Towards a Palestinian State: Reforms for Fiscal Strengthening

Economic Monitoring Report to the Ad Hoc Liaison Committee
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Contents

List of Figures

List of Tables

Acronyms

AHLC	Ad Hoc Liaison Committee
EU	European Union
GDP	Gross Domestic Product
GEDCO	Gaza Electricity Distribution Company
GoI	Government of Israel
HEDCO	Hebron Electricity Distribution Company
ICBS	Israeli Central Bureau of Statistics
IEC	Israel Electricity Company
IMF	International Monetary Fund
IPSAS	International Public Sector Accounting Standards
JDECO	Jerusalem District Electricity Company
JSC	Joint Services Council
LGU	Local government unit
MDLF	Municipal Development Lending Fund
MENA	Middle East and North Africa
MoF	Ministry of Finance
MoLG	Ministry of Local Government
MoSA	Ministry of Social Affairs
NEDCO	Northern Electricity Distribution Company
NGO	Non-governmental organization
NIS	New Israeli Shekels
PA	Palestinian Authority
PalTrade	Palestine Trade Center
PCBS	Palestinian Central Bureau of Statistics
PFM	Public financial management
PNCTP	Palestinian National Cash Transfer Program
PRDP	Palestinian Reform and Development Plan
SAACB	State Audit and Administrative Control Bureau
SELCO	Southern Electricity Company
SHC	Special Hardship Case
SSNRP	Social Safety Net Reform Project
UNRWA	United Nations Relief and Works Agency for Palestine Refugees in the Near East
UPL	Unified Pension Law
WB&G	West Bank and Gaza

Executive Summary

a. **A viable state requires public institutions that create an enabling environment for private sector-driven growth, manage public finances efficiently, and are able to deliver effective services to the population.** The Palestinian Authority (PA) is making steady progress on implementing its reform program and building the institutions required by a future state: the PA has strengthened its public financial management systems, improved service delivery, and made significant reforms to increase security and shore up its fiscal position. However, only a dynamic private sector can generate the jobs required by a young and growing population and furnish the resources needed to provide basic services to citizens. While recent economic resurgence is a cause for optimism - with Gross Domestic Product (GDP) growth in 2009 reaching about 6.8 percent coming on top of nearly 6 percent in 2008 – the situation remains precarious. Most growth is in the West Bank, while Gaza continues to experience falling per capita GDP. Furthermore, growth is driven by a combination of large inflows of donor assistance, PA government reforms that have increased investor confidence, and the loosening of some Israeli security restrictions. Sustainability of the growth, given the reliance on donor assistance, is a cause for concern.

b. **Sustained private sector growth requires a shift from public sector-driven investment to a real takeoff in private sector investment.** Part of this can be achieved by the PA continuing and accelerating its reforms. However, the largest impediment to private sector investment in the West Bank and Gaza remains the restrictions on movement and access to resources and markets imposed by the Government of Israel (GoI). Sustained growth is dependent on the GoI further easing restrictions it has already taken loosened - particularly through increased Palestinian access to the land and resources in Area C, access to markets in East Jerusalem and Israel, and by creating a higher level of predictability on movement and access.

c. **The PA will continue to be dependent upon donor financing of its operating budget for some time to come, while it implements an ambitious reform agenda.** The international community should commit to continuing to support this agenda including through more predictable flows of financing. In 2009 the PA's recurrent budget deficit rose to nearly US$1.6 billion compared to US$1.3 billion in 2008. This was mostly due to the need to respond to the emergency situation in Gaza. The PA recognizes that it cannot sustain such a high deficit and that while donor funding has been generous it will not remain at such a high level. The 2010 budget commits the PA to reducing its recurrent deficit to about US$1.2 billion while also increasing development expenditures to US$670 million. Nearly US$350 million of these expenditures will be committed to community development projects that are a central part of the PA's strategy to spur development and meet the needs of the

population. The PA reports that it has already completed 1,000 of these demand driven projects and aims to complete another 1,000 by the end of 2010. Lack of predictability in external financing jeopardizes the ability of the PA to efficiently manage its expenditures and thus consolidate the gains made to date.
d. **Critical elements of the PA's reform and institutional development agenda focus on improving public financial management and strengthening its fiscal position.** The Ministry of Finance (MoF) continues to steadily improve its public financial management system. It has linked all ministries to the new computerized accounting system, closed non-zero balance bank accounts, and introduced new methods of commitment control. The 2008 financial statements have been compiled and submitted to the external auditor. Public procurement remains an important issue that the Government is pursuing with a new law drafted but not yet adopted. The PA plans to refine the current draft and adopt it in 2010, which will allow the establishment of a new public procurement system based on international best practice.
e. **For fiscal strengthening, the PA is concentrating on pensions, net lending, electricity distribution and municipal finances, which have substantial effects on the budget.** The PA has committed to reform the public pension system and is currently working on a plan to move forward, but the pace of reform needs to be stepped up. On net lending the results are encouraging -- the PA was successful in reducing net lending by over 30 percent between 2007 and 2009 and some 80 percent of the remaining sum was in Gaza, where the PA has little ability to take action. On electricity there is some progress -- a new electricity regulator is operational and the systems for the Northern Electricity Distribution Company are being established. However, more sustained efforts are needed to effectively tackle this issue in the West Bank by transferring electricity distribution from local governments to commercially run distribution companies, as required by the Electricity Law.
f. **The reforms of the electricity distribution system are interwoven with the broader agenda of municipal finances.** In a highly decentralized system, local government units are responsible for delivering extensive services and have a large impact on the PA's fiscal position though net lending and other transfers. Thus, improving the fiscal sustainability and efficiency of service delivery of local government units is a priority. In addressing the net lending issue, the PA has analyzed local governments' fiscal operations and is developing plans to address identified constraints. Important steps, such as increasing and extending property tax collections and creating incentives to improve accounting systems, have been taken. In the longer term, the PA plans to address the inefficiency of the large number of small government units by moving to a more viable structure.
g. **By many measures the PA is well on the way to delivering on its promise to create a Palestinian state that can deliver services and economic prosperity to its population.** Nonetheless, this is not the time for complacency. Concerted action on creating the enabling environment for private sector growth is needed. This implies continued easing of movement and access restrictions by GoI, perseverance on the reform agenda by the PA, and sustained and predictable support by the international community. This period represents an opportunity for all parties – Palestinians, Israel, and the international community -- to rise to the challenge and ensure that the underpinnings of the future state are as solid as they can be.

Introduction

1. **The 13th Government of the PA presented in August 2009 a program entitled "Palestine: Ending the Occupation, Establishing the State" (hereafter referred to as the Program) that lays out the vision, foundational principles, and national goals for the future Palestinian state, as well as institution-building and sector priorities.** The sector priorities are presented in four broad themes – governance, social, economy, and infrastructure – and ensuing policies and programs are classified by the implementing ministries and non-ministerial agencies[1]. Furthermore, Prime Minister Salam Fayyad announced in the March 25, 2010 Local Development Forum meeting his Government's intention to present another document by the summer of 2010 outlining the priorities for the last year prior to the declaration of the state in 2011.
2. **Arguably, one of the most critical current reform areas for the PA is strengthening its fiscal position in order to achieve fiscal sustainability for the future state.** Reforms revolving around fiscal strengthening and improved public financial management are listed in the Program as priorities and have been high on the PA's reform agenda for some time now -- they were also salient in the PA's Palestinian Reform and Development Plan (PRDP) for 2008-2010. Some of the main reforms that aim to strengthen the PA's fiscal position involve the social safety net, pension system, and electricity distribution and net lending[2]. Another set of related reforms aims to increase the efficiency and transparency of government expenditures, in and of itself important but also serving to raise the confidence of donors in the PA's financial systems and facilitating untied budget support. Reforms in public financial management and public procurement are particularly important in this context. This report will therefore provide some background and an update on the progress to date in the implementation of these key reform areas.
3. **Local governments are important actors when it comes to improved fiscal strengthening and greater efficiency of Government expenditures.** Both the PRDP and the Program affirm the important role played by local government units (LGUs) in delivering services to the population and the Government's commitment to developing the capacities of LGUs. In particular, the Program stresses the need to promote the participation of LGUs in the development process, helping them attain financial and administrative independence, and at the same time, promoting accountability of LGUs by developing oversight systems within relevant central institutions. This report will therefore explore in some detail the role played by LGUs, municipalities in particular, both in service provision as well as the impact they have on the fiscal position of the PA.

4. **The PA's focus on institution-building and reform must of course be set in the overall framework of sustainable growth in WB&G.** This report will therefore begin by discussing recent trends in the economic restrictions imposed by the GoI on WB&G. The next section will focus on an analysis of economic and fiscal developments, highlighting the fact that WB&G experienced in 2009 a third consecutive year of economic growth and rising per capita GDP, driven by large inflows of external assistance and a relatively stable security situation. Despite the growth, however, the recurrent deficit rose from roughly US$1.3 billion in 2008 to US$1.6 billion on a commitment basis in 2009, mostly as a result of emergency spending in Gaza in the aftermath of Israel's military operation (Operation Cast Lead, December 27, 2008 -- January 18, 2009) as well as arrears brought forward from 2008 and recognized as commitments in 2009[3]. Given this finding, the discussion in remainder of the report is particularly relevant, focusing on the reform areas of fiscal strengthening and improved public financial management and the important role played by local governments in this regard.

Potential for Economic Revival

Easing of Economic Restrictions

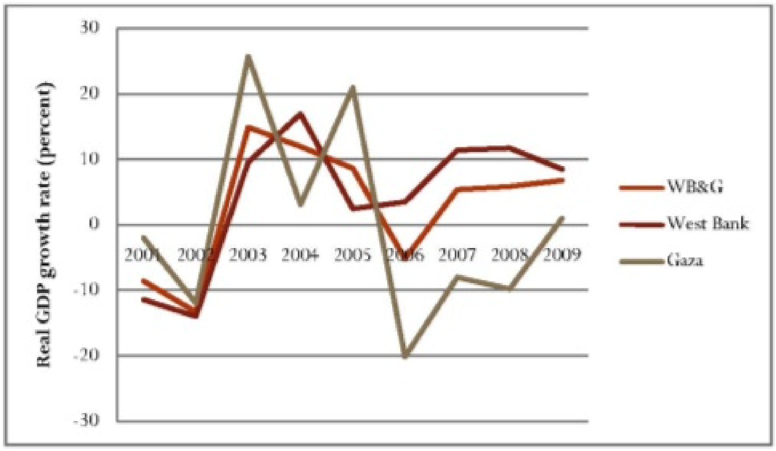
5. **In the West Bank, Israel's upgrading of commercial crossings is welcome but continued restrictions on Palestinian activity in Area C and settlement growth[4] remain significant impediments to economic growth.** With regard to the commercial crossings, the opening of Jalemeh Crossing in Jenin Governorate to Palestinian citizens of Israel is particularly noteworthy and has given a strong boost to the economy in the northern West Bank. This opening was expanded to include vehicular traffic as of October 13, 2009[5]. Nonetheless, the underlying economic restrictions that constrain growth in the West Bank have changed little. Israel remains in control of Area C, amounting to nearly 60 percent of the land in the West Bank, and has not relaxed its restrictions on Palestinian economic activity there, including in the economically valuable Jordan Valley[6]. Despite the declaration of a settlement freeze in November 2009, settlements continue to grow. Since the freeze only applies to new construction, there was a rush to initiate new building immediately before the freeze took effect which in turn allowed construction to continue unabated during the freeze period. According to the Israeli non-governmental organization (NGO) Peace Now, citing information from the Israeli Central Bureau of Statistics (ICBS), there was a 33 percent increase in construction starts in the last quarter of 2009 and a 300 percent increase in construction projects initiated by GoI[7]. According to ICBS data[8], 2009 ended with 1,703 new housing units in the settlements – more than in 2006 and 2007 (1,518 and 1,471 respectively) but less than in 2008 (2,107 housing units). These figures are underestimates of the actual growth because ICBS only counts authorized construction that is officially reported and not outposts or other activity not authorized by the GoI.
6. **The Israeli blockade on Gaza continues, but the GoI has recently allowed entry and exit of some materials for the first time since the blockade began in June 2007 with the Hamas takeover of Gaza.** Under the terms of the blockade imposed by the GoI, barring rare exceptions, only humanitarian goods are allowed to enter Gaza, and no goods are allowed to exit. Thus, food products, including food intended for both human and animal consumption, made up the majority of imports into

Gaza, representing approximately 76 percent of total imports (UN OCHA oPt 2010). However, agricultural imports into Gaza have increased in recent months, with the average number of truckloads of agricultural materials from November 2009 through February 2010 (99 truckloads per month) more than double the average number between January and September 2009. Of particular note is the entry of a total of 103 truckloads of glass into Gaza beginning in December 2009 – the first time that glass has entered Gaza since the imposition of the blockade. Glass was identified as a key priority for entry into Gaza to address the winter needs of thousands of families living in houses with shattered windows as a result of Israel's military operation. In addition, Israel allowed the export of 81 truckloads of cut flowers and 31 truckloads of strawberries in recent months (data as of end-March 2010 and as reported by the Palestine Agricultural Relief Committee). Nonetheless, the movement of Palestinians in and out of Gaza through the Erez and Rafah border crossings with Israel and Egypt respectively continues to be largely restricted. The borders remain officially closed, allowing limited access for medical and other humanitarian cases only.

Recent Economic Developments

7. **Growth in WB&G accelerated in 2009: initial estimates suggest real growth reached 6.8 percent, well above the 5.5 percent projected in the PA's 2009 budget.** Most of the growth was in the West Bank, where the International Monetary Fund (IMF) and Palestinian Central Bureau of Statistics (PCBS) estimate real GDP growth was 8.5 percent. In addition, and despite the continued closure of Gaza, growth there was estimated to be positive at about 1 percent[9]. For 2008, PCBS initially estimated real growth for WB&G at 2.3 percent, which translates to a real per capita decline in GDP. However, PCBS has recently issued revised estimates for 2008 that put real growth at about 5.9 percent for WB&G, implying an increase in per capita GDP (see Figure 1). This means that the 2009 performance is the third consecutive year of per capita GDP growth and may signal that at least the West Bank economy is beginning to recover after years of decline. Nonetheless, growth is still less than what might be expected from an economy recovering from such a low base, where per capita GDP fell by nearly a third since 1999.

Figure 1: Economic growth 2001-2009



Source: PCBS and World Bank staff calculations

8. **The revival of growth in the West Bank is impressive but it is also precarious.** It is being driven by a combination of large sustained inflows of donor assistance, PA government reforms that have increased investor confidence, and the loosening of some Israeli security restrictions. However, the high level of external assistance over the past two to three years is probably the most important factor and sustainable growth requires significant additional loosening of restrictions on movement and access to Area C and other natural resources. In 2009, the PA received nearly US$1.4 billion in budget support coming on top of US$1.8 billion in 2008 and nearly US$1 billion in 2007[10]. The large amounts of budget support have allowed the PA to maintain expansionary fiscal policies to support growth. In 2009, total PA commitments were equivalent to around 52 percent of GDP, with wage expenditures alone around 24 percent of GDP. The importance of government spending in the economy is evidenced by the changing composition of GDP: the share of the mostly government funded sectors -- health and social work, water and electricity, education and public administration and defence -- rose from less than 21 percent in 1999 to almost 30 percent in 2009. In absolute terms, public administration and defence expanded more than any other sector in this period.

9. **In contrast to the public sector, growth in important parts of the private sector has not been as robust**. Between 1999 and 2009, manufacturing output was flat and its share in GDP fell from 12.5 to 11 percent. Output in agriculture fell by 47 percent during the same period, so that its share in GDP declined from 10.4 to 4.8 percent. The PA's reforms that have resulted in improved security and more efficient service delivery along with the GoI's loosening of its security restrictions have significantly increased investor confidence: discussions with the private sector reveal the importance it places on sustaining this loosening through additional measures in 2010. However, there is yet no sign of a large-scale revival of private investment in the productive sectors of the economy. Since 2007, real output in the "manufacturing" and "hotels and restaurants" categories of GDP has increased by 7.3 and 8.5 percent respectively, well below the overall increase of GDP of 13 percent. The biggest jump in private sector activity has been in the construction and real estate service sectors, which have gone up by nearly 28 percent. Based on interviews with financial institutions, PA civil servants and NGO employees form the backbone of this market, which again points to the importance of donor aid in driving the economy. In the face of the PA's projected fiscal retrenchment, it is imperative that private investment take off – and that will require improved access to markets in Israel, East Jerusalem, as well as to Area C.

10. **Despite the ongoing blockade, the IMF estimates that real GDP growth in Gaza was 1 percent in 2009, implying a continued decline in per capita GDP.** Since the vast majority of the Gaza private sector remains moribund, the economy is sustained by government spending and humanitarian assistance. It is unclear how much spending the Hamas authorities undertake, but they have a large security force and a substantial civil service. The PA regularly pays its more than 63,000 employees in Gaza and maintains its large system of social transfers to needy households in Gaza (see further below). In addition to this regular spending, the PA has also undertaken substantial emergency spending in Gaza to offset some of the effects of the recent fighting. In 2009, the PA indicates that emergency spending in Gaza reached US$300 million and has detailed US$142 million in spending to help families who lost their homes, make emergency repairs to utilities, and for other emergency requirements. In addition, the international community continues to provide humanitarian aid for Gaza, led by the United Nations Relief and Works Agency (UNRWA) which provides services for the more than 950,000 registered refugees. Thus, while the Gaza private sector is making a brave effort to survive, it is only the donor funded government spending and direct donor assistance that is averting a humanitarian crisis in Gaza.

11. **Rather than reflecting a recovery of the Gaza economy, the reported 1 percent real GDP growth results from the development of coping mechanisms that have allowed some economic activity to resume on a very limited scale.** The sustained flow of goods arriving through tunnels from Egypt, including fuel, spare parts, and limited inputs, has allowed some production and private sector activities to resume – albeit in the context of an unregulated informal economy. In some cases, industrial production has restarted though on a limited scale and focused solely on the domestic market. Monitoring by the Palestine Trade Center (PalTrade) and

local business organizations finds that employment in the industrial sector has increased from about 2,000 during 2008 to nearly 5,000 at the end of 2009 (see Table 1), well short of the 35,000 employed in June 2007 before the total closure[11]. In many cases, enterprises have transformed themselves to offer different services, such as a construction firm opening a restaurant or changing markets from export to domestic. However, most remain simply closed. A recent survey by the Palestinian Federation of Industries found that only 54 percent of industrial establishments destroyed during Israel's military operation have fully or partially rebuilt and only 23 percent of the workforce was rehired (PalTrade 2010b). The longer the closure goes on the more difficult it will be for businesses to resume normal operations. Capital and infrastructure are deteriorating, customers have switched to new suppliers, firms are unable to retain their skilled workers when they are not operating, and workers are unable to maintain their skills.

Table 1: Gaza – Status of key industrial sectors during three periods

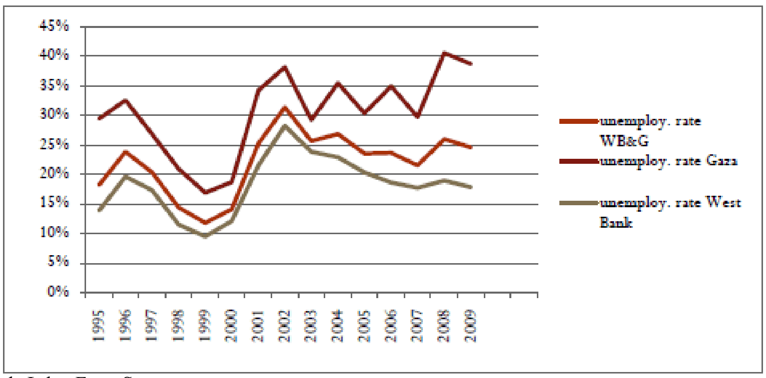
Sector	Indicator	Before Closure (14 June 2007)	During the Closure 2008	Currently Dec 09– Jan 10	Notes
Industry	No. of working establishments	3,900	117	1170 *See notes*	*10% of establishments are working with 20%-50% capacity; 20% operating with around 10% capacity; 70% of industrial establishments are closed*
	No. of workers	35,000	2000	5,000	
Construction	No. of working establishments	125	8	50	(Current scope includes small maintenance works)
	No. of workers	50,000	100	1,500	

Source: Palestinian Federation of Industries and Palestinian Contractors' Union, as reported in PalTrade (2010a)

12. **The resumption of growth in WB&G indicates that there has been a pickup in investment in response to the improved environment.** It is not possible to know the precise level of public investment since most of it is financed from external sources, which are often not reported to the Ministry of Finance (MoF). The original 2009 budget called for US$503 million in development capital expenditures and the MoF reports that an amount of US$216 million was processed through the treasury[12]. There are no published estimates of private investment; however, monetary statistics suggest that there has been an increase. Credit facilities to non-government resident customers at the end of December 2009 were almost 23 percent higher than in 2008. At the same time, deposits only increased by 5 percent, so that the banking sector has increased intermediation and the productive use of available funds. There are other indicators that suggest that investment has increased. For example, the number of business licenses issued in the West Bank in the fourth quarter of 2009 was more than 50 percent higher than in the fourth quarter of 2008. Nonetheless, an analysis of the growing sectors indicates that much of this investment is in real estate, construction, and the public sector – and not in manufacturing, agriculture, or high value added services such as tourism.

13. **Unemployment rates in the WB&G reflect the growth.** In the West Bank unemployment in the fourth quarter of 2009 fell to 18 percent from 20 percent in the same quarter of 2008. At the same time the labor force participation rate rose from 43 to 44 percent. Unemployment also dropped in Gaza, falling from 45 percent in the fourth quarter of 2008 to 39 percent in the last quarter of 2009. However, part of this can be explained by the fact that the labor force participation rate also dropped from 39 to 37 percent. Unemployment in Gaza has also been ameliorated by job creation schemes funded by donors. For example, in October 2009 UNRWA announced that it was doubling its program to create 14,000 job opportunities a month. While there are no recent poverty estimates for WB&G, poverty levels appear to have grown in Gaza since its closure. A recent survey conducted jointly by the Food and Agricultural Organization and World Food Program found that 61 percent of the Gaza and 25 percent of the West Bank population is food insecure.

Figure 2: Unemployment rates, 1995 – second quarter 2009



Source: PCBS Quarterly Labor Force Survey

The PA Fiscal Position

14. **Despite the revival of growth and its extensive reform program, the PA's recurrent deficit increased in 2009, mostly as a result of emergency spending in Gaza in the aftermath of Israel's military operation.** The recurrent budget deficit on a commitment basis was nearly US$1.6 billion, up from US$1.3 billion in 2008 and almost US$143 million more than projected in the revised 2009 budget. Most of the deficit growth can be attributed to the emergency situation in Gaza, which forced the PA to add US$300 million to the budget mid-year. In addition, about US$141 million in arrears were brought forward from 2008 and reported as 2009 commitments. Thus, commitments actually incurred in 2009 were below the revised budget. Nonetheless, wage expenditures exceeded the budget by about 2

percent, mostly due to compensation provided to public employees for the interest paid on loans they incurred in 2006 when the PA was unable to pay salaries.

15. **The original 2009 budget called for donor support of US$1.15 billion to fund the recurrent deficit and another US$503 million for the development budget.** It was hoped that there would be an improvement in the quality of the budget compared to previous years by beginning to shift donor funding from recurrent costs to development expenditures. In September 2009 the projected support necessary for the recurrent and development budgets was raised to US$1.45 and US$1.1 billion respectively to respond to the needs in Gaza. However, at the end of the year the recurrent deficit was nearly US$1.6 billion and including development spending made the overall deficit more than US$1.77 billion. Only about US$1.36 billion in budget support and another US$390 million in development financing materialized. Consequently, the PA was forced to turn to borrowing from local banks and accumulating arrears of US$221 million. In addition, development expenditures through the Central Treasury Account on a commitment basis were only US$215 million.[13] Thus, because of the emergency in Gaza, there was no significant shift of external resources from recurrent to development expenditures in 2009.

16. **The recently released 2010 budget commits the PA to resuming the path to less dependence on donor support for recurrent expenditures.** The budget projects a recurrent budget deficit of US$1.2 billion and US$670 million in development expenditures. However, these projections are based on strong assumptions and will require discipline on the PA's part. The projections assume real GDP growth of 7 percent and that the PA will be able to increase domestic revenues by almost 21 percent through improved tax collection. They also assume that the PA will be able to maintain the same level of non-wage expenditures that it did in 2009, even though non-wage expenditures have been growing rapidly and nearly doubled between 2007 and 2009. Finally, the PA's decision to give a general 4 percent wage increase to public sector employees has increased the budget[14]. However, the share of the wage bill in GDP is expected to decline from 24 percent in 2009 to 22 percent in 2010.

Improving Public Finance Management

17. **As mentioned in the introduction, related to the reforms that strengthen the PA's fiscal position are reforms that increase the efficiency and transparency of Government expenditure, i.e. reforms in public financial management (PFM) and procurement.** The PA has a strong track record of strengthening its PFM system in order to ensure that government resources are managed in a transparent and accountable manner. The reforms that started in 2002 gathered pace following the formation of the Caretaker Government of Prime Minister Salam Fayyad in 2007. The initial focus of the Caretaker Government was on ensuring that cash controls were operating effectively, while more recently attention has been given to improving the budget preparation procedures, and the accounting and reporting of government expenditures.

18. **In preparing the 2010 budget a number of advances were made.** For the first time the PA received expenditure requests from budget units through a shared database. It also took another step on the path towards a program based budget by updating the accounting system so that it can capture expenditure information at the level of programs. For the 2011 budget the MoF intends to introduce a new budget classification based on international standards. It is also establishing a fiscal forecasting unit that should help the MoF align the budget with its fiscal policy objectives. This should also assist in improving the timeliness with which the budget is prepared.

19. **In recent months a range of improvements have also been made to the way that the budget is executed.** These reforms have strengthened the MoF's control of expenditures, increased the quality of accounting and reporting, and allowed financing costs to be contained. In particular:

i. The computerized accounting system now connects the MoF with all line ministries and governorate offices and a robust system of access controls has been implemented. The system includes a procurement module and provides better control and reporting on budget execution. Coupled with improved internal audit capacity, the MoF is now able to devolve responsibility for a greater range of financial management tasks to the line ministries.

ii. A commitment control system has been introduced to provide MoF with more control over expenditures in 2010. The system will allow MoF to better align expenditures with available cash resources, and will help in reducing the stock of expenditure arrears.

iii. Further steps have been taken to consolidate cash management in the Central Treasury Account. "Zero-balance" bank accounts are now operating in all ministries – and all non-donor related bank accounts of line ministries are now closed.

20. **In another significant step, the MoF completed in December 2009 the preparation of the 2008 financial statements and submitted them to the State Audit and Administrative Control Bureau (SAACB).** The SAACB is auditing the statements with the support of the Norwegian audit body, and Deloitte. In preparing the financial statements the MoF used the cash based International Public Sector Accounting Standards (IPSAS) as a guide. This is the first time that the PA has produced closed financial statements based on international standards. It was able to meet many of the requirements of IPSAS with the 2008 statements, and hopes to meet most if not all of the standards in the presentation of the 2009 financial statements.

21. **Developments have also occurred in the tax administration system.** These changes have improved the effectiveness of enforcement activity since mid-2009 and in conjunction with the stronger economy there has been a noticeable increase in the taxes being collected. Further reforms are proposed for the tax administration system with technical support being provided by the United States Agency for International Development and the IMF.

22. **Solid progress has been made in recent years in improving the PFM system but the task is becoming more challenging as more complex issues are being encountered.** The PA needs to maintain its focus on improving the PFM system so that the achievements to date are entrenched and progress continues to be made. Particular areas for improvement include:

i. Continuing to strengthen the link between the cash plan and the commitment control system to reinforce the control of expenditures;

ii. Increasing the focus on the quality of budget expenditures by developing the analytical capacity in the MoF for challenge and review, and clarifying the roles of sector ministries in the preparation and management of the development budget – especially the community development projects;

iii. Approving the budget before – or soon after – the start of the fiscal year to support budget execution and provide more certainty for sector ministries and the providers of budget support; and

iv. Using the opportunities provided by the new accounting system to continue improving the quality and range of reports on fiscal operations.

Public Procurement

23. **In 2002, the PA began preparation and implementation of major reform programs in areas of governance, in general, and public procurement, in particular (World Bank 2004).** Today, the public procurement system in WB&G is regulated by two separate laws: Procurement Law No. (9) of 1998 (or General Supplies Law) and Law No. (6) of 1999 on Public Works Tenders. The first law governs procurement of goods and services, while the second one regulates procurement of construction. The General Supplies Law was supplemented by detailed regulations, while there are no such regulations under the Public Works Law. A 2004 World Bank Country Procurement Assessment Report analyzed the public procurement legal framework, assessed the related institutional and organizational aspects, and identified some important gaps in the above-mentioned laws. In particular, identified gaps include the: (i) lack of a single agency or central authority to set uniform and consistent policy, rules, and procedures in public procurement; (ii) absence of specific rules governing the procurement of consulting services; and (iii) lack of rules and procedures on dispute resolutions.

24. **The PA undertook the enactment of a new public procurement law and regulations, and the first draft, introduced in February 2006, was fully aligned with**

international practices. However, the law has since undergone several revisions, partly as a result of stakeholder consultations, so that the ratification and enactment of the law and regulations have been delayed. Once the law is ratified, the PA will be able to proceed with further steps, including enacting the supporting regulations for the new law, establishing an independent Public Procurement Authority, initiating national standard bidding documents, instituting a training program across the Government, in addition to additional measures necessary to make the law effective.

Strengthening the Fiscal Position

25. As previously mentioned, arguably one of the most critical current reform areas for the PA is strengthening its fiscal position in order to achieve fiscal sustainability for the future Palestinian state. This section looks in some detail at three areas – the social safety net, public pension systems, and electricity distribution and net lending – that have a significant impact on PA finances and where the PA has embarked upon a reform path to reduce or at least improve the efficiency of spending. The discussion will demonstrate that progress in implementing reforms has been achieved, in some instances more than others, and comment on future directions.

Social Safety Net

26. **The PRDP highlighted that social assistance in WB&G is provided through a complex web of PA organizations (including at least 3 ministries), NGOs, and other external agencies implementing a series of uncoordinated initiatives, including cash assistance and food aid, and that this has "inevitably led to wastage of resources and poor targeting of assistance" (PA 2007, page 56).** The PRDP deemed a coherent reform of the social safety net as essential, leading to an overall social assistance strategy with improved equity, efficiency, and effectiveness of social protection. The Ministry of Social Affairs (MoSA), one of the first operating ministries of the PA, administers two of the main on-going cash assistance programs: the European Union (EU)-funded Special Hardship Case (SHC) and the World Bank-funded program under the Social Safety Net Reform Project (SSNRP). Together, these two programs provide over US$50 million annually to roughly 57,000 poor households[15]. In the case of the SHC, the assistance takes the form of an allowance of NIS 1,000[16] per household every 3 months. Under the SSNRP, families receive a minimum of NIS 228 and a maximum of NIS 500 per month.

27. **In early 2009, the PA cabinet approved the merger of the EU-funded SHC and the World Bank-funded SSNRP program into a Palestinian National Cash Transfer Program (PNCTP) administered by MoSA.** This formal merger triggered the preparation of the PA's cash assistance strategy outlining the main components of the PNCTP, including a PNCTP targeting database, uniform payment modalities and amounts irrespective of funding source, and sound PNCTP monitoring and evaluation arrangements, amongst others. MoSA's draft cash transfer strategy was prepared in a participatory manner that outlined the steps needed to make the merger a reality. Furthermore, MoSA has made significant progress in implementing it. First and foremost, MoSA has committed to using the technique of "proxy means testing[17]" to identify those households eligible for cash assistance, and is in the process of instituting a uniform payment level (depending on household size and welfare status), regardless of the source of funding. Once MoSA completes these reforms, the PA will have one of the most advanced cash assistance programs in the Middle East and North Africa (MENA) region in terms of targeting, coverage, and ease of scaling up in the event of a crisis.

28. **The PRDP stressed that reforms to the social assistance programs are envisioned both to improve the efficiency as well as sustainability of these programs.** MoSA has updated the proxy means test formula using data from the 2007 Household Consumption and Expenditure Survey by PCBS, which has led to the determination that 1,500 households are no longer eligible for cash transfers. Unfortunately, application of the updated proxy means test formula in Gaza is delayed given the ongoing political situation. MoSA is therefore continuing to provide cash assistance to all households who previously benefited from the SHC and the SSNRP while at the same time exploring creative options to update the Gaza share of the PNCTP. Of course, while some households may exit the assistance program, others may enter, so that MoSA is accepting applications by new households. MoSA is also looking at ways to provide other types of assistance to households that are no longer eligible for cash benefits. In this regard, the EU and the World Bank are conducting a policy dialogue with and providing significant technical, managerial, and financial support to MoSA around the need to allocate available resources to the neediest families first as well as the amount of household benefit in order to begin to address issues of sustainability of the social assistance programs.

Public Pension System

29. **The PA's public pension system is a generous pension system with early retirement provisions, high benefit accrual rates, and provision of allowances not pertinent to retirement (World Bank 2003).** Budgetary pension expenditures accounted for about 4 percent of GDP in 2008, higher than the average in the MENA region and well above the GDP share in countries with similar GDP per capita, which range from 0.1 to 2 percent. The population of WB&G is very young, with only around 3 percent of the population over 65 years of age, so that the fiscal burden of the pension system will increase as the population ages. The fragmentation of the information on the pension system between the Palestinian Pension Authority and the MoF prevents the calculation of accurate pension liabilities, but preliminary MoF indications suggest that these liabilities are in the range of US$1.5-2 billion.

30. **Pension reforms began as early as 1998 when the PA began the gradual integration of the two civil service schemes that it had inherited from Jordan for West Bank civil servants and from Egypt for Gaza civil servants (World Bank 2010c).** In 2001 the West Bank scheme was closed to new entrants and all new civil service recruits were enrolled in the Gaza pension scheme. A new scheme was enacted in 2005 by the Unified Pension Law (UPL). The current pension system covers approximately 74,367 civil servants and 63,194 security personnel as of June 2009, together accounting for around 16 percent of the total labor force in the PA and 7 percent of the working-age population (ages 15-64 years).

31. **The PA has recently put in place some reforms to the existing public pension system, e.g. the decree issued by the MoF in 2009 requiring all ministries to comply with the career paths and promotions defined in the civil service regulations.** These guidelines stipulate that all civil servants must remain in each grade for a minimum of five years before being eligible for promotion, and in the case of security service personnel, a minimum of four years. In addition, all pensions, as of January 1, 2009, are calculated using the average of three years of wages to determine the pensionable salary. As such, artificial end-of-career salary increases that have a negative effect on pension liabilities are eliminated. Furthermore, no promotions are granted in the year before retirement. However, in order to improve the long-term financial situation of the pension system, a full overhaul of the existing system is necessary. In parallel, the PA is exploring some parametric adjustments for the short-term, including:

i. gradually increasing the retirement age;
ii. eliminating early retirement provisions or introducing actuarially fair reduction factors;
iii. reducing the accrual rate;
iv. reducing or eliminating some of the benefits, such as lump sum payments; and
v. substantially limiting or eliminating the possibility of purchasing years of service for civil servants with interrupted service in order to be eligible for a pension.

32. **The PA has committed to preparing a pension reform action plan and exploring some of the pension reform options outlined above, thereby making the UPL more sustainable.** The World Bank recently reviewed legal and institutional arrangements of the pensions system and provided up-to-date medium-term financial projections of pension liabilities for the 30- to 50-year timeframe, with and without parametric adjustments. The challenge facing the PA now is to use the existing analysis -- taking into account the current prevailing social, economic, and political context -- and choose a policy reform option that will best reduce the unfunded public pension liabilities while creating the preconditions for expanding system coverage in the future.

Electricity Distribution and Net Lending

33. **Despite a recent substantial reduction, the cost of subsidizing citizens' consumption of electricity continues to represent a significant drain on Government financial resources.** This is primarily driven by the "net lending" phenomenon in the electricity sector which arises due to the non-collection (by utilities and municipalities) of electricity bills, and the diversion of utility revenues to fund municipal operations. This behavior forces the central government to fund payments to the Israel Electricity Company (IEC) for bulk purchases of electricity in order to avoid service disruption. Increasing collection rates is vital to allow the PA to reduce net lending and to provide the utilities with the funds necessary to maintain the grid and expand to meet growing demand. Net lending began accelerating rapidly in 2006 and by 2007 was accumulating at a rate of approximately US$50 million per month; the PA and IMF estimate that it reached about US$535 million or nearly 11 percent of GDP in 2007. Since then, due to strong efforts by the PA, it has fallen to US$374 million or 6.1 percent of GDP in 2009[18]. Most of this decline is due to Government policies of encouraging improvements in electricity collections and payments to IEC by the local authorities in the West Bank. Major West Bank contributors to past net lending for electricity – the cities of Nablus, Hebron, Jenin, Qalqilya, and Tulkarem – have reportedly in the past few months raised their payments of IEC bills steadily. Going forward, the PA plans on intensifying its efforts to increase collection rates in Gaza from those households who can afford to pay. However, the IEC and Israeli Ministry of Finance do not provide information on the bills or payments of Palestinian local governments to the Palestinian MoF, so that the Palestinian MoF is unable to make an accurate assessment of electricity net lending.

34. **The electricity distribution system in the West Bank remains highly fragmented as many municipal and village councils have resisted transferring their electricity assets and services to regional electricity distribution companies, set up to operate as commercial entities, independent of the municipalities that own them, and with the goal of raising collection rates and increasing investment in the sector (PA 2004).** Exceptions are the network in the Jerusalem area, which has been managed by the Jerusalem District Electricity Company (JDECO) since 1927, and the distribution networks in the Gaza Strip, which were transferred in 1998 to a regional utility, Gaza Electricity Distribution Company (GEDCO), owned jointly by the municipalities that used to run the networks. Other components of the distribution system were managed until 2003 by individual municipalities, each running the network within its own boundaries and despite relatively high electricity tariffs, the distribution system was poorly maintained by selected municipalities. Since then, the Hebron Electricity Distribution Company (HEDCO) and the Southern Electricity Company (SELCO) were established in the southern region of the West Bank. And in 2008, the Northern Electricity Distribution Company (NEDCO) was established by the PA -- several steps were taken to make it operational, though it has yet to distribute electricity. In fact, both SELCO and NEDCO still do not operate effectively partly since local governments have been unwilling to transfer their electricity assets and give up the revenue they generate.

35. **In terms of collection of electricity bills, a culture of non-payment has taken hold in large parts of WB&G and the PA has taken steps to increase collection rates and re-establish a culture of payment.** The PA has initiated a system of requiring citizens to show "certificates of payment" attesting that they are current on utility bills in order to receive some government services. The PA has also begun directly deducting utility payments from the pay checks of delinquent PA employees. However, by far the most effective step to date has been the introduction of pre-paid meters: nearly 150,000 meters have now been installed and the PA has secured funding for another 140,000 to be installed by 2011.

36. **Collecting utility revenues is only half the equation: once they are collected, they must be used to pay for the electricity that is distributed to consumers.** Unfortunately, the established distribution companies have been less successful than hoped because, in some cases, they are not operating as independent companies and their municipal owners continue to tap their funds to run municipal operations. In the case of the newly formed NEDCO in particular, the local governments that are most reliant on electricity fees have not been willing to turn over electricity distribution to the new company. In order to ensure that all electricity distribution is indeed moved to the distribution companies and that these operate as commercially independent companies that pay all costs before distributing dividends to their owners, a new electricity law became necessary giving wider regulatory power to the Palestinian Energy Authority.

37. **The new General Electricity Law was approved by Palestinian President Mahmoud Abbas in April 2009, requiring the establishment of electricity distribution companies and the transfer to these utilities of the electricity assets of municipalities and village councils no later than May 2010.** After some delay, progress has been made in the establishment and approval of the Board of the Palestinian Electricity Regulatory Council, which is required in order to provide the legal underpinning to the selected method for asset revaluation and payment of dividends to municipalities, as well as for issuing of licenses for the distribution companies that will take over these service areas. However, less progress has been made in the transfer of electricity assets to the distribution companies as required by the Electricity Law. The main obstacle for the transfer of electricity assets to the distribution companies has been the reluctance of many municipalities and village councils to relinquish their revenues from electricity sales, on the grounds that their financial situation would be seriously unsustainable without them. Therefore, in the coming months, the PA will need to undertake the following measures:

a. Issue licenses for distribution companies in accordance with the new Electricity Law;

b. Prepare a time-bound comprehensive strategy to transfer West Bank electricity supply and distribution services to the distribution companies; and

c. Develop a municipal finance plan to mitigate, for a transitory period, loss of revenues by municipal and village councils due to transfer of their electricity services to the distribution companies and to provide them as well with incentives for joining the distribution companies.

Municipalities: Contribution to Service Delivery and Fiscal Impact

38. **In the PRDP, the PA expressed a commitment to bring "government closer to the people by ensuring that local government is both empowered and accountable" (PA 2007, page 22).** Several reforms were envisioned, including introducing new legislation to clarify and regulate the relationship between central and local government; establishing a policy framework that promotes fiscal autonomy and discipline at the local level; and building the operational, administrative, and financial management capacity of local government bodies. The PRDP's focus on local government is an indication both of their importance in delivering services to the population as well as their impact on the fiscal position of the PA. Fiscally sustainable local governments that deliver quality services are essential for any future Palestinian state.

39. **There are three different types of local government units (LGUs) in WB&G: municipalities (132), village councils (235), and project committees (115).** The Law on Local Authorities of 1997 brought all three forms of local governments under one regulatory legal framework. To distinguish between different municipalities, the Law divided them into four main categories, based mostly on population criteria, location and date of establishment (see Table 2). Class A and B municipalities have extensive experience in local administration and generally perform well, both in terms of service provision and revenue generation for their expenditures. The experience of class C and D municipalities has been mixed, some performing well but others poorly.

Table 2: Classification of local government units

Category	Number	Date of Establishment	Population
Class A municipality	14	Governorate centers	------
Class B municipality	25	Prior to 1994	------
Class C municipality	41	After 1994	over 15,000
Class D municipality	52	After 1994	between 5,000 and 15,000
Village councils	238	------------	less than 3,000
Project committees	127	Very small communities	
TOTAL	497		

Source: World Bank. 2010b. *West Bank and Gaza: Municipal Finance and Service Provision.*

40. **Following the establishment of the PA in 1993, the number of municipalities in WB&G jumped from 30 to 132, an increase due to political rather than functional considerations.** Therefore, not all have the capacity to function as municipalities, raising revenues and managing financial accounts as a public service agency (UNDP 2004). The Ministry of Local Government (MoLG) also established village project communities in small communities to act as local authorities on its behalf (MDLF/MoLG 2009). During the mid- 1990s, the MoLG also upgraded some village councils to municipalities and provided them with revenues and representation (replacing mukhtars with elected councils) that they did not previously enjoy. Starting in 1997, the MoLG also established Joint Services Councils (JSCs), intended to improve economies of scale and quality in provision of some services, the most effective of which is for solid waste collection. There are a total of 86 but not all operate effectively.

Table 3: Historical overview of the Palestinian local government system

	Ottoman Period 1516-1917	British Mandate 1917-1948	Jordanian Administration 1948-1967	Israeli Occupation 1967-1994	1994-1997	2000	2003	2004	2010
Municipalities	22	62[a]	25	28	86	95	96	121	132
Village councils			87	87	197	212	214	252	235
Project committees					98	111	128	130	115
Total	22	62	112	115	381	418	438	503	482
JSC						42	51	86	86
TOTAL	22	62	112	115	381	460	489	589	568

Source: Joint Services Councils Department, Ministry of Local Government

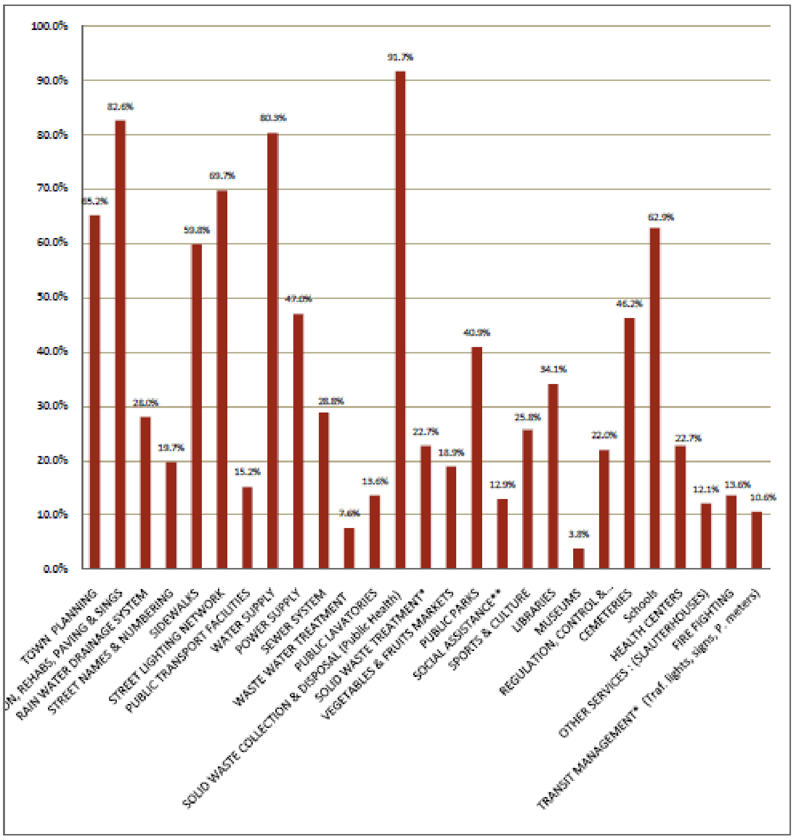
[a] Of which 38 were local councils, i.e. intermediate in size between a municipality and a village council

41. **The proliferation of local governments and the existence of many small municipalities that lack the capacity to deliver services and achieve economies of scale in service provision has become a central concern for the PA.** As part of its local government reform agenda, the PA is promoting amalgamation of local government units and in 2009 developed an amalgamation strategy (MDLF/MoLG 2009).

42. **Although the law assigns some 27 different functions to municipalities, there are just six core services that most provide: (a) solid waste, (b) street maintenance, (c) water, (d) road maintenance, (e) school maintenance (includes building new classrooms, school supplies, etc.), and (f) street lighting.** Electricity distribution (by 46 percent of municipalities), public parks (40 percent), and libraries (34 percent) are also municipal services[19] (World Bank 2010b). Those services with large social impacts such as health, education, and social services, as well as services with direct local effects are not legally assigned to municipalities. In many countries, at least certain aspects of such services, such as emergency services for the health sector, kindergarten services for the education sector, and some social services addressing local problems, are assigned to local governments. In addition, some key services that according to international standards are typically provided by municipalities, such as traffic management, fire fighting, and wastewater treatment, are rarely provided. Figure 3 provides an overview of municipal services and the percentage of municipalities that provide them, showing that most municipalities provide a handful of core services, while many services such as slaughter houses, traffic lights, sewer systems, and museums are not provided.

43. **To cover the costs of these services, municipalities are able to generate revenues from various sources, some collected on their behalf by the central authorities and others collected by them.** Table 4 summarizes the sources of financing available to municipalities. Yet despite the availability of this range of revenue sources, municipalities are not able to generate sufficient financing to cover their expenditures. A large part of municipal budgets (90 percent) are spent on operating costs, primarily to cover salaries, and municipalities have limited resources for capital investments (World Bank 2010b). By international standards this constitutes an insufficient allocation for public investment on the part of municipalities.

Figure 3: Percentage of municipalities providing a given service



Source: World Bank. 2010b. *West Bank and Gaza: Municipal Finance and Service Provision.*

44. **Municipalities have difficulty in recovering their service costs.** As levels of unemployment and poverty have risen, many Palestinians are unable to pay for municipal services. Furthermore, there is widespread free-rider behavior and unwillingness to pay due to consumers' low satisfaction with municipal service provision. Even once well-performing municipalities are now unable to raise enough revenues to provide adequate services and recover their costs. Some services, such as solid waste management, are a public good and are therefore subsidized through other revenue sources: per capita expenditures for solid waste are three times larger than the revenues it generates (World Bank 2010b). In part, this is because of the difficulty in enforcing fee collection but it is also because the service charge is low. Consequently, 65 percent of municipalities are currently running budgetary deficits that cannot be sustained -- only 38 of the 132 municipalities have operational surpluses and only 25 have balanced budgets (World Bank 2010b).

Table 4: Revenue sources of local government units

Revenue source	Collection Responsibility
LGU revenues collected by the central government (MoF)	
Property tax	MoF evaluates and collects property taxes on behalf of municipalities and transfers 90% of the revenues collected.
Profession and industry fees	MoF collects fees on behalf of LGUs and transfers 90% of the revenue collected.
Transfers from the central government	
Transportation fees and fines	MoT collects fees for motor vehicle licenses and traffic violation fees are collected by police and 50% of revenues generated are allocated to municipalities by MoF on the basis of the MoLG's recommendations and cabinet decision.
Emergency transfers	Cabinet may decide to allocate transfers for emergency situations on the basis of the MoLG's recommendations.
Fees collected by LGUs	
Construction permit fees	Municipalities may collect fees for construction permits. Village councils collect "commissions" for construction permits, but the fees are collected by MoLG's regional branches on their behalf.
Public property rents	LGUs collect rent for the lease of their properties.
Craft fees	Professional and business license fees are collected by municipalities. This duplicates the profession and industry fees collected by MoF.
Signboard fees	These are collected by municipalities.
Public market fees	Those municipalities with public markets collect the fees.
Other user fees	Municipalities (or Joint Councils) collect fees for the provision of relevant public services (e.g., solid waste collection).
Personal (poll) tax	Collected by some municipalities from adult males (based on Jordanian law).
Education tax	This tax is based on a Jordanian regulation, for the rehabilitation and maintenance of schools and provision of school supplies.
Utility fees collected by LGUs	
Water fees	LGUs provide water services by purchasing it from the Israeli water supply company and charge user fees. When surplus is generated municipalities use it to subsidize operating costs (often salaries).
Electricity fees	LGUs provide electricity services by purchasing it from the Israeli Electric Company and charge user fees. When surplus is generated municipalities use it to subsidize operating costs (often salaries).

Source: Ministry of Local Government. March 2009. *Local Government Financial Policies.*

45. **Municipal leaders do not have an accurate picture of the financial health of their institution due to the accounting methods applied.** Most municipalities use a cash-flow based accounting system that does not take into consideration actual bills to be paid, debts owed or to be paid, the depreciation of assets, or their investment costs. With the support of the Municipal Development and Lending Fund (MDLF), the MoLG has prepared a new chart of account for municipal budgets in use since 2008 and is currently rolling out an accrual based accounting system that will enable municipalities to have a much clearer understanding of their fiscal situation and allow them to plan and manage their finances better.

46. **Whether a municipality provides electricity or not has a direct impact on the budgetary constraint it faces and therefore on its expenditure on other services and the resulting quality of delivery of these services.** On average, in 2008, the services and public works with the largest per capita expenditure in municipalities included (World Bank 2010b): (i) electricity (NIS 96.80); (ii) water supply (NIS 38.36); (iii) solid waste (NIS 36.92); (iv) street maintenance (NIS 16.01); and (v) roads (NIS 11.76). However, when considering municipalities that provide electricity and therefore face a soft budget constraint since they can tap into electricity bill revenues separately from those that do not provide electricity, a different picture emerges. Those municipalities facing a soft budget constraint spend significantly more, in per capita terms, than the other municipalities, in particular on water, roads, and streets. It may therefore be inferred that future municipal fiscal restructuring due to the transfer of electricity distribution to distribution companies will have, at least in the short-term, an impact on the provision of these three services.

47. **Since municipalities currently use cash-flow based accounting, they often confuse fees that they have collected for utility sales, especially electricity, with profits.** This is especially the case for those 58 municipalities that provide electricity services. These municipalities are running accrual operating deficits greater than 50 percent of their budgets (World Bank 2010b). They have been using the income from the service to cover other expenditures (primarily salaries) and not paying the IEC (especially between the years 2000 and 2008) which in turn deducted the unpaid amount from the clearance revenues due to the PA MoF. This diversion has been considerably lowered since 2008, following efforts by the PA to introduce fiscal discipline. Comparing those municipalities providing electricity to those who do not, a clear pattern emerges. Because municipalities that are electricity providers have soft budgetary constraints, they are characterized by poorer financial performance. As non-providers face hard budgetary constraints, they have noticeably better fiscal management: higher surpluses, more diverse sources of revenue, and higher collection rates (World Bank 2010b).

48. **Current efforts by the PA to transfer electricity provision from municipalities to utilities are a step in the right direction and indeed there seems to be wide consensus among municipal leaders on the value of this reform.** In the interim period, however, measured support including temporary financial assistance is required to ensure that service delivery to citizens will not be impacted and so that municipalities can enhance their revenue collection in other areas. Thus, key areas of focus for the new local government draft strategy include (MoLG 2010):

i. continuing the work of enhancing the administrative, financial, and technical capabilities of local governments;

ii. restructuring local governments, especially working towards consolidation of LGUs;

iii. improving the legal framework and institutional structure of local governments; and

iv. enhancing revenues of local governments.

49. **Reform of the legal framework is necessary since it assigns the central government strong formal controls over the local governments even though local governments rely little on the central government in raising their revenues and delivering services.** The legal framework for municipalities (based primarily on the Law on Local Authorities of 1997) grants significant authorities to the central government, primarily the MoLG in its role as the sector regulatory agency, including provision for approvals of a wide range of activities ranging from planning, budgeting, and revenue raising activities. Local governments have little or no control over setting the base or the rates for their various taxes and service charges. The MoLG must approve all such fees and taxes before they are put into effect. There is also no provision in the law that requires local governments to set user fees at a level that covers the cost of service or addresses the possibility of local government solvency (UNDP 2004). The current draft local government strategy under review by the PA recognizes the tension between overemphasizing local governments' accountabilities to the central government versus to the citizens who have elected them (World Bank 2006). The draft strategy therefore sets gradual but deliberate

moves towards decentralization as an important objective.

50. **The 1997 Law on Local Authorities also includes many provisions that remain unclear, such as the criteria for determining the functions and powers of LGUs or the resources that are allocated to them (UNDP 2009).** Thus far, little progress has been made on the reform of this Law, although the need for reform was recognized and set as an important goal by the MoLG since 2004. In part, this is due to a lack of a clear vision about the role, shape, and form local governments should take. Both enacted and planned amendments to the Law continue to reflect a clear centralizing (rather than decentralizing) attempt by the MoLG through increased financial oversight and control over LGUs and establishing LGU salary scales or approval of new appointments, as well as the authority of the Minister to dismiss elected local councils under certain conditions.

Concluding Remarks

51. **The above discussion and analysis has documented the substantial progress made by the PA in implementing reforms in public financial management and fiscal strengthening while also acknowledging the need for significant further steps.** The goal is clear: a Palestinian state that can deliver services and economic prosperity to its population. By many measures, the PA is delivering on much of this promise at this stage already. Nonetheless, this is not the time for complacency. Instead, prioritization of and concerted action on reform measures is essential, and this report argues that strengthening the PA's fiscal position must rank high as a priority. This period therefore represents an opportunity for all parties – Palestinians, Israel, and the international community -- to rise to the challenge and ensure that the underpinnings of the future state are as solid as they can be.

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Endnotes

[1] Perhaps recognizing that the list of sector priorities in the Program is extensive, the PA presented in January 2010 another document entitled "Palestine: Moving Forward – Priority Interventions for 2010" that highlights 201 development projects identified as high priority interventions to be initiated or continued in 2010 in order to implement the Program. While some identified projects are already funded and have begun implementation, others are either partially or totally unfunded. The Ministry of Planning and Administrative Development has undertaken to follow up with international partners to secure the remaining necessary funding.

[2] "Net lending" refers to a phenomenon in the electricity sector which arises due to the non-collection (by utilities and municipalities) of electricity bills, and the diversion of utility revenues to fund municipal operations, forcing the central government to fund payments to the Israel Electricity Company (IEC) for bulk purchases of electricity in order to avoid service disruption.

[3] About US$141 million in arrears from 2008 was recorded as commitments in 2009. Thus, commitments actually incurred in 2009 were slightly below the budget.

[4] On the impact of settlement growth on the Palestinian economy, see World Bank. 2007. *Movement and Access Restrictions in the West Bank: Uncertainty and Inefficiency in the Palestinian Economy.*

[5] Information provided by the Israeli Ministry of Foreign Affairs.

[6] There have been a handful of Palestinian development projects, e.g. a landfill in the Jenin Governorate, allowed by Israel to proceed in Area C after long and difficult negotiations, usually involving international partners. In general, it is not possible for Palestinians to access Area C for significant public or private investment.

[7] Peace Now. March 2010. *Steep Rise in Construction on the Eve of the Freeze*. Available at www.peacenow.org.il/site/en/peace.asp?pi=61&docid=4598&pos=0

[8] Ibid.

[9] PCBS has not yet published GDP estimates for West Bank and Gaza separately. These figures are based on IMF estimates.

[10] These figures do not take into account hundreds of millions more in aid that have flowed into the economy through the United Nations and from bilateral assistance programs.

[11] Employment in 2007 was already depressed since even then it was costly and difficult to import and export.

[12] The revised budget increased the need for development expenditures by US$600 million to finance reconstruction in Gaza. The PA has indicated that it now estimates that there were about US$400 million in development expenditures of which roughly US$185 million were implemented directly by donors outside the budget. [i]

[13] The MoF tables report only $45 million in development financing and $215 million in development expenditures. The MoF reports that $10 million in community development projects were financed from the Central Treasury Account. The remaining expenditures were financed from aid received in previous years but not recognized in those years because previously the MoF only recognized development financing when it was spent. In 2009, the MoF changed to a practice of recognizing development financing when it is received. In addition, the PA estimates that there is US$185 million in development projects directly financed by donors.

[14] The PA recognized that public sector wages were higher than in the private sector and unsustainable. To deal with this challenge the PRDP committed the PA to having no general wage increase and allowing inflation to slowly lower real wages. However, due to unexpectedly high inflation of nearly 10 percent in 2008, the PA provided a 6 percent wage increase in 2009. Inflation in 2009 was only about 2.75 percent. The 4 percent general wage increase provides a real wage increase for most PA employees.

[15] In addition to these two PA-administered programs, UNRWA provides cash assistance to roughly 30,000 poor refugee households.

[16] On March 27, 2010, the exchange rate was US$1 = NIS 3.75.

[17] This technique was used under the SSNRP program and an eligibility review suggests that a large majority (87 percent) of SSNRP beneficiaries belong to the poorest 25 percent of the total number of applicants for the MoSA cash assistance program – indicating an acceptable level of targeting.

[18] The PA reports that net lending in the West Bank fell from US$350 million in 2006 to US$70 million in 2009.

[19] With the approval of the Electricity Law in 2009, municipalities will no longer be providing electricity services.