, 2006.

In general, UNRWA appears to face challenges similar to the PA's—a shrinking budget envelope with an expanding proportion of salary expenditure. The expansion of the salary budget share puts increasing pressure on non-salary expenditure and undermines UNRWA's ability to provide good quality services.

Table 6.1: Budget and Actual Public Health Expenditure, 2000-2006
(current, millions of exchange rate US dollars)

	2000		2001		2002		2003		2004		2005		2006
	Budget	Actual	Budget	Actual	Budget	Actual	Budget	Actual	Budget	Actual	Budget	Actual	Budget[1]
Public health expenditure	94	95	99	91	96	88	108	122	126	129	126	157	189
Recurrent expenditure	92	93	97	90	96	87	108	122	126	128	123	155	187
Salaries	45	48	47	55	51	49	57	57	74	77	73	83	95
Non-salaries	47	46	50	35	45	38	51	65	52	51	50	71	92
Investment expenditure	2	6	2	1	0	1	0	0	0	1	3	2	3
Public health expenditure as percent of total public expenditure		8		8		9		11		9		10	
Per capita		30		28		26		35		35		42	
Per capita (real)		29		27		24		33		34		40	
Memo items													
Consumer Price Index		2.7		1.2		5.7		4.4		3.0		3.5	
Exchange rate (NIS/$)		4.08		4.21		4.74		4.54		4.47		4.53	4.67
GDP (million)		4,636		4,034		3,396		3,454		3,765		4,044	
Total public expenditure		1,212		1,120		984		1,140		1,512		1,496	
Population (million)		3.14		3.28		3.39		3.51		3.63		3.76	

1. According to the MOH Finance Department, since 2000 a similar budget plan with almost the same proposed expenditure was prepared on an annual basis and submitted to the Legislative Council for approval. This procedure was initiated for the 2006 budget and the budget plan was submitted to the Legislative Council in August 2005. However, as of May 2006, no new budget was approved. Instead a new budget procedure was initiated. The MOH is now required to submit a budget request on a monthly basis, based on previous year requirements plus a rate of expected budget increase. The budget data for 2006 stems from the proposed budget for the MOH from the MOF.

Source: World Bank staff calculations based on World Bank, MOF and MOH data, 2006.

Data from the MOH that disaggregates public expenditure into sub-categories is shown in table 6.2. This data confirms that, among all recurrent expenditure items, salaries and special treatment referrals increased most significantly. According to table 6.2, by 2005 special treatment referrals accounted for 17 percent of all public health expenditure. However, these numbers only represent the special treatment referrals that were actually paid.[82] The MOF stopped paying contracted providers for special referrals sometime in 2005. Since then, the actual cost for special treatment referrals in 2005 is an estimated $55 million (MOH 2006). That would amount to about 26 percent of all public health expenditure and 44 percent of non-salary recurrent expenditures. There does not appear to be a consistent information flow between the MOH and MOF on special treatment referral costs, nor is an accurate recording system in place. The proportion of salaries comprised about 53 percent of all public expenditure in 2005 (56 percent in 2002).[83]

Table 6.2: Recurrent and Investment Expenditures in Health, 2002-06
(current, millions of US dollars)

	2002		2003		2004		2005		2006
	Budget	Actual	Budget	Actual	Budget	Actual	Budget	Actual	Budget[1]
Recurrent expenditure	96	87	108	122	126	128	123	155	187
Salary	51	49	57	57	74	77	73	83	95
Non-salary	45	38	51	65	52	51	50	71	92
Medical supplies and drugs	25	19	26	20	26	26	25	31	36
Special treatment referrals	6	8	13	31	13	11	11	26	40
Other operating costs	15	11	13	13	13	14	14	14	40
Investment expenditure	0	1	0	0	0	1	3	2	3
Total	96	88	108	122	126	129	126	157	189
Memo item									
Exchange rate (NIS/$)		4.74		4.54		4.47		4.53	4.67

1. Proposed budget, MOF 2006.
Source: World Bank staff calculations based on MOF and MOH data, 2006.

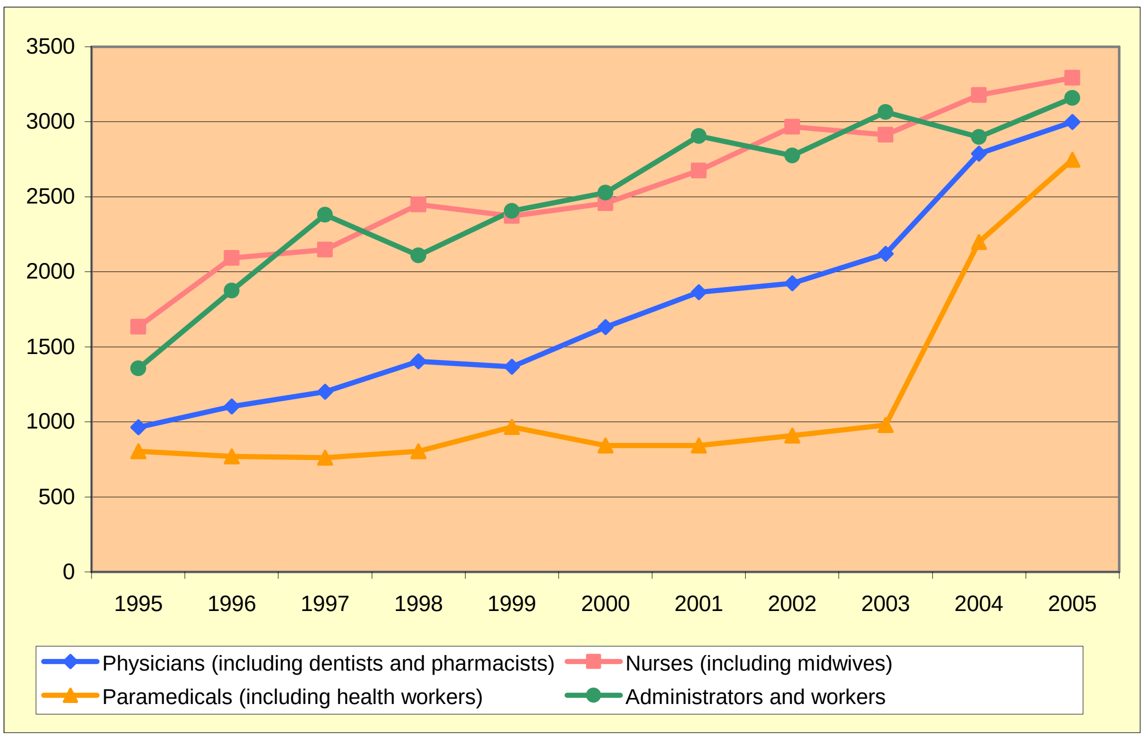
Public health expenditure is occupying an increasing share of public expenditure and GDP, raising serious fiscal sustainability issues for the MOH budget. One particular danger lies in the growing imbalance of salary and non-salary expenditure. Permanently hired staff make it hard to adjust budgets in the short-run when a tighter fiscal policy is necessary.

[82] The figures in table 6.2 show the planned (budget) amount and actual payments, but do not account for the total liabilities due to arrears on unpaid bills. According to MOH, the total cost of contracted services was estimated at about $55 million in 2005, which represents significant arrears of about $30 million for that year. In the absence of accrual accounting, these liabilities are not captured in the MOH budget figures.
[83] This figure was 46 percent in 2003 and 60 percent in 2004.

And increasing non-salary expenditure is required to offset quality concerns where additional staff are not supported with sufficient supplies, like drugs. According to MOH staff, there is also concern about a qualitative shift in expenditure, with the MOH receiving lower value for money and paying the same price for goods and services of diminished quality.

Salaries and Benefits. Both tables 6.1 and 6.2 point towards a dramatic expansion in salary expenditure since 2002. Although budget allocation for salaries increased over the last few years, the actual expenditure for salaries continued to exceed the allocated budget. Much of the increase can be accounted for by new staff hired between 2003 and 2004. There were also reported increases in salaries. The number of MOH employees increased steadily over the last decade (figure 6.1). The most sizeable increase in the number of MOH employees, 18 percent, was between 2003 and 2004. In 2005 the MOH employed a total of 12,197 people, most of them civil servants (11,054 in March 2005 and 11,284 in February 2006).

Figure 6.1: Number of Ministry of Health Employees, 1995–2005



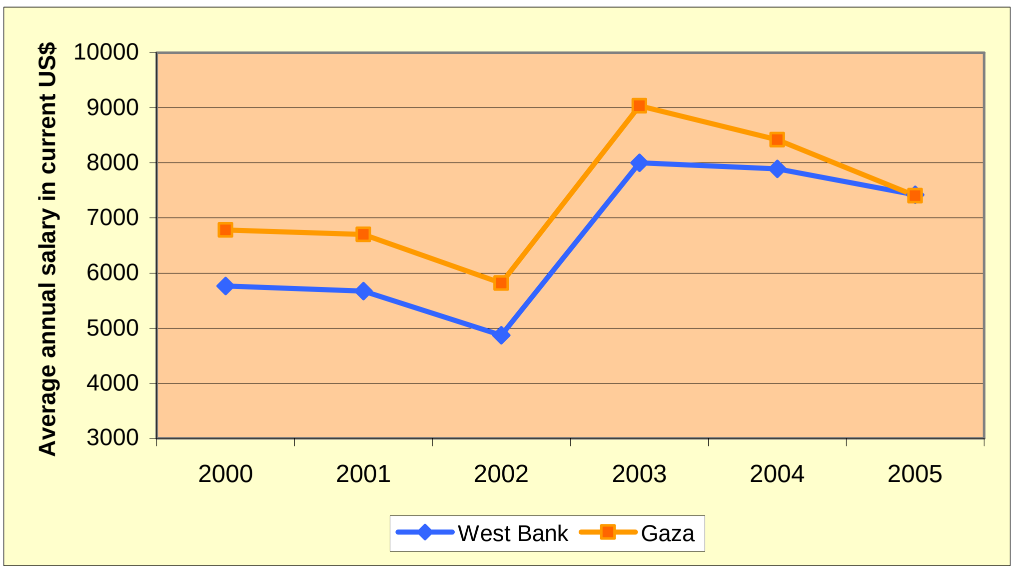
Source: MOH 2003, 2005 and 2006.

The number of employed medical personnel (physicians, dentists and pharmacists) nearly doubled from 1,631 in 2000 to 2,999 in 2005. The other two categories with a high increase were paramedicals and administrators and workers. Paramedicals had one of the largest increases in numbers, more than doubling between 2003 and 2004 from 978 to 2,199.[84] Administrators and workers consistently accounted for about a third of all employees.

[84] Between 2002 and 2004 the number of health employees also increased for UNRWA and NGOs. The sharpest increase was for NGOs, from 4,700 to 6,327. UNRWA's number of employees increased from 949 to 1,139. However, for Medical Services for the Police and Security (MPS) the number of employees

Since 2003 there has been a significant increase in the real average annual salaries of MOH employees (figure 6.2). Gaza salaries are higher on average, since more high-level administrators are located in the Gaza MOH headquarters. Salaries paid are based on the civil service salary system containing 12 different payment grades that vary substantially. For example, in 2005 the real average annual salary for the highest grade employee in the MOH was $36,302 and the lowest grade was $4,169. Doctors earn around $6,000 a year and most of them have to work in their own practices after hours to afford the relatively high living costs in Palestine. This fact is widely confirmed, even though there is a law that prohibits doctors from operating a private practice outside of MOH employment without a license.[85] The MOH also seems to have difficulties in enforcing regular working hours for their physicians and specialists. Given the current crisis situation, where salaries are not paid regularly, it seems likely that it will become even harder to guarantee the presence of health personnel in MOH facilities in the near future.

Figure 6.2: Real Average Annual Salary for MOH Employees, 2000–05



Source: World Bank staff calculations based on MOH data adjusted for inflation, 2006.

Special Medical Treatment Referrals. Figure 6.3 shows a significant increase in the special treatment component of non-salary expenditure.[86] It includes specialized treatment in non-MOH Palestinian institutions, treatment in facilities abroad and expenses for the treatment of patients in MOH facilities by external personnel. Between 2002 and 2004

decreased from 1,001 to 954 (MOH 2003 and 2005). These numbers do not reflect a dramatic increase in health professionals in Palestine. It is widely acknowledged that many doctors, and indeed most other health services personnel, have more than one job.

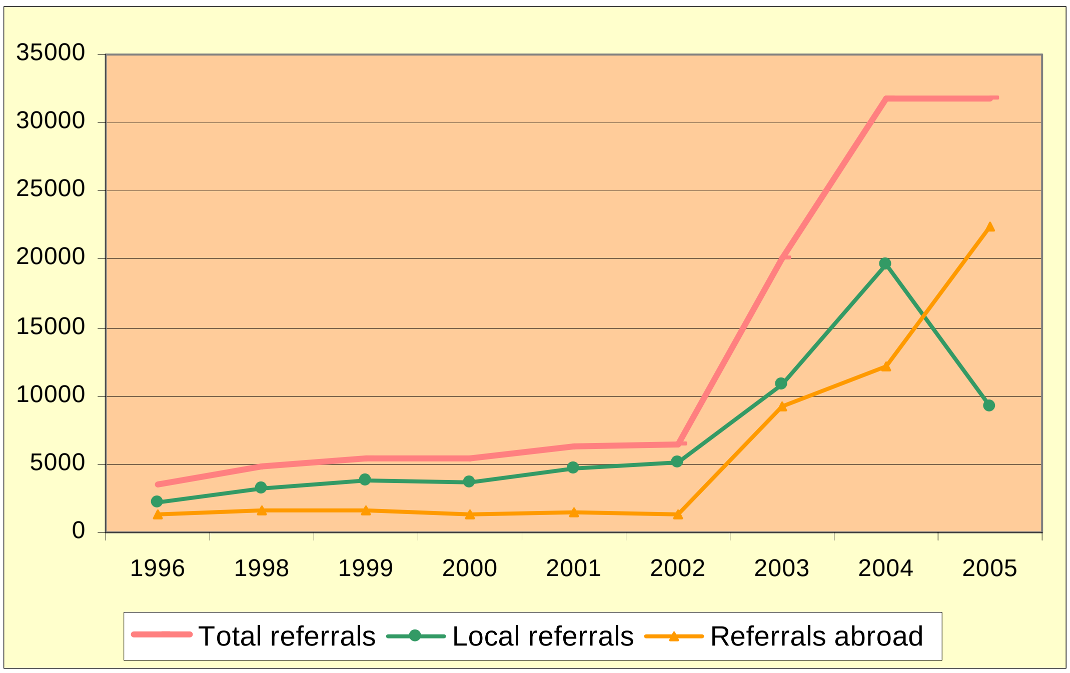
[85] Anecdotal reports also suggest that some physicians might refer the same patients they tend to in the MOH facilities to their private practices. These reports also suggest that most of the expensive diagnostics are performed in the MOH system, including filling necessary prescriptions, while the remainder of the treatment is performed in private practices. This would mean that the public system is indirectly subsidizing private practices, but also that treatment costs are shifted in part to the patient.

[86] Special Treatment is sometimes also referred to as "Treatment Abroad" for historical reasons, although most of the special treatment occurs within West Bank and Gaza territories.

these expenditures increased from $8 to $55 million.[87] Special treatment referrals now account for about a quarter of the MOH budget. Total expenditure on specialized treatment for the sector by the government is considerably higher than these figures indicate, as less than half of the total net expenditure comes from MOH budgets and the remainder comes from the President's Office.

The number of special treatment referrals tripled between 2002 and 2003 from 6,483 to 20,100. It peaked in 2004 with 31,744 referred cases, where it remained in 2005 (figure 6.3). In the first quarter of 2006 there were more than 5,000 new referrals (MOH 2006). Until 2002 local referrals increased steadily while referrals abroad remained around 1,400 cases a year. By the end of the period of the most rapid expansion (between 2000 and 2004), the number of referrals abroad climbed to 12,100, and the number of local referrals to 19,644. However, this trend reverted in 2005, when referrals abroad increased to 22,473 cases and local referrals decreased to 9,245 cases.

Figure 6.3: Number of Special Treatment Referrals, 1996–2005



Source: MOH 2006.

Over the last few years, the leading medical causes for referrals were diseases of the heart (especially heart catheterization), cancer treatment, infertility treatment, eye diseases and rehabilitation treatment. The majority of the patients were in the age group of 15–49 years, followed by the age group of 60+ years (about a quarter).

There are multiple reasons for the increase in special treatment referrals. One is the lack of resources within the MOH facilities, including adequate equipment and medical personnel.

[87] The "total expenditures" on special referrals include the total cost of contracted services, distinct from the actual payments made by MOH to the contracted providers. For example, the estimated cost for special referrals in 2005 is $55 million, of which $26 million has been paid by MOH (see footnote 5 above).

Another reason is the misuse of medical referrals as a means to obtain travel clearance from Israel.

In the past year there have been serious efforts to contain the further increase in medical referrals, especially to prevent the misuse of financial resources in dire need in other areas of the public health sector. In November 2005 a decree was passed to prevent special treatment referrals that fall under the so-called "exemptions."[88] All special referrals now have to be approved by a Medical Committee for Treatment Abroad. This committee contains medical specialists who use objective medical criteria to determine if a referral will be granted.

There are also efforts to improve infrastructure bottlenecks, such as the opening of a new catheterization lab in Gaza and proposed eye disease rehabilitation services in West Bank and Gaza. Before embarking on new public investments, it is necessary to undertake a more comprehensive assessment of the health delivery system to compare the cost-effectiveness of investing in new MOH facilities with the alternative option of contracting NGO or private sector providers within West Bank and Gaza.

Pharmaceuticals. Pharmaceutical costs occupy a significant share of public health expenditure (see box 6.3). The MOH is increasingly unable to pay drug manufacturers and drug providers. Drug availability will soon become an urgent problem and may lead to more special treatment referrals.

Around 17 percent of the $40 per capita pharmaceutical expenditure is spent on antibiotics and another 16 percent is spent on chronic diseases, mainly diabetes and cardiovascular diseases. There is an unequal distribution of drugs and other medical supplies between the West Bank and Gaza. This leads to more shortages in the West Bank, forcing people there to privately seek more expensive drugs or go without.[89]

The laws that regulate the pharmaceutical sector in the West Bank and in Gaza are outdated and deal mainly with the regulation of private pharmacies, drug stores and pharmacy practices. Inconsistency between the laws hinders the development of a unified regulatory framework. Current laws do not make any provision for drug pricing, generic substitutions and drug registration.[90] At time of registration, agents/importers are asked to provide the price of the drug in the country of origin, the export price to Palestine and the suggested price to the consumer (the cost price adds 35 percent wholesaler profit and 15–25 percent

[88] For example, under these exemptions all Palestinians that spent time in an Israeli prison qualified for referrals for infertility treatment. According to officials in the MOH, these referrals stopped by the end of 2005.

[89] After adjusting for population size, Gaza received about 50 percent more drugs per capita than the West Bank over the period 2002−04. It should also be noted that a larger share of the Gaza population's primary health care needs, including drugs, are covered by UNRWA (75 percent as compared to 27 percent of the West Bank). In the past, this higher level of public support may have been justified due to a higher poverty rate in Gaza, but needs to be adjusted due to the increasing poverty rate in the West Bank.

[90] Legislations governing the pharmaceutical sector in the West Bank consist of the Jordanian public health law 43/1966 and the Jordanian pharmaceutical law 10/1957, enacted in June 1967. In Gaza the Egyptian public health law 21/41/1967 is the relevant legislation.

retail pharmacy profit). MOH procurement prices are fairly high and show significant fluctuation. Median price ratios of MOH-procured generics and the lowest priced generic equivalent were 6.9 and 9.7 respectively. MOH average procurement prices were four times the UNRWA average procurement prices for the same period.

Box 6.3: Pharmaceutical Expenditure

Pharmaceutical expenditure accounted for about 20 percent of total health expenditure in 2005. Drug expenditure increased around 50 percent between 2001 and 2005. Obtaining the correct figures on total pharmaceutical expenditure per capita is challenging, since expenditure information is often unavailable from private insurers, small NGOs and charitable societies. Tentative figures indicate a number around $40 per capita, excluding private insurers, NGO hospitals and small NGOs.

Box table 1 Pharmaceutical Expenditure by Provider, 2004–05
(millions of US dollars)

	2004	2005
MOH	17	20.9
UNRWA	6.3	6.5
NGOs (HWC&PMRS)	1.5	1.8
Total	**24.8**	**29.2**

Source: MOH Directorate of Medical Drug Store, West Bank and Gaza, May 2005.

Private Spending on Health. Private health expenditure data is only available from the *Health Expenditure Survey 2004*, which was conducted by the Palestinian Central Bureau of Statistics (PCBS) in August 2004. This is the first comprehensive data collection of its kind on a national scale. Since it was a one time only survey, cross-sectional data is provided but not trend information. Data on household health expenditure was collected from 4,016 households (2,666 in the West Bank and 1,350 in Gaza). The survey covered residents in urban and rural areas and in refugee camps.[91]

PCBS estimated from the survey a per capita health expenditure of $138 in 2003, which corresponded to 13 percent of the GDP. These results also confirm that about one-sixth of all health expenditure is MOH expenditure. The survey also indicates that 80 percent of total health expenditures were made by households. However, this seems unlikely in light of the high level of health financing from external donors and NGOs. The European Community/HERA *Health Sector Review 2003* estimated that 15 percent of funds came from the Palestinian Authority, 37 percent from direct patient payment (including premiums and fees), and 48 percent from external donors. Thus, it seems more likely that household expenditure is around 40 percent of the $138 per capita health expenditure.

According to the PCBS *Health Expenditure Survey 2004*, most households visit a Primary Health Care center (PHC) about once a month (54 percent had at least one household member visit in the past two weeks). Household expenditure related to a PHC visit thus comprises an important component of all household health expenditure. The average cost

[91] Numbers presented here are based on data from the PCBS *Press Conference on the Initial Survey Results: Health Expenditure Survey 2004*. The data refers to the collection period, is not standardized and might include seasonal influences.

per PHC visit in 2004 was $28 for a household, $16 in Gaza and $33 in the West Bank (Table 6.3).[92] All components of the average cost per PHC visit were more expensive in the West Bank, with doctors, lab services and transportation costing three times as much as in Gaza. Expenditures on drugs accounted for 60 percent of all household medical expenditures in Gaza, and 35 percent in the West Bank.

Table 6.3: Composition of Average Household Expenditure per Primary Health Care Visit, 2004

	Gaza		West Bank		Total	
	Cost in US dollars	Percent	Cost in US dollars	percent	Cost in US dollars	percent
Doctors	4	22	12	35	10	34
Medication	10	60	11	35	11	39
Lab services (including X-ray)	1	8	4	12	3	12
Transportation	1	7	3	10	3	9
Other	0	3	2	8	2	6
Total	16	100	33	100	28	100

Source: World Bank staff calculations with PCBS 2004 data.

The average expenditure per PHC visit for a household can vary substantially depending on the provider. Private clinics are the most expensive with average cost per visit of $45 ($39 in Gaza and $46 in the West Bank), followed by NGO PHC centers with cost per visit of $20 ($15 in Gaza and $21 in the West Bank). Private clinics in Gaza are over six times more expensive than government PHC centers. The average cost per PHC visit in all types of PHC centers—other than pharmacies—is more costly in the West Bank than in Gaza (Table 6.4).

Table 6.4: Average Cost per Primary Care Visit by Type of Facility, 2004
(US dollars)

	Gaza	West Bank	Total
Government Maternal Child Health Centers	3	5	5
Government Primary Health Care center	6	17	12
UNRWA Primary Health Care center	4	9	6
NGO Primary Health Care center	15	21	20
Private clinic	39	46	45
Pharmacy	11	11	11
Other	30	23	24
All centers	16	33	28

Source: World Bank staff calculations with PCBS 2004 data.

About 21 percent of households had sought hospital day treatment without admission in the past month. Two in five households (41 percent) had at least one household member

[92] An average of NIS 127, NIS 72 in Gaza and NIS 146 in the West Bank.

admitted to the hospital in the past year. The average cost for a day visit was $35, with average costs of $17 in Gaza and $47 in the West Bank (table 6.5). An admission to a hospital cost the household on average to $116 ($39 in Gaza and $163 in the West Bank). Overall, hospital day visits were the most expensive in NGO hospitals. In Gaza private hospitals were most expensive for treatment without admission and government hospitals were the most affordable. For all admissions, private hospitals were the most expensive and military hospitals the most affordable.

Table 6.5: Average Cost per Hospital Visit by Type of Hospital, 2004
(exchange rate US dollars)

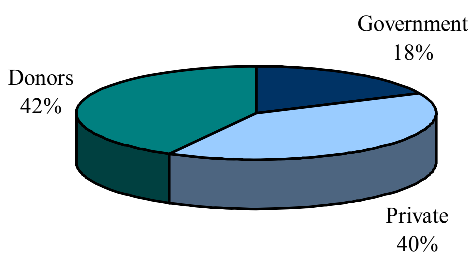
	Gaza		West Bank		Total	
	Day visit	**Admission**	**Day visit**	**Admission**	**Day visit**	**Admission**
Government hospital	15	37	23	69	19	53
UNRWA hospital	10	19	26	152	25	121
NGO hospital	21	56	157	297	126	275
Private hospital	45	118	81	340	75	325
Total	17	39	47	163	35	116

Source: Calculated with PCBS 2004 data.

4. Health Financing

Between 2003–04 about 18 percent of all health funds came from the Palestinian Authority, 43 percent came from private households in the form of direct patient payments (including health insurance premiums and fees) and 39 percent came from external donors (figure 6.4).

Figure 6.4: Health Expenditure by Source of Financing, 2003–04



Source: World Bank staff estimate.

The financial situation of the MOH became increasingly precarious during the second *intifada*. Originally the main sources of government health financing were general taxation, health insurance premiums, fees/co-payments and international funds. After a steep decline in health insurance revenues, financing through international funds became more and more important. For example, in the early phase of the *intifada*, PA Chairman Arafat issued a decree that absolved all *intifada* victims from paying health insurance, including those who were unemployed because of the Israeli closures. As a result, between 2000 and 2002, the number of households covered by the GHI scheme increased by 207,434, while revenues from premiums declined 26 percent, from $29.5 to $22 million, and co-payment revenues fell. More than half of all persons eligible for health insurance no longer pay for it. Beginning in 2002 health insurance revenues and co-payments increased slightly and by 2004 reached pre-*intifada* levels.

MOH salary and transfer costs are covered by the MOF (with substantial budget support directly to the PA budget from donors). MOF non-salary support to the approved MOH budget has been declining steeply. Donors covered 89 percent of budgeted non-salary operating costs in 2003, with a slightly lower proportion in 2004. The 2003 budget allocation for MOH non-salary operating costs was $51.3 million, equivalent to a 12 percent increase over the 2002 level (table 6.6).[93] This exceeded the available budget and left a financing gap of $5.4 million in 2003. Donor funds have declined, while allocated non-salary budget remains at around $50 million, resulting in an increasing financing gap. The sharpest decline in donor assistance was in 2005, leading to a dramatic financing gap of $35.9 million.

Table 6.6: Budget Allocation and Revenues for MOH Non-salary Expenditure
(millions of US dollars)

	2001	2002	2003	2004	2005
Budget allocation	49.9	45.4	51.3	51.9	50.3
Revenues					
Funds received from MOF	16.1	10.3	0	0	0
Funds received from donors	16.1	31.2	45.9	43.5	14.4
Financing gap	17.7	3.9	5.4	8.4	35.9
Percent financing gap	36%	8%	11%	16%	71%

Source: MOH 2004, 2006.

As a result of the PA's current budget crisis, the MOH accumulated considerable debts to a range of service providers and especially pharmaceutical manufacturers and wholesalers. At the end of 2005 outstanding debts amounted to $38.9 million. The biggest share of outstanding debts (65 percent) was unpaid special treatment referral bills, but the most pressing debts are the ones for unpaid pharmaceuticals and medical supplies. They comprised 31 percent of all outstanding debts in 2005 and providers are increasingly unwilling to deliver these goods without payment.

[93] Donors also provide in-kind assistance (like drugs and medical disposables), which is often not included in the monetary value of donor assistance.

Table 6.7: Government Health Insurance Contributions

Beneficiary category	Monthly premium	Collection system
1. Compulsory	5% of the basic salary—with a minimum amount of NIS 40. The minimum amount is not applied to retired people.	Automatically deducted from the salary and transferred from MOF to the GHI account.
2. Voluntary	NIS 75 per family and NIS 50 for any individual.	To be paid to one of the health directorates in the West Bank or to the post offices in Gaza monthly, every six months or yearly.
3. Workers in Israel	NIS 75 per month—the Israeli Authorities deduct NIS 93 and reimburse only NIS 75 for GHI. Workers should have to pay NIS 93 but have not paid since November 2000.	The Israeli Authority pays the premiums (NIS 75) to the Palestinian MOF on a monthly basis.
4. Contracts[1]	5% of the overall salary with a minimum amount of NIS 50 and a maximum amount of NIS 75.	Payments are made collectively through the employers on a monthly or yearly basis.
5. Special Hardship Cases	NIS 45 per month per family.	The MOF is making transfer payments from the MOSA budget to the MOH account for all beneficiaries once a year.
For all categories	Premiums for additional dependants: NIS 5 per month for each additional dependant.	Amount is included in the monthly premiums.

[1] This group includes workers registered in the labor union employed in the Palestinian Territories.
Source: MOH 2006.

Government Health Insurance (GHI). Enrollment in the GHI is compulsory for governmental employees and voluntary for all other individuals and households.[94] There are five categories of beneficiaries: compulsory, voluntary, workers in Israel, contracts and special hardship cases. Each membership category has different monthly premiums and a varying premium collection system (table 6.7).

In recent years the number of hardship cases and detainees increased steadily (table 6.8). The number of insured workers in Israel decreased. In fact, since the PA's decision to insure all *intifada* victims free, the majority of the insured are not paying premiums. In 2004 there were 148,573 paying families and 169,904 non-paying families insured. This development seriously undermines the MOH's ability to generate revenues. These membership developments are an immediate result of the deteriorating economic situation in the second *intifada*. The number of workers in Israel declined because of border closures and hardship cases increased due to the resulting economic conditions. The only expanding paying group was the compulsory insured, since the number of civil servants increased dramatically in 2003. Table 6.8 contains a comparison of quarter one 2005 and quarter one 2006 data on GHI membership and GHI revenues. The comparison of membership in these two periods confirms the previously described trends: the proportion of special hardship cases and non-paying/exempt families is increasing.

[94] The benefits include primary and secondary health services available through government PHCs, diagnostic centers and governmental hospitals, and tertiary health services available in Egyptian, Jordanian and Israeli hospitals based on referral through the Special Treatment.

Table 6.8: GHI Membership and Revenue Trends, 1997–2006

	1997	1998	1999	2000	2001	2002	2003	2004	2005 Quarter 1	2006 Quarter 1
GHI Membership										
Compulsory	45,542	50,937	55,963	56,767	66,139	68,736	66,618	72,756	41,777	43,456
Voluntary	36,023	14,577	15,637	15,941	9,452	9,173	2,769	4,612	2,230	2,291
Workers in Israel	28,878	30,200	34,539	33,830	3,189	6,136	11,700	8,054	14,741	8,408
Contracts	47,975	48,581	51,936	59,030	31,900	71,878	13,229	15,939	8,777	9,166
Hardship cases (MOSA)	39,391	39,701	38,216	38,782	41,904	40,741	45,303	47,212	51,602	54,791
Total paying families	**197,809**	**183,996**	**196,291**	**204,350**	**152,584**	**196,664**	**139,619**	**148,573**	**119,127**	**118,112**
Prisoners (MOD)					800	1,153	1,467	1,680		
Free/exempt families					189,934	207,434	95,449[1]	168,224	79,544	82,692
Total non-paying families					**190,734**	**208,587**	**96,916**	**169,904**	**79,544**	**82,692**
Total	**197,809**	**183,996**	**196,291**	**204,350**	**343,318**	**405,251**	**236,535**	**318,477**	**198,671**	**200,804**
GHI Revenues (in $ million)										
Premium revenue	32.93	34.61	33.05	30.68	20.76	20.99	25.84	30.75	10.66	8.98
Co-payment revenue	4.35	5.58	4.10	4.14	4.40	3.75	4.71	5.26	6.67	6.09
Total GHI revenue	**37.28**	**40.19**	**37.15**	**48.16**	**25.16**	**24.74**	**30.55**	**36.01**	**17.33**	**15.06**
% of MOH budget coverage	**39.7**	**46.3**	**41.6**	**50.9**	**27.7**	**28.1**	**25.0**	**27.9**	**11.1**	**8.0**
Memo items										
Exchange rate (NIS/$)	3.2	3.64	4	4.22	4.25	4.74	4.54	4.47	4.53	4.67
MOH actual budget (in million of US dollars)	93.9	86.8	89.4	94.61	90.74	87.97	122.03	128.86	156.51	189.0[2]

[1] Registration shortage in WB.
[2] 2006 planned budget.
Source: World Bank staff calculations with MOH and World Bank WDI data, 2006.

For various services provided by MOH facilities the insured have to contribute fixed co-payments. Those include drug co-payments (NIS 3 per item, NIS 1 for children), laboratory co-payments (NIS 1/NIS 6 per test depending if for routine or culture test), co-payments for X-rays (NIS 2/NIS 18 depending if normal or colored), ultra-sounds (NIS 6), CT-scans (NIS 50) and ECGs (NIS 9) and co-payments for services in referral facilities (non-governmental services and services abroad).[95] There are a number of other treatment co-payments for non-MOH facilities, but they have not been enforced since the beginning of the economic crisis in 2000 (table 6.9).

Table 6.9: Government Health Insurance Co-payments for Treatment in Non-Ministry of Health Facilities

Service type	Category of Insured	Co-payment
Outside MOH in the West Bank and Gaza	• Compulsory insured	5%
	• Social Cases	10%
	• Voluntary insured (continuous payments more than five years)	10%
	• Voluntary insured (continuous payments but less than five years)	20%
	• Voluntary insured (2 to 6 months)	25%
Emergency services	• Voluntary insured (less than 2 months)	35%
Exceptional cases referred by the President	• All insured	5%
Operations like artificial joints, Cesarean sections, bolts, mineral plates, heart beat regulators, arteries support, artificial valves	• All insured	25%

Source: MOH 2006.

GHI revenues decreased substantially between 1999 and 2002 (table 6.8). Since then they have slowly increased towards pre-*intifada* levels. The total health insurance revenue was the lowest in 2001, at $20.8 million. In 2004 the total revenue reached $36 million. A similar trend could be observed for the GHI revenues as contributions to the MOH budget. The GHI share of MOH budget coverage decreased between 2000 and 2003 from 50.9 to 25 percent. Since then it recovered slightly, to 27.9 percent in 2004, but it remains below the pre-*intifada* MOH budget coverage. In 2005 the total GHI revenues were $35.1 million ($29.8 million in contributions and $5.3 million in co-payments; MOH 2006), slightly less than in 2004. The decline in revenues between the first quarter of 2005 and the first quarter of 2006 is mainly due to a decline in revenues from workers in Israel and the compulsory insured. The number of workers in Israel decreased and government employees, the compulsory insured, had not been not paid since February 2006, thus no deductions for GHI premiums were made from their salaries. Revenues

[95] Exemptions for co-payments are cancer treatment, dialysis and kidney transplantations for children, communicable and infectious diseases and blood diseases (like Haemophilia and Thalasemia).

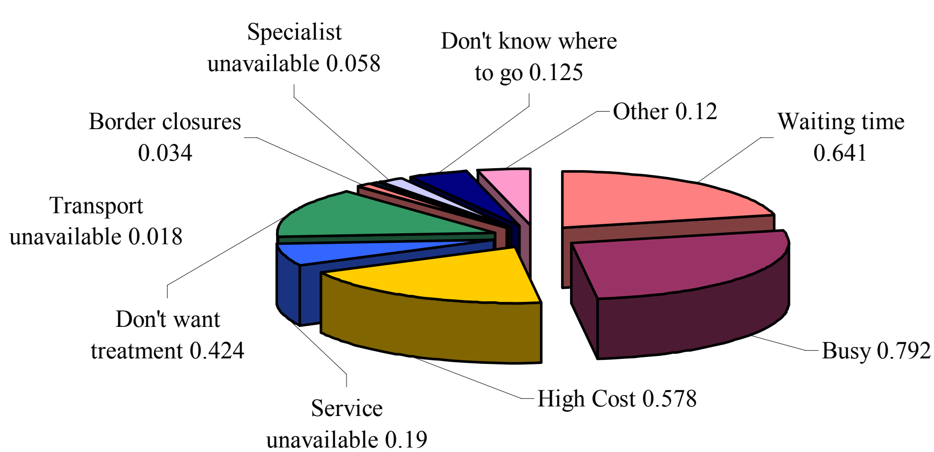
from the voluntary insured improved after the implementation of new regulations that allow no further exemptions from premiums.

5. Equity and Efficiency Assessment

Equity. According to the PCBS *Access to Health Services Survey 2003*, conducted between November 2003 and January 2004, Palestinian households have good access to health services. About 94 percent of all households (93 percent in the West Bank and 98 percent in Gaza) had access to a physician where they lived. The physical access to pharmacies was equally good. About 83 percent of all households (97 percent in Gaza and 77 percent in the West Bank) had a pharmacy nearby. In rural areas, coverage was significantly lower, at 63 percent for physicians and 46 percent for pharmacies. Only three percent of people in rural areas lived near a hospital. Generally access to health services was better in Gaza because it is more urbanized than the West Bank.

According to the same PCBS survey, the three main reasons that individuals did not receive necessary medical advice were that they were too busy (79 percent), waiting times were too long (64 percent) or the cost was too high (58 percent; figure 6.5). In the West Bank, high cost was the leading reason for not receiving medical care (68 percent). This was also true for rural areas throughout Palestine (67 percent). This would suggest that a significant segment of the population is unable to access health services for financial reasons, and that financial barriers are more pronounced in the West Bank and rural areas. Since the survey did not report on households' income levels, it was not possible to link financial barriers with income.

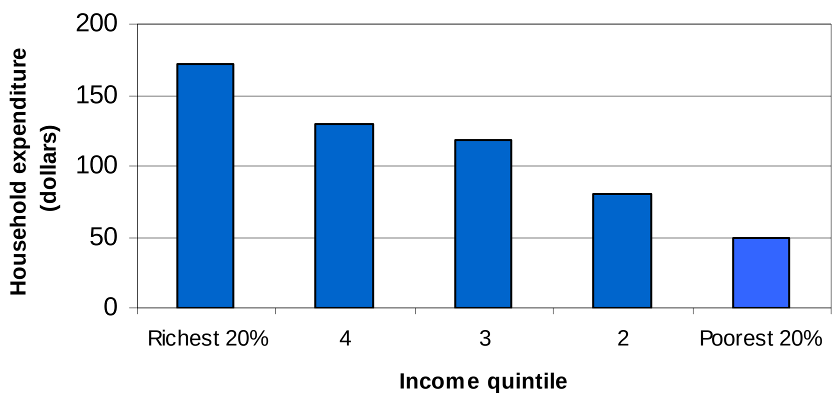
Figure 6.5: Reasons for Not Receiving Needed Medical Consultations, 2003-04



Source: PCBS 2004.

The PCBS *Health Expenditure Survey 2004* does provide data on household health expenditure by income level. At all income levels, a high proportion of household income was spent on health. However, the poor in the West Bank & Gaza spent a larger proportion of their income on health than the rich. In 2004 the average monthly household expenditure on health was $89 in Palestine. The average monthly health expenditure differs greatly between Gaza ($45) and the West Bank ($111). This can be attributed to a higher proportion of rich households in the West Bank and the tendency of households in Gaza to visit health facilities less often. Overall, the richest 20 percent spent $172 on health—about twice the national average and more than three times more than the poorest 20 percent (figure 6.6).

Figure 6.6: Household Expenditure on Health by Income Quintile in 2004



Source: World Bank staff calculations with PCBS 2004 data.

As a share of total average household spending, the poorest quintile spent an estimated 40 percent of their income on medical expenses, while the richest quintile spent some 15 percent (table 6.10). Because the poor spend a higher share of their income on health, they are more vulnerable to the financial risks associated with ill-health and injuries.

Table 6.10: Average Household Expenditures on Health by Quintile in 2004
(in US dollars)

Income quintiles	Monthly income (NIS)	Average out-of-pocket health expenditure (NIS)	Average income[1] spent on health (%)
Poorest 20%	<1,000	212	42.4
Second quintile	1,000–1,900	357	24.6
Third quintile	2,000–2,900	529	21.6
Fourth quintile	3,000–3,900	580	16.8
Richest 20%	>4,000	770	15.4

[1] Calculated by averaging over the quintile end-points, for example, for the second quintile: (1,000+1,900)/2. For the poorest 20% the end-points were 0–1,000, for the richest 20% the end-points were 4,000–6,000.
Source: World Bank staff calculations with PCBS 2004 data.

Efficiency. The total number of health professionals has continued to expand over the last few years. This trend is illustrated it table 6.11, which compares 2002 and 2004 data. The number of health professionals increased between 2002 and 2004 by 27.4 percent. In 2002 there were 15,233 health professionals in the West Bank & Gaza. In 2004 there were 21,002.

The number of health professionals per 1,000 people also increased. For example, the number of physicians increased by 62 percent, from 1.05 per 1,000 people in 2003 to 1.70 per 1,000 people in 2004. The other group of health personnel that increased significantly in this period was paramedics, from 0.56 to 1.06 per 1,000 people. Only the number of nurses remained stable, at around 1.57 per 1,000 people. The nurse-to-doctor ratio decreased substantially, by 26 percent, between 2002 and 2004, from an already low ratio of 1.54 down to 1.34. These trends reveal a significant imbalance in the health workforce structure and a serious shortage in nursing staff that will likely have negative implications on the cost and quality of care.

Table 6.11: Health Professionals by Sector, 2002–04

	Physicians (including dentists and pharmacists)		**Nurses (including midwives)**		**Paramedicals (including health workers)**		**Administrative staff**	
	2002	**2004**	**2002**	**2004**	**2002**	**2004**	**2002**	**2004**
MOH	1,923	2,787	2,966	3,177	909	2,199	2,775	2,898
Non-MOH	1,638	3,378	2,349	2,548	1,005	1,653	1,668	2362
Total	**3,561**	**6,165**	**5,315**	**5,725**	**1,914**	**3,852**	**4,443**	**5,260**
Per 1,000 people	1.05	1.70	1.57	1.58	0.56	1.06	1.31	1.45
Memo item								
Population (million)	3.39	3.63	3.39	3.63	3.39	3.63	3.39	3.63

Source: MOH 2003, 2005.

In 2004 there were 77 hospitals with 4,824 beds in Palestine, 57 percent of them in the public MOH sector, 34 percent in NGOs and UNRWA and 10 percent in the private sector. Between 2002 and 2004 the total number of hospital beds increased by 1.3 percent, but the number of hospital beds per 1,000 people decreased from 1.41 to 1.33 partially due to the faster population increase. In addition, the number of hospital beds only increased for MOH and UNRWA hospitals, where most donor assistance was concentrated (table 6.12). As a result, the percentage of hospital beds in the NGO and private sector declined as a share of the total hospital beds

Table 6.12: Distribution of Hospital Beds by Provider and by Specialization, 2002-04

	General hospital		**Specialized hospital**		**Rehabilitation hospital**		**Maternity hospital**		**Total**	
	2002	**2004**	**2002**	**2004**	**2002**	**2004**	**2002**	**2004**	**2002**	**2004**
MOH	1,527	2,163	926	572	0	0	150	0	2,603	2,735
NGOs	1,102	1,117	252	131	136	157	154	160	1,644	1,565
Private	208	196	152	110	0	0	137	155	497	461
UNRWA	38	63	0	0	0	0	0	0	38	63
Total	**2,875**	**3,539**	**1,330**	**813**	**136**	**157**	**441**	**315**	**4,782**	**4,824**

Source: MOH 2003, 2005.

Between 2002 and 2004 the number of total admissions to MOH hospitals increased by 20 percent, from 224,087 to 278,839, possibly reflecting a shift of patients from NGOs and the private sector (table 6.13). Bed-occupancy rates were around 81 percent in 2004, an increase of 5 percent since 2002. Occupancy rates were about 10 percent higher in the West Bank than in Gaza. The average length of stay was 2.6 days in 2004, reflecting a decrease of 8 percent from 2002. Patients stay on average half a day less in West Bank hospitals than Gaza hospitals.

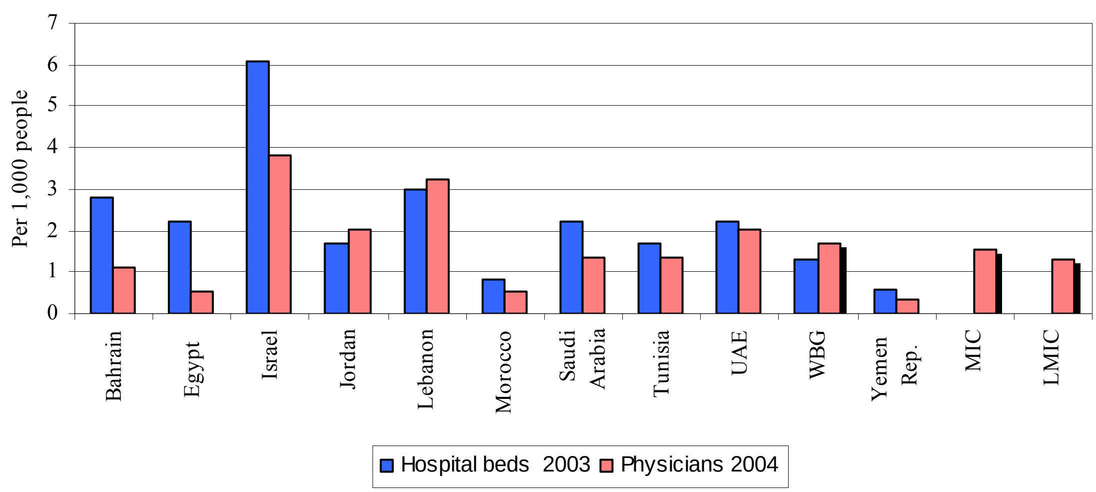
Table 6.13: Ministry of Health Hospital Utilization Rates, 2002–04

	2002			2004		
	West Bank	Gaza	All	West Bank	Gaza	All
Hospital admissions	101,138	122,949	224,087	127,755	151,084	278,839
Bed-occupancy rate (%)	81.4	73.8	76.7	88.6	79.4	81.1
Average length of stay (days)	2.50	3.00	2.80	2.34	2.89	2.60

Source: MOH 2003, 2005.

An international comparison of the number of physicians and hospital beds per person indicates that the West Bank and Gaza have human and capital resources that are comparable to those of other middle income countries in the region (figure 6.7). These figures do not reflect the efficiency or the quality of services rendered.

Figure 6.7: Physicians and Hospital Beds Across MENA Countries, 2003 and 2004



Source: World Bank, WDI database and MOH 2005.

6. Challenges and Opportunities for Action

The current fiscal crisis presents a major challenge for the already over-extended Palestinian health system. Bold measures are needed to address the structural constraints in the system and to mobilize substantial resources to meet the basic and urgent health needs of the population. Box 6.4 below summarizes the main recommendations for action.

Box 6.4: Health Policy Recommendations

Strengthen Health Policy, Planning and Coordination:

- Develop a broad policy framework that will support an effective coordination mechanism among all the key stakeholders and make the most effective use of the limited available resources. Such a framework would also help donors to align their assistance with the local priorities, avoid duplication and ensure a measure of stability and predictability in the flow of resources for the priority services and programs. It should also promote an efficient allocation of resources that optimizes the complementarity of services among MOH/PA, UNRWA and NGOs/private sector providers.
- The PA and the donor community should continue to support the development of institutions and organizational capacities (like the GHI system) that will be essential in the future for mobilizing, planning and managing resources in the health sector.

1.
2. ***Improve Budget Planning and Fiscal Management:***

- The MOH needs to address its internal staffing structure, and to achieve a better balance between staffing and non-staffing operating expenditures. It should develop a strategic manpower plan for the sector to avoid ad-hoc recruitment.
- The MOH needs to coordinate closely with the Ministry of Planning to develop a realistic medium term public investment plan with adequate allocation of operating and maintenance budget to ensure effective returns on investments.
- The MOH needs to manage its commitments and introduce the principles of accrual accounting to monitor and track any outstanding revenues and payments and avoid the accumulation of arrears.
- The MOH needs to introduce greater transparency in the allocation and use of public resources, which will help to create an environment that will encourage and reward better performance through greater accountability. To this end, the MOH will need to invest in its internal accounting and financial management systems, strengthen its procurement procedures and develop institutional capacity to design and manage contracts.

Develop Strategic Purchasing Capacity:

- The MOH needs to develop effective provider payment systems and upgrade its management information system to achieve a better alignment of incentives with performance.
- For services provided directly through MOH facilities, the Ministry needs to improve the timeliness and accuracy of financial data provided to line managers.
- For services contracted through Special Treatment Referrals, the MOH needs to develop more rigorous criteria for prioritizing services which should be outsourced Contracts should include appropriate quality measures and technical audits to ensure adherence to those standards.

Specific Programs:

- *Refocus Attention on Public Health Programs*. The emergency situation and difficulties in mobility have severely limited access to preventive care, including early screening and participation in health promoting activities. These conditions will likely increase morbidity rates due to late diagnosis and treatment of illnesses, which in turn will increase the cost of care. Refocusing attention on public health programs that emphasize preventive care would help to alleviate some of the long-term negative consequences of these problems.
- *Develop a Comprehensive Drug Policy*. In the face of constrained resources and limited access to health services, the availability of affordable, safe and effective drugs takes on a greater importance. A comprehensive drug policy should be developed that addresses the critical elements of the pharmaceutical sector, including pricing, registration, quality assurance, distribution and appropriate use.
- *Revitalize the Quality Improvement Program.* In order to counter the negative effects of recent years, and prevent deterioration in the quality of care, the MOH should continue to invest in quality improvement programs that focus on both the people and the institutions, including the development of a system of accreditation for service providers, and continuing medical education programs for health care professionals.

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CHAPTER 7: SOCIAL POLICY AND SOCIAL SAFETY NETS

1. Key Issues and Challenges

A top policy priority for the Palestinian Authority has been to ensure social protection for Palestinians. This is the goal underlying the first of four national programs identified in the 2005–07 Medium Term Development Plan. Social protection is provided in West Bank and Gaza through a complex web of programs supported by the PA, international donors and NGOs and charitable organizations. Diverse sources of safety net and welfare programs are common for most countries of the world. In the West Bank and Gaza, the combination of complicated political and socioeconomic circumstances, the relatively small population and the huge donor presence make the need for cooperation between providers especially important. Given the limited financial resources of the PA and the massive social assistance requirements, it is critical that all available support be well targeted to those most in need. More efficiently designed and administered programs will allow the PA to make the best use of limited funding in this area to ensure that as many resources as possible are directed towards those who truly need them.

Unfortunately there is very little immediate guidance available in the current atmosphere, with near total government bankruptcy and severely constrained donor resources. The analysis and recommendations presented here are put forward with a view toward a future when economic conditions and funding for services improve and the efficiency and effectiveness of social protection services is assured for Palestinian citizens.

2. Recent Developments

Despite current difficulties, providers of social protection services in the PA have pressed on. Even in the summer of 2006, when civil servants had not been paid since the beginning of the year, the staff continued to report for work. Some social programs are still operating, albeit in a limited form. Food rations from the World Food Program (WFP) continue to be distributed. The United Nations Relief Works Agency (UNRWA) Special Hardship Cases program and other services are functioning. And food rations for newly poor families in Gaza are being issued through contributions from Egypt. The Ministry of Social Affairs (MOSA) is currently working with the World Bank to improve the targeting of social assistance benefits and to link the receipt with the development of children in health and education through a conditional cash transfer under the Social Safety Net Reform Project.

The PA began the process of setting priorities for social protection and other sectors in 2005 with the formulation of a plan for a Social Safety Net Fund and progress on the preparation of the next Medium Term Development Plan. The PA anticipated $240 million in donor support for a quick-disbursing Social Safety Net Fund. The goal of the programs within the fund was to support about 35 percent of the population for one year.[96] But the funding did not materialize. Even pre-existing programs received sporadic funding in 2005.

3. Spending on Social Protection

Total spending on social protection in West Bank and Gaza is difficult to ascertain because of the large number of PA programs and the important role of donor funds and outside interventions. This relationship will be discussed in more detail below. Table 7.1 provides a summary of spending on benefits for the major programs supported directly by the PA, excluding donor funding. In 2004 the PA spent about 3.5 percent of GDP on social protection, with the major items including pension benefits and cash transfers from the Detainee's Fund for the detainees in Israeli jails and their families.[97] Cash transfers were the biggest expenditure in social protection spending, amounting to 1.8 percent of GDP (excluding pensions). In 2005 there was a massive increase in spending. Preliminary estimates are that social protection spending nearly doubled in 2005, to 6.5 percent of GDP. The major source of the increase was the program for Temporary Employment (spending reached five times the level in 2004) and from pensions (nearly two and a half times the 2004 expenditure).

Table 7.1: Benefit Expenditures for Social Protection Programs Administered by the Palestinian Authority, 2004–05
(NIS millions)

	2004	2005[1]
Public pension	126.6	312.1
Cash transfers		
Special Hardship Case	78.1	89.2
Temporary Employment	45.8	288.2
Martyrs and the Injured Fund	46.7	82.3
Detainee's Fund	121.9	150.0
Other services[2]	98.7	102.7
NGO support	44.0	30.0
Total	561.8	1,054.5
Total as share of 2004 GDP	3.5%	6.5%

1. Estimated or budgeted amounts for 2005.
2. Includes health insurance costs for SHC participants, vocational training for youth and unemployed and shelter and rehabilitation centers for children, elderly and the disabled.
Source: Bank staff calculations based on budget and expenditure data from the Ministry of Finance and from the Ministry of Social Affairs, Ministry of Labor, Ministry of Detainees and Ex-Detainees Affairs.

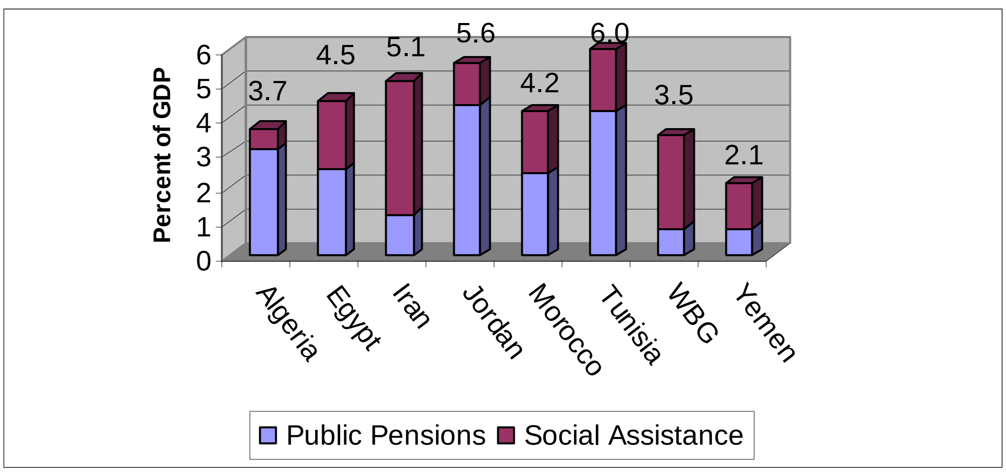
This spending pattern is deceptive, however. Significant PA resources were allocated in 2005 in an effort to scale up cash transfers and social assistance as part of a

[96] The Safety Net Fund had the goal of providing 200,000 families with $100 per month for one year, assuming a family size of 6.
[97] Table 7.1 does not include administrative or operating costs. Spending on social protection in 2004 totals 4.2 percent of GDP if total expenditures for the main ministries providing social protection are included in the table (excluding donor resources).

socioeconomic stabilization plan before the January 2006 elections. For this reason, 2004 levels may be a more appropriate reflection of average expenditure. But even 2004 spending figures are incomplete, given the prominence of international donors. Including budgeted spending on assistance programs from UNRWA, for example, would raise social protection expenditures to 4.0 percent of GDP for 2004.[98]

The PA spends less on social protection programs as a share of GDP compared with other countries in the MENA region (excluding donor assistance). Figure 7.1 shows that general social protection spending on benefits among selected countries in the region has averaged about 4.5 percent of GDP in recent years, with different allocations between social assistance (welfare) and public pensions depending on the country, but with pensions typically accounting for between half and three-quarters of total expenditures. In West Bank and Gaza, slightly over half of current spending is devoted to safety nets. This balance may change rapidly, as recent changes in public sector salaries and new pension legislation are expected to require increased pension payments, as evident in 2005 spending. ven with estimated spending levels of 6.5 percent of GDP in 2005, West Bank and Gaza remains comparable with countries in the region that have not suffered from similar conditions of near constant crisis because of the important role played by outside donors, whose contributions are not reflected in figure 7.1.

Figure 7.1: Spending Patterns on Social Protection, Late 1990s–Early 2000s



Note: Public pensions spending includes civil service and military pensions where figures available, but excludes private sector pensions. Social assistance includes food subsidies, public works and cash transfers, such as family, maternity and child allowances and compensation to the sick and temporarily disabled. It excludes expenditures on in-kind social services and unemployment insurance.
Source: World Bank 2005 and Robalino 2005.

[98] UNRWA budget for 2004 for relief and social services in West Bank and Gaza was NIS 75.3 million ($16.8 million).

4. Public Sector Pensions

Pension benefits for former public sector employees represent the largest single source of social protection expenditures. Table 7.1 indicates that NIS 126.6 million ($28.2 million) was paid to beneficiaries in 2004, and this amount is expected to jump to NIS 312.1 ($69.4 million) when final expenditures for 2005 are determined. Future costs are forecast to increase even more. The system is not fiscally sustainable as currently designed and implemented.

Schemes. There are currently two pension schemes covering civil servants in West Bank and Gaza. In the Gaza Scheme, the government contributes 12.5 percent of the wage bill and employees contribute 10 percent of wages to the Gaza Pension Insurance Corporation (GPIC). The West Bank Scheme requires a nominal 2 percent contribution from employees, but it is not paid into any fund. Pension benefits are financed directly from the budget. The West Bank Scheme was closed to new entrants in 2001 and all subsequently hired civil servants are added to the Gaza Scheme. Both schemes are considered generous by international standards, with replacement rates in excess of 90 percent of final salaries, liberal early retirement provisions and future increases in pension benefits tied to wage levels, as opposed to a cost of living index.

Palestinian security services personnel have been excluded from the public sector pension system. In January 2005, however, a new Security Services Pension Law (SSPL) was enacted which provides pension coverage to all those 45 years and older in the security services. Like the Gaza system, this law mandates a contribution rate of 22.5 percent of wages (12.5 percent from government, 10 percent from employees), but provides a benefit formula even more generous than the Gaza Scheme's. Retirees can receive 100 percent of their final salary and can be eligible for retirement at 40 years old. Since there are no pension assets, and nearly all those covered will be eligible for retirement upon the law's full implementation, all expenditures under the SSPL must be met from the PA's revenues, not from any built-up assets in the fund.

Financing and Arrears. The PA has made only sporadic contributions to the system, though pension benefits have been paid consistently. The outlays from the budget have been reduced by running arrears to GPIC and using the fund's financial assets to pay current pensioners. However, as this policy will lead to the depletion of all assets, over time the PA budget will have to directly fund all current GPIC pension benefit expenditures as well as make contributions for the future. To make matters worse, the government has periodically used both government and employee contributions to fund other government expenses. As a result of these practices, MOF has built up arrears to the GPIC, currently estimated at around $253 million.[99] The GPIC fund currently has recoverable financial assets estimated at between $120–$150 million. Given the relatively small number of pensioners, the GPIC's financial assets have been sufficient to pay current benefits. However, the continuing accrual of arrears, the use of pension contributions for other expenditure needs and the generous benefit formula and early

[99] The last financial report of the GPIC that was independently audited was in 2003.

retirement provisions collectively imply that the GPIC fund could be bankrupt within a few years.

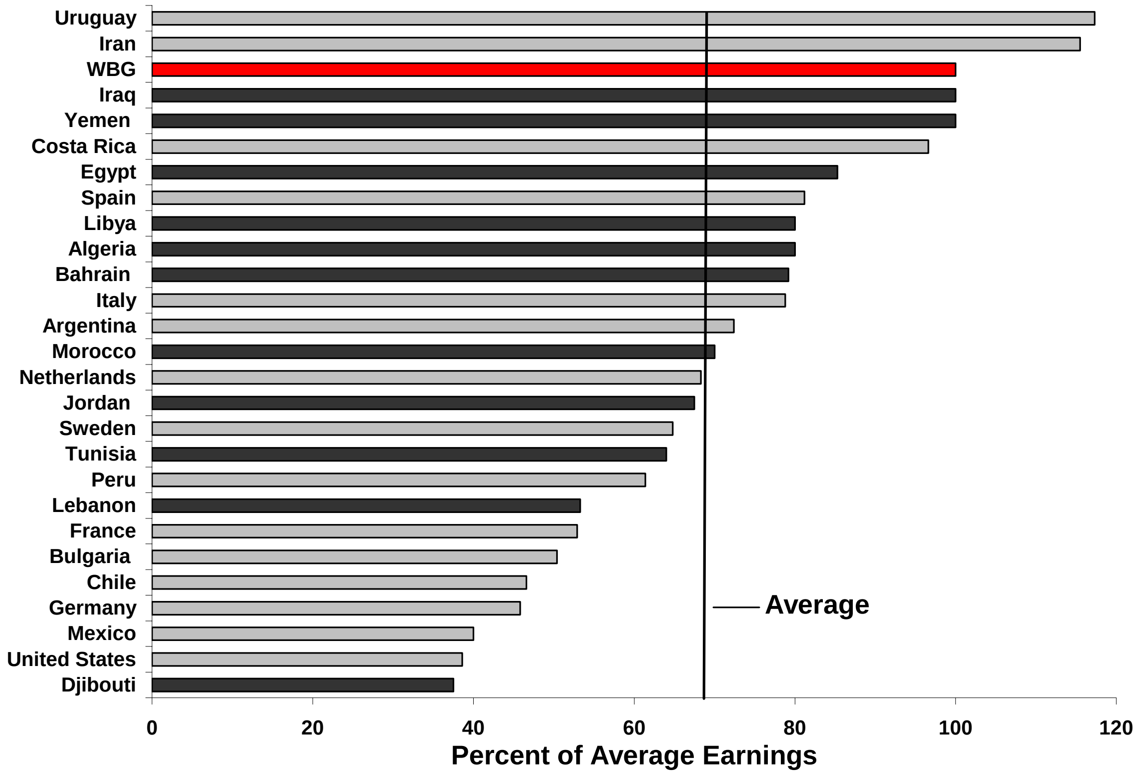
The annual financing burden for public pensions has been estimated at between $140 and $150 million for each of the next five years if all legislated schemes are enforced. This includes paying existing civil service pensions and incorporating the security services. For the civil service alone, before the 2005 wage increases, annual PA costs for the pension system were estimated to be, on average, $65 million a year for the next five years.[100] For the security services under the SSPL, an additional $40 million a year will be required in outlays over the next five years, including for security personnel over age 45 eligible for the scheme (about 6,800 individuals). If the rest of the security services personnel were part of the Gaza scheme, it would add another $40 million.

Taken together, West Bank and Gaza offers its public sector employees one of the most generous schemes in the world in replacement rates, as shown in figure 7.2. This is particularly striking because the vast majority of private sector workers have no pension coverage at all. Current Bank estimates suggest that the current system has accrued liabilities to date worth NIS 32.9 billion ($7.3 billion), over 180 percent of 2005 GDP. This stock of implicit debt, the current value of the future liabilities of the system, is among the highest in the world.

Reform Efforts. Pension reform has been high on the public policy and fiscal agenda in the West Bank and Gaza since 2003, when the PA became aware of the looming crisis. With the backing of the international donor community, the PA committed itself to a serious effort to reform its public sector pension system starting with the establishment of a broad-based National Pensions Committee (NPC), chaired by the Ministry of Finance, to consider pension policy and institutional reform. Based on the outcome of the NPC's discussions and recommendations, the drafting of the Unified Pension Law (UPL) began in March 2004. The law was intended to launch a new two-pillar system (with both Defined Benefit and Defined Contribution components) to cover all employees, to be governed by a modern, transparent and independent pension agency. Unfortunately, the legislation was progressively weakened as it moved from drafting through the National Pension Committee, the Cabinet, the Palestinian Legislative Council (PLC) Budget Committee and finally the PLC itself. And the passage of the SSPL further derailed the pension reform effort by promising hugely generous pensions to a relatively small group of security services personnel without regard to cost, funding or equity.

[100] Over a 30-year time horizon, PA pension expenditures for the civil service without reform will be at least $150 million annually.

Figure 7.2: A Global Comparison of Average Pension Gross Replacement Rates



In addition, considerable pressure was put on the PLC to pass a law providing pension coverage for the private sector. Unlike the public sector, very few workers in the private sector have pension coverage. A small number of limited private schemes exist for certain professions. Palestinians who had regular employment in Israel and contributed to social security schemes there were also entitled to pension payments, though benefit payments from Israel are increasingly undependable.101 A social security law was passed in late 2003, but has not been implemented. The Ministry of Labor, with World Bank analytic support, determined that the law was seriously flawed in both its parametric design and institutional provisions.

Reform of the pension system is possible if the PA makes it a priority and, in particular, addresses the shortcomings in the current version of the UPL. This would include adjusting the parameters, rolling back early retirement provisions and limiting acquired rights. It requires appropriate changes in the legislation to ensure that the system is well-governed and transparent and that financial assets are safeguarded for the benefit of plan participants. To speed the transition, severance payments for older employees of the security and civil services should be considered in lieu of pensions. The UPL provision for a "Citizen's Pension" could provide a useful mechanism for providing social insurance to the elderly, but it needs to be properly targeted and appropriate to the

[101] Unfortunately, Israeli policy has made it difficult for these workers to collect their pensions without first taking action in court.

prevailing fiscal situation.102 A properly designed public pension institution could be expanded over time to cover the provision of private sector pensions. Fundamental reform is not a trivial undertaking, however, especially since new pension legislation has been so recently adopted. Reform should begin in earnest as soon as possible.

5. Public Safety Net and Employment Programs

The patchwork nature of social protection programs in West Bank and Gaza emerges due to the variety of safety net and employment programs managed by the PA. The Ministry of Social Affairs is the primary public provider of social safety nets. It is responsible for three programs: the Special Hardship Case program, a vocational training program for disadvantaged youth and in-kind shelter and institutional care for orphans, victims of family violence, the disabled and the elderly. Until 2006 MOSA was also responsible for a fourth program, the Program for the Families of Martyrs and the Injured. The Ministry of Detainees and Ex-Detainee Affairs operates a cash transfer program for current and former detainees of Israeli prisons and their families, and a donor-financed training and microcredit program for former detainees. The Ministry of Labor manages the large Temporary Employment workfare program and a number of technical and vocational training programs. This section investigates each of the largest four programs highlighted in table 7.1, the Special Hardship Case Program, the Temporary Employment Program, the Fund for Families of Martyrs and the Injured, and assistance to detainees and ex-detainees.

Special Hardship Case (SHC) Program. The main public social assistance program is the SHC, which is supported by MOSA with food-aid support from the World Food Programme. It was inherited from the Israeli Civil Administration after 1994 and the design remains essentially the same today. The program provides cash and food benefits to households that are poor and that do not contain an able-bodied working-age male.

Beneficiary families can receive a cash transfer depending on family size, health insurance through MOH and a food ration available several times year, as well as exemptions from paying school fees and assistance for school books. Some families receive full support and others receive only food or insurance. Cash benefits are reduced accordingly if a family receives food or receives support from UNRWA. The value of the total benefit is estimated at about NIS 800 ($178) per person per year (Astrup and Buyuksahin 2005; Ayala and Abdel-Shafi 2002). The SHC benefit represents about 30 percent of the absolute per capita poverty level, or 13 percent of the main poverty line level.

The MOSA program serves about 47,000 families in Gaza and the West Bank, totaling around 155,000 individuals. Determining who should be in the eligible population is difficult given the lack of current data. Using the estimated extreme poverty rate of 16 percent from 2003, there are at least 607,000 very poor people in West Bank and

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[102] The law sets the benefit of the Citizen’s Pension at NIS [provide value] (US $100) a month with a relatively low age threshold (those 60 and above), making the social pension distortionary and unaffordable.

Gaza. Current conditions may have increased the extent of severe poverty, but this cannot be verified. By the last available measure, SHC program coverage is about one-quarter of the extremely poor population.

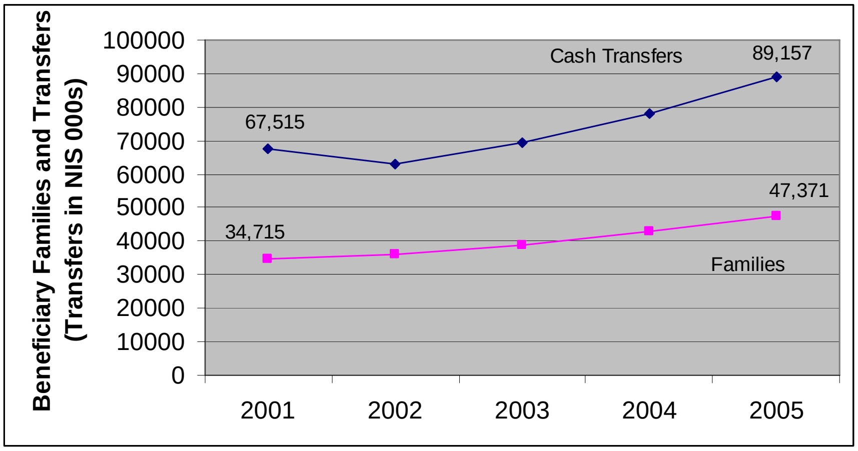
Figure 7.3 displays the number of beneficiary families and the total cash benefits disbursed in recent years for the SHC program. It is clear that the number of families receiving assistance has increased dramatically, rising 36.5 percent from the 35,000 families covered in 2001. The level of cash transfers have not quite kept pace, increasing 32 percent between 2001 and 2005 to a current estimated level of NIS 89.1 million. Together, the figures in the graph imply that average cash benefits per family have declined in nominal terms while coverage has expanded.

The current targeting properties of SHC benefits are broadly consistent with available international averages, if below what could be achieved. A preliminary assessment using data collected in the spring of 2004 found that 55 percent of the sampled beneficiaries of the program have incomes above the national poverty line (Astrup and Buyuksahin 2005) Similarly, nearly 60 percent of the SHC benefits accrue to non-poor beneficiaries. Evidence from a range of international cash transfer programs suggests that up to 75 percent of benefits can "leak" to the non-poor. Well-targeted programs tend to reduce the leakage rates to between 30 and 40 percent, although it is difficult to draw conclusions across programs given the variation in program design and targeting approaches (Coady, Grosh and Hoddinott 2004). One reason for the higher leakage rates observed with SHC may be the focus on providing benefits to special categories of eligible groups, such as widows, the elderly and those families with a disabled household member. These groups may not necessarily be correlated directly with income poverty. The limited resources available for the MOSA SHC program, along with the relatively large demand for these funds, suggests that improving the targeting of the program should be a priority.

Table 7.2 explores staffing, the wage bill and rudimentary administrative costs for the SHC program. Between 2001 and 2005 the wages and salary bill for all MOSA employees has increased more than 47 percent, far outpacing inflation over the period, but it is modest in comparison with the wage bill of some other ministries and the security services. Staffing increased by about 420 over that period, an increase of 46 percent. The staffing increase is among the highest experienced in the PA ministries (see chapter 3). MOSA has a much smaller staff than the Ministries of Education or Health, but its increase in staff and salaries has nonetheless contributed to the PA funding problems.

Administrative costs have remained fairly constant over the last four years. Estimated costs for key MOSA programs are about 24 percent of total cash benefits for 2005. Available information does not separate the costs by program, so this figure includes the cost of some in-kind operations of the ministry, including vocational training for youth and institutional care for the vulnerable. This estimate puts the SHC on the high side compared to many cash transfer programs around the world, but it is in line with traditional in-kind programs. Administrative costs for a well-run cash transfer program are typically between 5 and 10 percent of benefits, while for in-kind food-related programs they can be upwards of 20 percent.

Figure 7.3: Ministry of Social Affairs Special Hardship Case Expenditures and Beneficiaries, 2001–05



Source: MOSA budget data and SHC program data.

Table 7.2: Staffing, the Wage Bill and Rudimentary Administrative Costs for the Special Hardship Case Program, 2001 and 2005
(NIS thousands)

	2001	2005
Cash transfers	67,515	89,157
Salaries	24,098	35,465
Staff	917	1,338
Administrative cost ratio	26%	24%

Source: MOSA budget data, SHC program data and staff estimates. Includes some costs for programs other than SHC, including vocational training and institutional care.

In summary, a brief examination of the SHC program reveals it to be a generally well-administered program by international standards, but the targeting should be improved. Administrative costs are high, but do not differ wildly from those of many other programs in other countries. Program coverage is relatively low but coverage should be examined together with the other SHC program administered by UNRWA, as these are in a sense a single program. Benefit levels are roughly in the middle of the range observed across country programs. SHC average benefits are about 13 percent of the poverty line, while typical benefits in most countries range between 5 and 25 percent of the poverty line. Leakage of benefits from SHC to the non-poor is in the high range, at 60 percent of total benefits. Preliminary analysis has shown that changing from the current categorical targeting practices to a proxy means test approach would reduce leakages to the non-poor to between 30 and 40 percent. The World Bank is currently working with MOSA to help improve targeting practices through the Social Safety Net Reform Project.

Temporary Employment Program (TEP). This major employment program was started by the MOF in May 2004 with initial technical and financial support from the International Labour Organization. TEP is now managed by a Temporary Employment Committee under the leadership of the Ministry of Labor with the participation of the MOF, MOSA, the MOA and representatives from labor and the private sector. The program was intended to be the flagship intervention under the proposed Social Safety Net Fund from 2005, but external donor funding did not materialize to expand the TEP as planned. All benefit payments and placements stopped as of January 2006 due to lack of funding.

TEP is a "workfare" intervention that is targeted to the unemployed, offering temporary jobs in the PA, local councils and, to a lesser extent, the private sector. It is not a classic public works program in which beneficiaries work almost exclusively in labor intensive activities. The program places some beneficiaries into public works jobs, but places others in white collar positions in line ministries and the public sector, depending on the background of the individual.

The program draws its participants from among the registered unemployed. As of January 2006 there were over 486,000 unemployed individuals registered on the Labor Market Information System (LMIS) maintained by MOL. Available benefits are allocated geographically based on district unemployment maps maintained by PCBS. Lists of eligible unemployed are drawn up for each region in proportion to the severity of the unemployment problem, then the groups of individuals cycle through the TEP program. The lists are determined based on established criteria, including current unemployment status, occupational qualifications, age, gender and health status. Field workers then check the eligibility of the individuals through cooperation with municipal councils and home visits. Throughout employment, participant compliance is monitored through attendance reports submitted to local unemployment offices and spot checks by field workers to ensure that the individuals are at work.

Originally, each new cycle was three months, and each person on the selected list would work and be paid for this period. At the conclusion of the cycle, a new list of participants would be brought into the program for three months, replacing the previous group. Payment arrears and limited funding resulted in longer lists as the program expanded and the job commitment was reduced to two months. By the last months of 2005, the program had practically become unemployment assistance, with payments made without recipients going to work or MOL checking on employment status. By January 2006 about 200,000 unemployed individuals had benefited from TEP, receiving NIS 334.1 million in beefits.

TEP appears to be generally well run. It has a standardized process for application and a developed LMIS and planning involves major ministries and the private sector in setting standards and verifying eligibility. Improvements in the system and management have been made since the early days of the program under MOF. The creation of beneficiary lists of the unemployed should be more transparent, as it is possible that program administrators could choose beneficiaries in a subjective or discriminatory manner, perhaps selecting those with particular characteristics, leaving less impressive candidates without jobs and benefits for longer. Program operations need better monitoring and evaluation. An evaluation of the private sector placement component of TEP has been planned, but implementation was stalled along with major operations.

TEP should continue to be an important employment program as budgetary resources become available. The basic design, linking benefit receipt to productive employment, should be maintained, especially in the private sector. Unfortunately, there are very few private sector opportunities within the West Bank and Gaza at present and the situation is unlikely to change in the near future. Simply building up the supply of ready workers does not create the needed demand for labor.

Therefore, the PA may wish to consider diversifying the program in two main directions. First, TEP could allow for an increased role for the traditional public workfare model. Labor-intensive jobs building needed infrastructure such as roads, water and sanitation facilities and basic construction can help absorb labor productively and possibly develop longer lasting job opportunities in construction trades. The traditional workfare model also avoids pushing the unemployed into an already overstaffed civil service and does not require a formal applicant screening or targeting procedure, as participants self-select based on the offered wage.

Second, TEP could incorporate a microcredit component to stimulate private sector small business development. Prior to the start of the second *intifada*, Palestine for Credit and Development (FATEN) and UNRWA had well-established microcredit programs. While FATEN was still relying mostly on group lending to poor communities, UNRWA's program was undertaking individual lending and was financially sustainable (UNCDF 2004). These experiences may hold lessons for the PA, perhaps even leading to direct support or partnering with successful lenders and encouraging some beneficiaries of TEP to seek microcredit through able NGOs.

The Ministry of Labor also runs vocational and training centers geared to the unemployed. These run in parallel to those operated by the Ministry of Social Affairs for disadvantaged youth. The coordination and consolidation of training programs should be considered to avoid needless duplication.

Fund for Families of Martyrs and the Injured. This program was managed from within MOSA, but was separated into a distinct program of the PLC beginning in 2006. Cash transfers are provided to the families of martyrs and those injured during the conflict with Israel. The program served between 6,000 and 7,000 families from the late 1990s through 2003. Between 2004 and 2005 the number of families increased rapidly, reaching 10,630 families in 2005. Average benefits also increased dramatically. The average benefit per family in 2005 was estimated at about NIS 7,750, up from NIS 5,000 in 2004. As a safety net program, the Fund for Families of Martyrs and the Injured is generous. Even the average benefits in 2004 were more than 20 percent of the contemporary poverty line; in 2005 they were 33 percent of the poverty line.

Very little is known about the operation of the Fund. It is not known how many of the recipient families are poor, nor the specific criteria for eligibility. Administrative costs are not readily available, even from MOSA, since their costs are not broken down by program. The program is clearly not targeted to the poorest households. While some assistance should be directed to this population, the level of resources devoted to the Fund for Martyrs and the Injured does not seem justified from a welfare or fiscal perspective. In 2005, for example, the Fund is estimated to have commanded nearly the same level of resources as the entire SHC program.

Assistance to Detainees and Ex-Detainees. At the end of 2005 there were about 8,800 Palestinians inside Israeli detention centers (PMA 2006). The families of approximately 6,300 received monthly benefits from the Ministry of Detainees and Ex-Detainees Affairs. These include monthly payments to families of detainees, transfers to detainees inside prisons through Israeli authorities, health insurance for detainee families, medical treatments for children of detainees and lawyers' costs associated with legal proceedings in Israel. Ex-detainees are entitled to a monthly pension that varies depending on the period of detention and can also receive up to six months of unemployment payments. All of these benefits have stopped temporarily since the January 2006 elections. During 2005 monthly expenditures for these benefits averaged about NIS 10.3 million ($2.3 million), or NIS 1,710 ($380) per detainee family. Average benefits are therefore nearly 90 percent of the poverty line, making this the most generous PA program. It is also the most expensive social protection program, and is second only to public pensions in terms of the resources devoted.

Funding for detainees and their families increased over the last several years relative to the larger MOSA programs. Staffing for the ministry has increased by almost 20 percent since 2000, among the larger staffing increases observed within the PA, though still far below MOSA. The total number of staff is modest, at 312 staff members in 2004.

Together with the Fund for Martyrs and the Injured, the programs for detainees and ex-detainees are clearly areas for considering future rationalization and streamlining of services. These two programs alone absorbed more than 1 percent of GDP in 2004, and may have accounted for as much as 1.3 percent in 2005. Yet collectively they provide benefits to fewer than 20,000 families. Certainly from efficiency and fiscal considerations, if not equity considerations, some of these resources could be better targeted.

6. International Donors

The international donor community plays a vital role in the provision of social protection services, as it does with education and health services. For example, emergency and humanitarian programs accounted for up to 36 percent of annual donor disbursements between 2001 and 2003.[103] And in 2002 alone, donors disbursed NIS 950 million ($200 million) for food, cash assistance and employment generation programs, more than one and half times the entire transfer budget for the PA in 2004. Most of the operating

[103] Excluding UNRWA programs.

costs of the social ministries, including MOSA and MOL, have been paid in recent years from the donor-financed Emergency Social Services (ESSP) trust fund.

The two largest donors in terms of on-the-ground support and the number of beneficiaries served are the UNRWA and the World Food Program (WFP). In addition to its provision of basic education and health services for registered refugees, UNRWA provides cash assistance and food support through its Special Hardship Case program as well as shelter and rehabilitation services.

UNRWA Special Hardship Case (SHC) Program. The SHC accounts for about one-third of the agency's budget allocated to relief and social services in West Bank and Gaza. For the 2004–05 funding cycle, it is expected that NIS 47.7 million ($10.6 million) will be spent on the SHC program. This is less than half the level of resources typically committed by the PA.

The UNRWA SHC served about 124,600 individuals in 2005, 68 percent residing in Gaza and 32 percent in West Bank. These figures have increased slightly over the past several years, but have not changed dramatically.

Individual beneficiaries of UNRWA's SHC program all receive a quarterly uniform food ration together with a cash subsidy. This differs from the design of the PA program, where benefits vary depending on family size and other characteristics. Table 7.3 summarizes the UNRWA and PA programs in terms of the numbers of beneficiaries and the average value of the benefits. The MOSA program covers more families (and individuals) and also pays nearly double the average UNRWA benefit. This is consistent with the higher MOSA budgets. The table indicates that the majority of the MOSA benefit is in the form of cash, whereas the UNRWA program focuses more on the food subsidy.

Table 7.3: Special Hardship Cases: Palestinian Authority and United Nations Relief Works Agency Programs, end-2005

	MOSA Special Hardship Cases	UNRWA Special Hardship Cases
Recipient individuals	154,724	124,649
Annual benefit value per capita (NIS)	800	495
Cash	72%	36%
Food	38%	64%

Source: UNRWA Program Budget for 2006–07; World Bank staff estimates.

Together, the SHC programs reach about 279,400 individuals, or 46 percent of those in extreme poverty. This is a respectable coverage rate compared with international experience, provided that the recipients are in fact among the poor. The fact that the eligibility criteria for the two programs is similar, and that the preliminary analysis of the MOSA program suggests high benefit leakages, suggests that MOSA and UNRWA may wish to coordinate closely on targeting reform. The different benefit packages in the two programs also highlight the need for greater collaboration.

WFP Assistance. WFP emergency programs target the "non-refugee food insecure" population. Support is provided through four types of programs, including general food distribution to the chronically poor, food-for-work/training, institutional feeding and supplementary feeding. Starting in July 2006 WFP estimates that it will increase food coverage from 480,000 to 600,000 non-refugees in response to the escalating humanitarian crisis. This implies increasing distribution from a planned 150,000 tons of food to 190,000 tons, at a total cost of about NIS 450 million ($100 million) over the period September 2005 to August 2007.

WFP uses a geographic targeting approach to identify the most vulnerable communities and those suffering limited job opportunities, limited physical movement and significant destruction of assets. This last group, the so-called "new poor," represents a departure from the past practice of focusing almost exclusively on the humanitarian needs of the chronically poor and disadvantaged. In 2003 WFP provided food to about 367,000 non-refugees classified among the new poor.

About a third of the available resources are devoted to supporting the chronically poor through the Special Hardship Case programs of the PA. About 150,000 chronically poor individuals were provided WFP food rations in 2003, a figure consistent with expectations for 2005. Individuals receive about 2,100 kcal worth of food per person per day, slightly higher than the UNRWA food ration for chronically poor refugees (who are also provided with cash, as noted above).

The assistance of donors such as UNRWA and WFP is critical to provide continuing humanitarian relief and to complement and enhance the PA assistance programs. Even with donor resources, the basic needs of many of the poorest in West Bank and Gaza remain unmet. Making those resources reach as many of the needy as possible requires the most efficient use possible. Coordinating outreach planning, harmonizing targeting approaches and synchronizing benefit packages between the PA and donors can go a long way toward reaching this goal. Many steps have already been taken, including coordinating food resources between the PA, WFP and UNRWA. Donors have also been discussing the value of different targeting approaches toward a more unified approach. But more can clearly be done to improve the efficiency of resource use.

7. Private Provision of Assistance

Privately provided social assistance, both in cash and in-kind, is critical to filling the gaps in coverage left after PA and donor support. The two major sources of assistance are NGOs and the families and friends of the needy. Any strategic planning and reforms undertaken must incorporate the private providers and not crowd out their participation.

As of 2005 there were more than 700 international and local NGOs in the West Bank alone, double the number in 1999. Given this diversity, establishing the resources of this sector is difficult, but a conservative estimate put total funding for NGOs in West Bank and Gaza at NIS 660 million ($150 million) in 2003. Even if the true level is now significantly less, such resources likely exceed all PA transfer resources for public programs.

It is estimated that about half of the NGOs shifted focus from development toward relief and emergency services from 1999 to 2005. This is consistent with a smaller survey conducted during 2003 which found that half of the surveyed NGOs had to reallocate resources away from development programs to emergency response. It is likely this trend will accelerate under the current conditions.

The PA can benefit from explicit coordination with NGOs, both local organizations that have strong ties to the community and large international organizations that have significant operational capacity, such as Oxfam, the International Committee of the Red Cross (ICRC) and Premiere Urgence Palestine, among others. The Ministry of NGO Affairs can serve this role and help support particularly promising NGOs and their projects. In 2005 it is estimated that NIS 30 million ($6.6 million) was provided to NGOs from the PA through the Ministry of NGO Affairs.

Remittances and aid from friends and relatives is also a significant source of assistance, although it appears not to be as important as public assistance, since the effects of the *intifada* sapped personal welfare reserves. In a survey of Palestinian perceptions of socio-economic conditions conducted by PCBS in the summer of 2005, about 11 percent of respondents indicated that social assistance from relatives, friends and neighbors is the most frequently received form of aid. The monthly value of those benefits (NIS 625) ($139) ranked behind only those provided by MOSA among respondents. Surveys conducted in prior years showed a higher percentage of remittance receipt, including a 16 percent rate in late 2004 and 34 percent rate in 2003. These results are not strictly comparable, but are perhaps indicative of a general pattern of declining personal remittances.

8. Conclusions and Recommendations

The PA and its social line ministries are operating in an extremely difficult environment. Resources are at best uncertain and are frequently nonexistent. Some services are provided and some benefits are sporadically distributed, though civil servants are still not receiving regular salary payments. Within this uncertain environment, it is all the more important to ensure that the limited resources are well used, realizing available efficiency gains through a combination of greater program and institutional coordination, better policy and program planning and improved targeting of large programs, so that benefits reach the poorest and most vulnerable. Several specific recommendations emerging from the discussion in this chapter are incorporated into box 7.1 below. Many of the recommendations place an equal responsibility on donors, NGOs and the PA for success. All will require strong leadership and accountability from the PA.

Box 7.1: Social Policy and Safety Nets

General Reform Initiatives:

- *Strengthen program coordination.* The PA and donors often operate programs independently of one another with little exchange of information either at the policy or operational levels. Even within the PA, some line ministries are largely unaware of other ministries' programs with similar aims. At a minimum, regular fora for information exchange should be set up by the Ministry of Planning, such as monthly policy meetings, where attendance by line ministries and donors is mandatory.
- *Reduce potential for overlapping programs and beneficiaries.* Due in part to the lack of coordination between providers, there are many interventions purporting to reach the same or very similar populations with similar benefits. A few examples highlighted in the chapter include:
    - MOSA provides vocational training for dropouts and young adults, while MOL also provides vocational training for unemployed adults.
    - MOSA provides cash transfers to the needy through the Social Hardship Case program, the UNRWA provides similar benefits to the refugee population through its Social Hardship Case program and the Ministry of Detainees and Ex-Detainee Affairs provides a separate transfer program for those detained in Israel and their families.
    - Both UNRWA and WFP provide similar packages of in-kind food rations to similar populations, differing primarily only in their refugee status.
- *The development of a strategy for social protection that would identify and clarify the roles of the PA, donors and private sector is highly desirable.* This process could lead to a review of the legislative framework governing ministry mandates and new amendments to develop a more streamlined and effective social protection system.
- *Improve policy planning, budgeting and fiscal management.* Social protection line ministries should take a more active role with regard to policy planning and fiscal management. Currently, they see themselves only as implementers of policies developed elsewhere in the PA. Little attention is given to budget planning or to linking expenditures to revenues or transfers. It is frequently difficult to obtain recent budget and expenditure information from ministries, and when it is available it bears little relevance to actual operations. This is partly a reflection of the uncertain revenues that have plagued the PA, but is also a problem with overall fiscal management. Planning units should be developed within the key ministries, Management Information Systems (MIS) should be upgraded to allow monitoring of program performance and budget departments should move toward more systematic programmatic budgeting practices.
- *Develop and implement a monitoring and evaluation strategy.* Programs such as the SHC programs, the TEP and others should be subject to routine monitoring through an updated MIS, and should be part of a strategy of external program evaluation. Only through rigorous monitoring and evaluation can programs be improved and effective long term funding decisions taken to enhance fiscal sustainability.

Program Level Initiatives:

- *Reform the pension system.* This is a top priority from a fiscal perspective. Implicit debt accumulated from the current civil service schemes are nearly twice current GDP, and even making payments to current recipients requires an ever-larger share of the budget, estimated at nearly 2 percent of GDP in 2005. Fundamental reform is not a short term undertaking. However, an initial step would be to strengthen the administrative capacity of the GPIC. It would also include analyzing and revising the Unified Pension Law to adjust the parameters of the current public system to ensure long term sustainability, revising the Unified Pension Law, strengthening the GPIC and eventually developing an independent and transparent pension institution. Similar reform is needed with regard to the 2003 Social Security Law for private sector workers.

Continued…

- *Improve safety net targeting*. Preliminary analysis of the MOSA Social Hardship Case program found high leakages of benefits to non-poor individuals. Targeting methods that move away from categorical targeting to more needs-based standards, such as a proxy-means approach, can increase the proportion of benefits that go to the poor. The Social Safety Net Reform Project is developing a pilot proxy-means test which could be considered for wider application across different safety net programs.
- *Consider a public workfare program component*. MOSA and the PA would benefit from considering a traditional self-targeted workfare program component, perhaps as part of TEP, to provide benefits to the able-bodied poor unemployed in a way that does not burden the staff-heavy public sector and does not require a screening mechanism to identify participants. Workfare projects can also be targeted to geographic areas with particularly high unemployment and poverty.

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ANNEX 1: PUBLIC EXPENDITURE AND FINANCIAL ACCOUNTABILITY (PEFA) PERFORMANCE INDICATORS

The measurement framework developed by the Public Expenditure and Financial Accountability (PEFA) program is an integrated methodology that allows the measurement of public financial management (PFM) performance over time. This set of high level indicators, which draws upon the methodology used by the World Bank and IMF in assessing the PFM systems in highly indebted countries (HIPC), the IMF Fiscal Transparency Code and other international standards, highlights areas of improved performance against best practice in developed and developing countries. The indicators analyze performance in the six core areas of public financial management:

1. Credibility of the budget
2. Comprehensiveness and transparency
3. Policy-based budgeting
4. Predictability and control in budget execution
5. Accounting, recording, and reporting
6. External audit.

The central government level is the main area of focus, along with issues relating to the overall scrutiny of public finances. The activities of public enterprises and sub-national levels of government are not addressed directly.

I. Methodology

Each indicator is broken down into several dimensions, which are assessed separately to generate a combined score along a 4- point scale. The highest possible score is an “A”, while lower scores, “C” or “D”, suggest areas for improvement. In some cases, an intermediate score indicated by a “+” may be appropriate. Also, a ↑ may highlight progress in indicators were reforms implemented to date have not yet impacted PFM performance. Further information on the methodology may be found in the PEFA website along with documentation published by the World Bank’s PEFA Secretariat.[104]

Some of the indicators were not rated since the topics concerned fell outside the scope of this mission (for example, indicators 13-15 on taxation) and indicator19 on procurement, which will be covered by an on-going analytic report.

[104] PEFA, “Public Financial Management, Performance Measurement Framework,” PEFA Secretariat, World Bank, June 2005 (www.pefa.org).

PEFA Indicator Set: West Bank & Gaza 2006

A. PFM-OUT-TURNS: Credibility of the Budget			SCORE
PI-1	**Aggregate expenditure out-turn compared to original approved budget**		B
	(i) Difference between actual expenditure and budgeted expenditure during 2003-05 Actual expenditure deviated from budgeted expenditure by 6.3% in 2003, by 4.2% in 2004 and by 13.9% in 2005 (excluding debt service and externally financed project expenditure, see section Summary of PA Finances). (source: IMF)	B	
PI-2	**Composition of expenditure out-turn compared to original approved budget**		C
	(i) Extent to which the variance in primary expenditure composition exceeded the overall deviation in expenditure during 2003-05 1/ The variance in expenditure composition exceeded the overall deviation in primary expenditure by 25.7% in 2003, by over 6% in 2004 and by 5.8% in 2005 (source: IMF). Thus in executing the budget for 2003 there was a significant reallocation of expenditures across items, but this was considerably less in 2004 and 2005 budget execution.	C	
PI-3	**Aggregate revenue out-turn compared to original approved budget**		B
	(i) Actual domestic revenue collection compared to domestic revenue estimates for 2003-05 2/ Actual domestic revenue collection exceeded revenue forecasts by 30.4% in 2003, by 6.1% in 2004 and by 23.8% in 2005 (source: IMF). This strong revenue performance is attributed to improvements in tax collection and administration and the decision of the GOI to resume withheld clearance revenues, rather than weaknesses in revenue forecasting.	B	
PI-4	**Stock and monitoring of expenditure payment arrears**		D+
	(i) Stock of expenditure payment arrears Due to the shortage of funding for operational expenditures arrears to suppliers and borrowing from commercial banks arise. Due to the unpredictability of the release of funds, line ministries accumulate expenditure arrears, based on the implicit assumption that these will in due course be paid by funding from the MOF. The stock of arrears to commercial banks stood at $600 million at the end of 2005.	D	
	(ii) Availability of data for monitoring expenditure payment arrears Data is held by the MOF concerning borrowing from commercial banks and arrears for payments made centrally by MOF. Line ministries are required to maintain information on arrears for items paid direct by them and inform the MOF. However, there is no transparent system to determine the relative priority in which arrears are paid.	C	

B. KEY CROSS-CUTTING ISSUES: Comprehensiveness and Transparency			
PI-5	**Classification of the budget**		**D**
	(i) The classification system for budget formulation, execution and reporting of the central government's budget The budget classification provides limited breakdown of expenditures. The object classification is not consistent with GFS. There is no functional classification. There is no provision in the standard chart of accounts for breakdown of expenditure by spending units, programs or activities.	**D**	
PI-6	**Comprehensiveness of information included in budget documentation 3/**		**B**
	(i) Share of the listed information in the budget documentation by the central government Recent budget documentation (Budget book, annual budget law, Minister of Finance's budget speech, budget circular) fulfils 6 of the information benchmarks. It includes information on 1.macroeconomic assumptions, aggregate growth, inflation and exchange rate, 2. Fiscal deficit, 3. Deficit financing, 6. Prior year's budget out-turn, 7. Current year's budget, 8. Summarized data on revenues and expenditures.	**B**	
PI-7	**Extent of unreported government operations**		**C+**
	(i) Level of extra budgetary expenditure (other than donor funded projects), which is unreported i.e. not included in fiscal reports The level of extra-budgetary expenditure (other than donor funded projects) is insignificant. The comprehensiveness of the budget has been enhanced by the establishment of a central treasury account to receive all PA revenues. The Organic Budget law provides that the central budget comprises the consolidated fund and all special PA funds. The budget encompasses the expenditures of all PA ministries, agencies and public institutions).	**A**	
	(ii) Income/expenditure information on donor-funded projects, which is included in fiscal reports Donor project funding has traditionally funded the great bulk of PA capital expenditures. However, the 2006 budget circular required information on all donor projects, with a view to developing a comprehensive budget dialogue reflecting the scope of the draft MTDP 2006-08. Information on donor funded projects is now being incorporated in the project data base developed by MOP (although it is recognized as neither fully complete nor accurate) as part of the MTDP. This information, including PECDAR managed projects, is included in the Budget book.	**C**	
PI-8	**Transparency of inter-governmental fiscal relations**		**D+**
	(i) Transparent and rules based system in the horizontal allocation among governorates of unconditional and conditional transfers from central government	**C**	

	Transfers from the central government are small and consist of automobile licensing fees and fines, which are allocated in proportion to their population size. The bulk of local revenue is from user charges (e.g. water and electricity charges) and smaller amounts of property tax. The main current issue in inter-governmental fiscal relations concerns local authority debts to the central government for energy bills paid to Israel on their behalf by MOF (see also discussion under PI-9).	D	
	(ii) Timeliness of reliable information to local government allocations from central government of the incoming year No information is provided to local governments on the timing and amount of the transfers agreed with the MOLG.	D	
	(iii) Consolidated fiscal data is collected and reported for general government across sectoral categories Local governments operate without a guiding framework for accounting and financial management. The lack of a unified chart of accounts results in revenues and expenditures being reported differently by different municipalities, making data aggregation at the sector level impractical and unreliable. The General Accounting Office of MOLG carries out periodic audits, but no reports are prepared and their findings remain undisclosed. The submission of local government financial statements has been irregular.		
PI-9	**Oversight of aggregate fiscal risk from other public sector entities**		**D+**
	(i) Extent of central monitoring of autonomous government agencies and public enterprises Only two SOE's remain: the Petroleum Corporation managed directly by MOF, and the Cement Company, which is part of the PIF investment portfolio and overseen by PIF. They operate on a commercial basis and their operations are not included in the budget. The recent reduction in PIF's fiscal reporting has been problematic.	C	
	(ii) Extent of central government monitoring of sub-national governments' fiscal position The monitoring of the fiscal position of local governments is weak and there is no consolidated report. MOLG lacks capacity to monitor. Local governments have accumulated liabilities to the PA for utility bills paid to Israel on their behalf, reflected in the budget as part of the "net lending" component. The previous practice of local government negotiating programs directly with donors has ceased, but local governments can incur in debt subject to the approval of the MOLG.	D	
PI-10	**Public access to key fiscal information**		**C**
	(i) Public access to information includes: Annual budget documentation, in-year budget execution reports, financial statements, external audit reports, contract awards, resources to primary service units (such as primary schools and hospitals.)	C	

	Progress has been made in providing greater access to fiscal information, but many of the above documents are not available because they have been delayed or not compiled. In-year monthly budget execution reports are available to the public and accessible at the MOF's website, as well as the Budget Speech, annual expenditure estimates and previous years' actual expenditure data.		

C. BUDGET CYCLE			
C (i) Policy-Based Budgeting			
PI-11	**Orderliness and participation in the annual budget process**		**C+**
	(i) Existence and adherence of a budget calendar A clear budget calendar is set out in the Organic Budget Law. The budget circular is to be issued by 15 July and line ministries have one month to respond, with the proposed budget to be submitted to Cabinet by 15 October, presented to the PLC by November 1 and passed by it on or before 31 December. Except for minor slippages this timetable has been adhered to. However, given the special circumstances of the 2006 election, the 2006 budget had not been presented to the PLC as of June 2006.	**B**	
	(ii) Clarity/comprehensiveness of political involvement in the guidance on the preparation of budget submissions The timetable allows little time for dialogue with line ministries or for Cabinet consideration or PLC review. The budget circular provides indicative allocations. The negotiations between the line ministries and the MOF concern only costing issues with no clear prioritization, performance or policy focus. When budget estimates reach the Cabinet, they are at their final stage with little time for an extensive review. Neither Cabinet nor PLC receives sufficient information (e.g. proposed expenditures by spending units for serious review.	**C**	
	(iii) Timely budget approval by PLC The PLC has, in two of the last three years, approved the budget with one month delay. The 2003 budget was approved on Feb 1/03, the 2004 budget on Jan 15/04 and the 2005 budget on Mar 31/05. It has not received or approved the 2006 budget, as of May 06, due to special circumstances.	**C**	
PI-12	**Multi-year perspective in fiscal planning, expenditure policy and budgeting**		**D**
	(i) Preparation of multi-year fiscal forecasts Forecasts of fiscal and macroeconomic aggregates are prepared on an annual basis by PCBS, working with IMF and World Bank. Work is underway on developing a medium-term fiscal framework. Starting in 2006 line ministries were provided with three year indicative recurrent expenditures and required to present estimates for total expenditures for the budget year and the following two years. However, this was more an exercise to sensitize budget entities to a multi-year budget framework and was not used by the MOF in the preparation of the 2006 budget.	**C**	
	(ii) Scope and frequency of debt sustainability analysis	**D**	

	No debt sustainability analysis has been undertaken in the last three years (see indicator P-17).		
	(iii) Existence of sector strategies with multi-year costing of recurrent and investment expenditure	D	
	Some sectors have prepared several competing plans, each of which reflects the work of different donors. The capacity of line ministries to develop meaningful plans requires significant development, but is being addressed in the context of initiatives to better link planning and budgeting through the draft MTDP 2006-08.		
	(iv) Linkages between investment budgets and forward expenditure estimates	D	
	Budgeting for investment and recurrent expenditure are separate processes, reflecting in part non-integration of donor funding. This may lead to unforeseen recurrent cost implications of capital or investment expenditures. However, a more comprehensive budget process to include donor funded projects and thus to provide better linkage is being developed through the draft MTDP 2006-08.		

C (ii) Predictability and Control in Budget Execution			
PI-13	**Transparency of taxpayer obligations and liabilities**		**n/a**
PI-14	**Effectiveness of measures for taxpayer registration and tax assessment**		**n/a**
PI-15	**Effectiveness in collection of tax payments**		**n/a**
PI-16	**Predictability in the availability of funds for commitment of expenditures**		**D+**
	(i) Cash flows are forecast and monitored	D	
	There is no systematic forecasting system or related monitoring system covering cash management and budget execution. A representative cash management committee would alleviate the current day-by-day approach to funds release and provide a basis for monitoring the extent to which the budget (both revenues and expenditures) is on track, hence, increasing predictability.		
	(ii) Reliability and horizon of periodic in-year information to ministries and agencies on ceilings for expenditure commitments	D	
	There is a serious lack of predictability of funding for operational expenditures. During the year line ministries have no advance knowledge of the amounts they will receive to make payments, when and for which items. There is no system of commitment control and many ministries assume the budget allocation is the upper limit for commitments. The accumulation of payments arrears has led suppliers to increase their prices to compensate for delays in payment.		
	(iii) Frequency and transparency of adjustments to budget allocations decided above the level of the ministries and agencies	B	

	There are relatively few adjustments to budget allocations given that appropriations are highly aggregated and based on ministry or agency, expenditure item or object. The MOF monitors the implementation of the budget on the more aggregate information, as set out in the annual Budget law, which does not allocate funds to particular spending units. The Organic Budget Law (Article 50) provides that funds cannot be reallocated between budget chapters without PLC approval. The annual budget law provides that budget entities may not reallocate from one of the 14 predefined expenditure items without the approval of MOF.		
PI-17	**Recording and management of cash balances, debt and guarantees**		**C**
	(i) Quality of debt data recording and reporting External debt records are updated and reconciled annually. Domestic debt records, which are the bulk of the obligations, are not as comprehensive and have gaps and reconciliation issues. However, debt service payments are made on time. However an external audit would confirm if the system operates satisfactorily, as part of the audit of the annual financial statement.	**D**	
	(ii) Extent of consolidation of the government's cash balances Cash balances are calculated and consolidated weekly, rather than daily. While the establishment of the CTA was an important step to improve cash management, it was spread over more than 1500 accounts and sub-accounts, including over 650 bank accounts and over 400 accounts used for advances only. Computerization improvements appear necessary for daily sweeping of accounts to occur.	**B**	
	(iii) Systems for contracting loans and issuance of guarantees The approval of the Minister of Finance is required for all loan agreements and issuance of guarantees, but neither is based on an overall ceiling and there are no criteria for guarantees, although they are required to be reported in the official Gazette.	**C**	
PI-18	**Effectiveness of payroll controls**		**C+**
	(i) Degree of integration and reconciliation between personnel records and payroll data Personnel records and payroll data are not directly linked and there are reconciliation problems. The flow of information between the GPC, the MOF, and the MOI is paper-based, resulting in limited integration between personnel records and the payroll data. However the GPC is actively developing a plan for a HR database system linked to the payroll and is working closely with the payroll directorate at the MOF.	**C**	
	(ii) Timeliness of changes to personnel records Up to three month's delay occurs in updating the changes to personnel records and the payroll. Retroactive adjustments are made occasionally.	**B**	
	(iii) Internal controls of changes to personnel records and the payroll The authority and the basis for changes to personnel records and	**C**	

	payroll are clear for the civil service, but not for the security services. An improvement to payroll management was the transfer of authority to change personnel records and payroll from the GPC to the MOF. GPC now controls only personnel policy issues and promotions. New civil service recruitment requests are sent to the Budget Office at the MOF and shared with GPC. The budget officer certifies the availability of funds, before the approval by the Minister himself. Clearance is needed from the Director General of Financial Control at the MOF and the financial controller at the line ministry. Payroll control at the MOI is independent of the MOF and there is limited ability to enforce compliance, resulting in limited connection between recruitment and budget allocations.		
	(iv) Existence of payroll audits to identify control weaknesses and ghost workers	C	
	A payroll audit in July 2005 focused on identifying partial and double dippers, ghost workers and the lack of documentation. A follow up audit of the payroll has been planned to assess the controls in greater detail.		
PI-19	**Competition, value for money and controls in procurement**		**n/a**
PI-20	**Effectiveness of internal controls for non-salary expenditure**		**D+**
	(i) Effectiveness of expenditure commitment controls	**D**	
	While expenditure commitments are required to be recorded, there is no commitment control system in place, to limit commitments to likely available cash. Most line ministries appear to treat the budget allocation as the upper limit on commitments (see P-16).		
	(ii) Comprehensiveness, relevance and understanding of other internal control rules/ procedures	**B**	
	The internal control rules are comprehensive and understood. Given the tight budgetary situation of the PA, the ex ante financial controller system, which also reviews financial reports and bank reconciliations, may prove effective in expenditure control in the short term. However, it needs to operate efficiently without leading to delays and duplication in approvals.		
	(iii) Degree of compliance with rules for processing and recording transactions	**B**	
	Compliance with rules is high.		
PI-21	**Effectiveness of internal audit**		**C↑**
	(i) Coverage and quality of the internal audit function 4/	**C↑**	
	The new Internal Audit Department was created in the MOF in May 2004 and until June 2006 made good progress towards becoming an effective organization. A number of useful audits were carried out (e.g. payroll audit, see P-18), a strategic plan has been developed and a systems approach adopted. Capacity development was provided by the EC through the financial control and internal audit technical advice and training program provided by Ernst & Young. However it was recognized that, the Department would take time to become fully operational.		

C (iii) Accounting, Recording and Reporting			
PI-22	**Timeliness and regularity of accounts reconciliation**		**C**
	(i) Regularity of bank reconciliation Treasury undertook the reconciliation of the central treasury account at the end of each month. Line ministries reconciled their advance accounts and development project accounts, but more attention was needed to ensuring they were done regularly. The reconciliation process is transparent.	**C**	
	(ii) Regularity of reconciliation and clearance of suspense accounts and advances Reconciliation and clearance of suspense accounts and advances takes place only annually and some accounts have un-cleared balances brought forward. A lag in the reconciliation of advances has delayed the preparation of the annual financial statements. Procedures for closing accounts, proving their accuracy, making final adjustments and formulating financial statements have not been formally established.	**C**	
PI-23	**Availability of information on resources received by service delivery units**		**D**
	(i) Collection and processing of information to demonstrate the resources received by the front-line service delivery units (primary schools and health clinics) The chart of accounts does not provide for recording expenditures at the spending unit level, although this may be done by line ministries using their own accounting systems e.g. MOH	**D**	
PI-24	**Quality and timeliness of in-year budget reports**		**B**
	(i) Coverage and compatibility of the reports with budget estimates The classification of the budget execution reports allows comparison to the budget, but only at an aggregate level. While the figures are preliminary, they have been generally close to the final numbers, as discussed in (ii) below.	**B**	
	(ii) Timeliness of the issue of reports Budget execution reports with information on revenues and expenditures have been prepared monthly and made available to the public on the website of the MOF shortly after the end of each month. Figures were preliminary for 4 to 12 weeks, as the MOF completes the reconciliation process, the recording of advance expenditure, and consolidation of figures.	**B**	
	(iii) Quality of information Overall data quality is fair and data issues are generally highlighted in the reports, but there is no external audit to provide credibility to the figures.	**B**	
	Quality and timeliness of annual financial statements		**D+**

PI-25			
	(i) Completeness of the financial statements The first aggregate financial statements of the PA were submitted in January 2004 for the year 2002, but were largely confined to a statement of budget execution, lacking information on the PA's financial position (financial assets and liabilities) and a clear definition of the budget balance. Some of this additional information was included in the 2003 financial statements, but they still did not meet international standards (IPSAS). Based on the English translation, the 2004 financial statements appear to be less satisfactory than the 2003 statements, being limited to a summary statement of budget execution (i.e. no supplementary information on financial assets or liabilities or any reference to the PA's financial position). It is also difficult to understand the calculation of the financing balance. No financial statements for 2005 appear to have been prepared.	**C**	
	(ii) Timeliness of submission of the financial statements for external audit Financial statements for 2003 were completed in late 2004 and submitted for audit by a private firm. Price Waterhouse Coopers completed the audit in January 2006 and prepared a detailed management letter of over 100 pages that awaits a response from the PA before the audit can be finalized. The 2004 preliminary statements were posted on the MOF website in June 2005 but had not been submitted for audit as of June 2006.	**D**	
	(iii) Accounting standards used The accounting standards used are not disclosed.	**D**	

C (iv) External Scrutiny and Audit			
PI-26	**Scope, nature and follow-up of external audit**		**D**
	(i) Scope/nature of audit performed (incl. adherence to auditing standards) 4/ There is no effective external audit institution. The work of new external audit institution, which replaced the GCI, the Finance and Administrative Control Bureau, has been severely hampered by lack of capacity and resources. However, its legislation provides for adequate independence and for reporting to the PLC, as well as to the President (addressing a weakness in the reporting arrangements of the GCI). The President and Deputy President have been appointed.	**D↑**	
	(ii) Timeliness of submission of audit reports to legislature GCI reported directly to the President and its audit reports were not submitted by the President to the PLC or otherwise made public.	**D**	
	(iii) Evidence of follow up on audit recommendations There is no evidence of response to or follow-up on GCI recommendations from the Executive. In addition, recommendations did address significant issues.	**D**	

PI-27	**Legislative scrutiny of the annual budget law**		**C+**
	(i) Scope of the PLC's scrutiny The PLC Committee on Budget and Financial Affairs is responsible for reviewing and recommending approval or rejection of the annual budget law. While the Committee has worked conscientiously it has lacked both the information and resources for effective scrutiny of either macro-economic issues or detailed revenue and expenditure issues.	**C**	
	(ii) Extent that the PLC's procedures are well -established and respected The Organic Budget Law details the Committee's role, which has been exercised since meaningful budgeting commenced with the 2003 budget.	**B**	
	(iii) Adequacy of time for the PLC to provide a response on the budget proposals, both on the estimates and macro-fiscal aggregates The PLC has insufficient time (less than two months) to fully review the budget proposals. Its role is weakened by the aggregated nature of the budget appropriations and the lack of effective external audit reporting on the previous year's budget execution or on performance of budget entities.	**C**	
	(iv) Rules for -in-year amendments to the budget without ex-ante approval of the PLC Clear rules exist in the annual budget law for in-year amendments to the budget without the approval of the PLC, which include administrative reallocations. However additional appropriations require PLC approval (see P-16).	**C**	
PI-28	**Legislative scrutiny of external audit reports**		**D**
	(i) Timeliness of examination of audit reports by the PLC The previous external audit institution, GCI, did not report to the PLC but only to the President. The President, who had the discretion of sharing such reports with the PLC, did not do so after 1997.	**D**	
	(ii) Extent of hearings on key findings No hearings have been conducted by the PLC	**D**	
	(iii) Issuance of recommendations by the PLC and implementation by the executive The PLC has not made recommendations on external audit reports.	**D**	

D. DONOR PRACTICES			
D-1	**Aggregate expenditure out-turn compared to original approved budget**		**D**
	(i) Annual deviation of actual external financing from budgeted external financing for 2004-05. 5/ External financing fell short of budget estimates by 56 percent for 2003, by 46 percent for 2004 and 47 percent for 2005 (source: World Bank). In 2005 external budget support amounted to $350 million of the estimated $663 million in the budget (without taking into account a further $240 million anticipated for a special social safety net fund).	**D**	

	(ii) In- year timeliness of donor disbursements Bilateral Arab donors have made unconditional commitments to the PA, of which the size and date of the disbursement is unpredictable. Other donors make conditional commitments and disbursement delays are the result of a requirement to meet benchmarks; for example the World Bank administered Public Financial Management Reform (PFMR) Trust stopped disbursement in the fourth quarter of 2005, accounting for over a third of total budget support. However donor budget support has ceased since the 2006 election.	**D**	
D-2	**Financial information provided by donors for budgeting and reporting on project and program aid**		**C**
	(i) Completeness and timeliness of budget estimates by donors for project support Full information on donor project funding is not available as discussed under PI-7(ii) above. While some donors such as EC, World Bank and Norway have channeled project assistance through the CTA, some donors have channeled their project funds through PECDAR or preferred separate financial arrangements. Some donors provide budget estimates for disbursement of project aid three months in advance but use a classification that is not consistent with the government's budget classification.	**C**	
	(ii) Frequency and coverage of reporting by donors on actual flows for project support As discussed under PI-7 above, MOP has developed a database of projects approved after 2002 with data coming directly from donors. However, it is not yet complete nor fully accurate.	**C**	
D-3	**Proportion of aid that is managed by use of PA procedures**		**C**
	(i) Overall proportion of aid funds to the central government managed through national procedures This information is not available. Before the 2006 elections, a significant part of donor project assistance was not managed through national procedures (Since then most donors have been dealing direct with the President's Office rather than MOF, and the actual procedures used are not known.)	**C**	

1/ Variance in expenditure composition is calculated as the weighted average deviation between actual and budgeted expenditure, as a percent of budgeted expenditure, on the basis of functional classification and using the absolute value of the deviation. As in PI-I, it excludes debt service and donor funded expenditure, source: IMF.
2/ Calculated as actual domestic revenue minus budgeted revenue as a percent of budgeted revenue, source: IMF.
3/ Budget documentation should include information on the: 1. Macroeconomic assumptions, (aggregate growth, inflation and exchange rate), 2. Fiscal deficit, 3. Deficit financing (describing anticipated composition), 4. Debt stock, 5. Financial assets, 6. Prior year's budget outturn, 7. Current year's budget, 8. Summarized budget data for revenue and expenditure (including current and previous year), and 9. Explanation of budget implications of new policies (budgetary impact of policy changes).
4/ A ↑ highlights progress in indicators were reforms implemented to date have not yet impacted PFM performance.
5/ The indicator was based on external financing forecasts as stated in the budget. The Public Financial Management Reform Trust Fund (PFMR) administered by the World Bank has been in place since April 04.