

SUSTAINING ACHIEVEMENTS IN PALESTINIAN INSTITUTION-BUILDING AND ECONOMIC GROWTH

ECONOMIC MONITORING REPORT TO THE AD HOC LIAISON COMMITTEE

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CONTENTS

Acronyms	4
A. Executive Summary	5
B. Introduction.....	6
C. Recent Economic and Fiscal Developments.....	7
C.I. Growth and Employment.....	7
C.II. The PA’s Fiscal Position	9
D. Institutional Capacity	13
D.I. Security and Justice	13
D.I.a. Security.....	13
D.I.b. Justice.....	14
D.II. Revenues and Expenditures	17
D.II.a. Public financial management.....	18
D.II.b. Civil Service	20
D.III. Economic Development	22
D.III.a. Investment climate	22
D.III.b. Banking and Finance	24
D.III.c. Infrastructure	25
D.IV. Service Delivery	27
D.IV.a. Health.....	28
D.IV.b. Education	29
D.IV.c. Social Protection	30
D.IV.d. Local Development.....	31
E. Conclusion	32
References	32

List of Figures

Figure 1: Global integrity scores on judicial accountability in select MENA countries	16
Figure 2: West Bank vs. MENA on judicial accountability indicators	16
Figure 3: Select Doing Business indicators, 2011.....	23

List of Tables

Table 1: Labor force statistics, first quarter 2011.....	9
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ACRONYMS

AHLC	Ad Hoc Liaison Committee
CTP	Cash Transfer Program
GDP	Gross Domestic Product
GoI	Government of Israel
GPC	General Personnel Council
HEPCO	Hebron Electric Power Company
IMF	International Monetary Fund
IT	Information technology
MDLF	Municipal Development and Lending Fund
MENA	Middle East and North Africa
MoEHE	Ministry of Education and Higher Education
MoF	Ministry of Finance
MoSA	Ministry of Social Affairs
NEDCO	Northern Electricity Distribution Company
NIS	New Israeli Shekels
OECD	Organization for Economic Co-operation and Development
PA	Palestinian Authority
PCBS	Palestinian Central Bureau of Statistics
PEA	Palestine Energy Authority
PEFA	Public Expenditure and Financial Accountability
PERC	Palestinian Electricity Regulatory Commission
PFM	Public financial management
PMA	Palestine Monetary Authority
PNDP	Palestinian National Development Plan
PRDP	Palestinian Reform and Development Plan
PWA	Palestinian Water Authority
SELCO	Southern Electricity Company
SJC	Supreme Judicial Council
TSA	Treasury Single Account
VAT	Value-added tax
WB&G	West Bank and Gaza

A. EXECUTIVE SUMMARY

a. The September 2011 meeting of the Ad Hoc Liaison Committee coincides with the completion of the Palestinian Authority's ambitious two-year program "Palestine: Ending the Occupation, Establishing the State", presented on August 25, 2009. There has been substantial progress in implementing the program's goals and policies, centering on the objective of building strong state institutions. However, the onset of an acute fiscal crisis, accompanied by declining economic growth, may undermine the promise of these institution-building achievements.

b. In areas where government effectiveness matters most – security and justice; revenue and expenditure management; economic development; and service delivery – Palestinian public institutions compare favorably to other countries in the region and beyond. These institutions have played a crucial role in enabling the positive economic growth in the West Bank and Gaza in recent years.

c. Though significant, this growth has been unsustainable, driven primarily by donor aid rather than a rebounding private sector, which remains stifled by Israeli restrictions on access to natural resources and markets. Under these conditions, lower-than-expected aid flows in the first half of 2011 had an immediate impact on the Palestinian economy. Real GDP growth, steadily increasing in 2009-2010 and previously projected to reach 9 percent in 2011, is now expected to be 7 percent. The shortfall in external financial support in the first half of 2011 has also contributed to the current fiscal crisis facing the Palestinian Authority.

d. The situation underscores the interdependence of institution-building and sustainable economic growth in laying the economic underpinnings of a future state. To date, the Palestinian Authority has continued to implement its reform agenda, but a protracted fiscal crisis risks jeopardizing the gains in institution-building made painstakingly over the past years.

e. Ultimately, in order for the Palestinian Authority to sustain the reform momentum and its achievements in institution-building, remaining Israeli restrictions must be lifted. The resulting revival of the private sector can be expected to grow the tax base and gradually reduce dependence on external assistance. Until then, however, West Bank and Gaza will remain vulnerable to reductions in aid flow, and these will need to be managed carefully.

B. INTRODUCTION

1. Sustainable economic growth and strong institutions are interlinked, and the present report summarizes recent economic and fiscal developments in West Bank and Gaza (WB&G) as well as providing a broad overview of institutional accomplishments to date. This report comes at the conclusion of the two-year period for the program of the 13th Government of the Palestinian Authority (PA) entitled “Palestine: Ending the Occupation, Establishing the State”, launched on August 25, 2009. This Program lays out the Government’s national goals and policies for the following 2 years, centering on the objective of building strong state institutions. The Program states that one of these goals -- the achievement of economic independence and national prosperity – requires close cooperation between a competent, capable, and visionary public sector and a pioneering private sector¹. Thus, economic prosperity driven by a strong private sector is inextricably linked with efficient and effective public institutions.

2. The present report begins by discussing the apparent slowdown in economic growth in WB&G and the current fiscal crisis facing the PA – resulting partly from lower-than-expected external support this year. A further drop in donor funding would likely reduce growth, which would in turn further aggravate the fiscal situation in the coming year. A protracted fiscal crisis, in turn, risks jeopardizing the gains made in institution-building and thereby losing what has been painstakingly achieved over the past years. To date, despite the increasingly difficult fiscal situation it faces, the PA has continued to implement its reform agenda. In future, tight control of recurrent and capital spending coupled with an increased focus on strategic priorities will be necessary. However, no curtailment of spending is sufficient to bridge the budget gap in the absence of increased domestic revenues, which in turn require a tax base emanating from economic growth.

3. Previous World Bank reports to the Ad Hoc Liaison Committee (AHLC) have noted that economic growth in WB&G in recent years is primarily donor-driven while the private sector remains stifled due to Israeli restrictions on access to natural resources and markets. Thus, though WB&G has experienced growth in recent years, it must be kept in mind that the economy is rebounding from a low base, particularly in Gaza. In addition, the growth is mostly confined to the non-tradable sector and probably reflects the importance of donor aid in driving the Palestinian economy. The easing of restrictions by the Government of Israel (GoI) in 2009 probably had a positive impact on the Palestinian economy as well, but there has been little further easing since². However, sustainable growth will require the unleashing of the private sector’s potential, which in turn necessitates a lifting of remaining Israeli restrictions on access to land, water, a range of raw materials³, and export markets, to name a few⁴.

¹ Palestinian Authority. August 2009. *Palestine: Ending the Occupation, Establishing the State – Program of the Thirteenth Government*, page 11.

² The GoI cites overriding security concerns that restrict its ability to continue to ease or lift restrictions on WB&G.

³ These materials are on the GoI’s list of dual-use items, i.e. items that have both civilian use as well as potentially other harmful use to which they could be diverted after import into WB&G. Israeli restrictions on dual-use chemicals and fertilizers have been in place for decades but in 2002 the Israeli military began limiting access to

4. **Previous World Bank reports to the AHLC have also discussed the performance of PA public institutions, but the present report applies a 2011 policy guidance from the Organization for Economic Co-operation and Development (OECD) in an effort to provide a more comprehensive and detailed overview.** The OECD policy guidance, entitled “Supporting Statebuilding in Situations of Conflict and Fragility”, identifies certain key state functions as strategically important, namely security and justice; revenue and expenditure management; economic development, especially job creation; and service delivery⁵. The bulk of the present report will therefore assess the extent to which PA public institutions today demonstrate the above capabilities. In addition, the report highlights that in order for the PA to sustain the reform momentum and its achievements in institution-building, remaining Israeli restrictions must be lifted and any reductions in international aid flows must be carefully calibrated and managed.

C. RECENT ECONOMIC AND FISCAL DEVELOPMENTS

5. **Economic growth in WB&G has slowed down in 2011, and together with the shortfall in external financing, this has led to a fiscal crisis for the PA.** No significant easing of Israeli restrictions has taken place in 2011, so that the Palestinian private sector’s potential remains thwarted. In addition, the PA’s inability to pay its bills to suppliers in a timely manner has hurt business confidence. Though the PA has sought to reduce its need for external assistance, lower economic growth and lower-than-expected donor assistance have resulted in an acute fiscal crisis. The crisis has meant that the PA is now also struggling to meet its wage payment obligations.

C.I. GROWTH AND EMPLOYMENT

6. **Economic growth in WB&G remains robust but appears to be slowing due to economic and political uncertainty, so that the IMF has revised the projected real GDP growth rate for 2011 from 9 down to 7 percent.** In the first half of 2011, real growth in WB&G was 10 percent. However, this strong performance was driven by exceptionally high growth of 28 percent in Gaza as it began to recover due to the 2010 loosening of the Israeli blockade. Disturbingly, there has been a marked slowdown in the West Bank, which had been the main driver of

chemicals and fertilizers further by lowering the maximum concentration levels allowed. Since 2002, the GoI has progressively added materials, machinery, and equipment (including telecommunications equipment) to the list of items considered “dual-use”.

⁴ For further details, see World Bank. September 21, 2010. *The Underpinnings of the Future Palestinian State: Sustainable Growth and Institutions*, Economic Monitoring Report to the Ad Hoc Liaison Committee.

⁵ OECD. 2011. *Supporting Statebuilding in Situations of Conflict and Fragility*, Policy Guidance, DAC Guidelines and Reference Series, page 13.

growth. In the first half of 2011, growth was only 4 percent compared to 8 percent in 2010. Output in the West Bank actually fell by nearly 5 percent between the fourth quarter of 2010 and the first quarter of 2011.

7. The GoI maintains its strict control over Area C⁶ of the West Bank and access to Gaza.

While the GoI loosened many of the internal movement restrictions within the West Bank, it still does not allow any Palestinian development in the 60 percent of the West Bank comprising Area C. In addition, the GoI maintains strict controls on the passage of goods and people between Israel and East Jerusalem and the rest of the West Bank. The GoI now allows most consumer goods and many intermediate inputs to enter Gaza. However, it restricts the entry of most construction materials. In addition, the GoI still prevents all exports from Gaza except for a limited amount of agricultural goods. These goods are not allowed to be shipped to the West Bank or Israel but must be directly exported beyond. The Rafah border crossing with Egypt is open to limited traffic of people but no cargo.

8. Much of the recovery in Gaza took place in the construction sector, which grew by more than 220 percent when comparing the first half of 2011 with the first half of 2010. This is the result of the GoI allowing some construction material in for donor-funded projects and more construction material entering through the tunnels from Egypt. The manufacturing, services, and public administration sectors also grew in the range of 12-16 percent each. In the West Bank, public administration is the only sector with a double-digit growth rate (14 percent) when comparing the first half of 2011 to the first half of 2010. This steady increase in the non-tradable sectors and relative stagnation of the tradable sector reflects the donor-driven nature of the economy and the precarious sustainability of current growth.

9. A slowdown in growth is indicated by recent trade figures. Israel remains WB&G's largest trading partner. According to the Israeli Central Bureau of Statistics, imports of goods and services by the PA from Israel grew by only 2 percent in nominal terms between the first quarter of 2010 and the first quarter of 2011. Exports from the West Bank to Israel were flat. Both imports and exports fell by 3 percent between the fourth quarter of 2010 and the first quarter of 2011. In 2011, the Palestinian Central Bureau of Statistics (PCBS) began to publish monthly trade figures. These estimates also indicate slow growth: exports only grew from US\$67 million in January to US\$68 million in May 2011, while imports dropped from about US\$405 million to US\$396 million.

10. Despite some improvement, unemployment remains stubbornly high and labor force participation low in WB&G. The overall unemployment rate fell from 22.9 percent in the second quarter of 2010 to 18.7 percent in the second quarter of 2011. In line with the slowing growth in the West Bank, unemployment stagnated at around 15 percent in the first half of 2011. In Gaza, PCBS reports that unemployment fell from 39.3 to 25.6 percent, indicating a continuing recovery in the territory. However, this improvement in the unemployment rate in Gaza must be set against the very low labor force participation rate of under 40 percent. The

⁶ The West Bank is divided into 3 areas: 2 areas are under Palestinian control and correspond to all major population centers (Area A) and most rural communities (Area B). The third area, Area C, is under Israeli control for both security and civilian affairs related to territory, including land administration and planning.

high level of youth unemployment and low youth participation in the labor force (see Table 1) remain a serious concern in WB&G: less than a third of Palestinians in Gaza aged 15-29 years are in the labor force and almost 40 percent of those are unemployed.

TABLE 1: LABOR FORCE STATISTICS, SECOND QUARTER 2011

(in percentage terms)	West Bank & Gaza	West Bank	Gaza
Unemployment rate			
--Overall	18.7	15.4	25.6
--Youth	28.6	23.8	38.1
Labor force participation rate			
--Overall	42.7	45.3	38.1
--Youth	35.4	38.3	30.8

Source: PCBS Labor Force Survey 2011

11. If Israeli restrictions remain in place, inhibiting trade and private investment, the IMF projects that real GDP growth would hover at about 4 percent in the medium-term and the unemployment rate at roughly 20 percent. This implies stagnant living standards for WB&G as the annual population growth rate is 3-4 percent. By contrast, a significant easing of movement and access restrictions, combined with sufficient donor funding to finance recurrent and development spending, would result in real GDP growth of 7 percent in 2012, rising to 10 percent in 2013-14, as well as a decline in the unemployment rate to 15 percent by 2013.

C.II. THE PA'S FISCAL POSITION

12. In the first half of 2011 the PA faced an increasingly difficult fiscal situation while it continued to implement its reform agenda. Total net revenues were 11 percent below the prorated budget projections while spending was only held to about 6 percent below budget. As a result, the recurrent budget deficit for the first half of 2011 was 5 percent more than budgeted. Though the recurrent deficit of NIS 2.1 billion was above budget projections, it was still nearly 7 percent below the deficit in the same period in 2010, showing the PA making some progress towards lowering its need for assistance. In the first half of 2011, the PA reported development expenditures of NIS 631 million but it only received NIS 151 million in development financing. Thus the total need for external financing (recurrent plus development) in the first half of the year was NIS 2.7 billion. Unfortunately, total external support was only NIS 1.2 billion. Consequently, the PA resorted to increasing domestic bank borrowing and accruing large arrears. By the end of June 2011, the net accumulation of arrears was more than NIS 1030 million and bank debt had increased by more than NIS 860 million to NIS 3.8 billion. If current trends continue and the PA maintains its funding of development projects directly out of its own budget, the PA will need more external support than the less

than US\$1 billion projected in the budget⁷. It appears that the PA has reached its limit for bank borrowing and that future shortfalls will have to be met through the accumulation of arrears. Though much of the arrears are to the pension system, the Ministry of Finance (MoF) reports that, by the end of the second quarter, NIS 612 million was owed to the private sector, which constitutes a substantial drag on economic growth.

13. In the first six months of the year, gross domestic revenues were nearly 9 percent lower than called for by the 2011 budget. The budget projected gross domestic revenues to grow by nearly 8 percent in nominal terms compared to 2010. Despite ongoing efforts to increase tax revenues, they were more than 4 percent lower than their prorated target for the first half of the year and dropped by nearly 5 percent compared to the first half of 2010. While VAT collections were up by more than 7 percent, income tax collections were down by nearly 25 percent and property tax collections were down by 78 percent compared to the first half of 2010, establishing a lower base for forecasting future tax collection. Non-tax revenues were about 17 percent lower than budget projections. As non-tax revenues are lumpy, additional dividends and fees are possible later in the year, but these are unlikely to reach the budget target of NIS 1.1 billion.

14. Clearance revenues collected by the Gol for the PA, which account for nearly two thirds of all PA revenues, were more than 8 percent below budget projections. Clearance revenues were expected to grow by around 14 percent compared to 2010. However, in the first half of the year they were only around 8 percent more than they were in 2010. Some of the reason for the slower than expected growth in clearance revenues can be traced to the Gol's decision to lower the petroleum excise tax. In addition, Gaza has stopped importing fuel from Israel for its power plant. Indeed, petroleum excise tax receipts only increased by 1 percent compared to the first half of 2010. The customs and VAT components of the clearance revenues increased by 12 and 13 percent respectively compared to the first half of 2010, i.e. not far from the budget projections. Second quarter receipts were 6 percent higher than first quarter receipts. In 2011, the PA conducted discussions with the Gol on ways to make collection of clearance revenues more efficient and to capture a larger portion of the revenues it believes are being lost since it has no presence at the crossings into the West Bank or Gaza. After an interruption, these discussions between the PA and the Gol have recently resumed and progress has been made at a technical level.

15. Total expenditures and net lending in the first half of 2011 were NIS 5.6 billion on a commitment basis, which is nearly 6 percent below the prorated budget. In fact, spending was nearly 2 percent lower than in the first half of 2010. Wages were above budget but the PA kept spending in check by reducing non-wage expenditures. The PA has stated that it is essential to maintain spending restraint in non-wage expenditures to compensate for lower than expected revenues. Operational expenditures were about 4 percent more than budgeted and 16 percent more than in the same period in 2010, with an increase in health commitments being a major factor. Thus, the savings have come from squeezing transfer payments: transfers

⁷ Some of this is due to the depreciation of the US Dollar. The budget planned on an exchange rate of NIS 3.7 to US\$1 but the exchange rate averaged only NIS 3.48 to US\$1 during the first half of 2011.

on a commitment basis were 31 percent lower than budgeted and 20 percent lower than in the same period of 2010. The PA has recently provided information on the major categories of transfer expenditures and how much was budgeted for each. It appears that the major savings come from lower payments for retirees' pension allowances: only NIS 85 million was spent in the first half of the year out of NIS 676 million that was budgeted for the year. However, it is not clear that this reflects a reduction in future commitments.

16. **Wage expenditures exceeded the prorated budget target by 3 percent.** The MoF reports that a number of salary adjustments and allowances were given in the first quarter of the year that were not in the 2011 budget. According to the MoF, the wage bill in the first half of the year also includes most of the budgeted retroactive payments to employees appointed at the end of 2010 but who did not receive salaries due to the long recruiting process. At this point it appears that the wage bill is on track to be at least 3 percent more than budgeted and nearly 9 percent higher than in the first half of 2010. This is a significant real increase in the wage bill. Despite the situation, the PA continued to increase hiring in the West Bank while decreasing employment in Gaza. Overall, PA employment rose by 1,030 workers in the second quarter of 2011 reaching 152,098 employees -- an increase of 1,137 in the West Bank and a fall of 116 in Gaza⁸.

17. **The PA continued to make substantial progress on reducing net lending in 2011⁹.** In the first half of the year, it was nearly 43 percent less than it was in 2010. Although it was almost 4 percent above its budget target for the first half, it declined by more than 7 percent between the first and second quarters of 2011, and if this trend continues, the PA would meet its 2011 budget target. Much of the decline in the last 6 months was due to the PA cutting off payment for fuel to Gaza. The PA is pushing ahead with its efforts to shift electricity distribution in the northern West Bank to the Northern Electricity Distribution Company (NEDCO) and it has targeted the municipalities of Anabta and Tulkarem for joining NEDCO by the end of 2011. However, there is less scope for further increases in electricity collections in the West Bank and it will be increasingly difficult for the PA to meet its targets for further reducing net lending.

18. **The PA is heavily in debt to the local banking sector.** As of June 2011, the Palestine Monetary Authority (PMA) reports that the Palestinian banking sector has provided more than US\$1.1 billion in credit facilities to the PA -- about 13 percent of the sector's total assets. The PMA has been carefully monitoring the situation and has required banks to increase reserves. While the sector as a whole appears strong, some individual banks are much more exposed than others, both through direct lending to the PA and through loans to PA employees. Thus, the PA's worsening fiscal position could hurt some banks more than others. The PMA recently conducted stress tests for all banks operating in WB&G and currently does not view any banks as in immediate risk, though some banks were required to increase their capital.

⁸ Another 9 were added to embassies and national fund staff outside of WB&G.

⁹ Net lending refers to subsidies provided to municipalities by the central government mostly for electricity bills that were not paid to the Israeli Electricity Company.

19. **The PA has entered a period of fiscal crisis: in early July 2011, the PA could not make its wage payments, and in early August 2011, it paid wages in full but was not able to cover all its transfers.** The 2011 budget called for external budget support of US\$967 million based on assumptions of strong growth in domestic revenue collections. In the first half of the year the PA only received US\$293 million – the vast majority of which was from European donors. Arab donors provided less than US\$80 million in the first half of 2011, compared to US\$231 million in 2010, US\$462 million in 2009, and US\$446 million in 2008. In addition, development aid was only US\$43 million – well below the US\$180 million the PA committed for development projects. The IMF reports that from January to end-August 2011, about US\$0.4 billion was disbursed and an additional US\$0.3 billion indicated by donors for the remainder of 2011, yielding total financing already disbursed or indicated of roughly US\$0.7 billion. The IMF projects net domestic bank financing for 2011 of about US\$0.1 billion, and given the projected recurrent deficit of US\$1.1 billion, this yields a financing gap of about US\$0.3 billion.

20. **The projected financing deficit of roughly US\$300 million for 2011 is arguably a best case scenario.** This estimate assumes that the recurrent deficit will return to be close to budget in the second half of 2011, which would be a positive development given the first half of 2011 performance, and is based on strong control of transfer commitments by the PA and a rebound in clearance revenues. If, on the other hand, the revenues do not rebound and transfer commitments cannot be constrained, then further financing up to US\$200 million could be required. On development expenditures, the IMF is projecting that the shortfall in development financing will be fully closed by the end of the year. However, if external donors do not finance the projects already executed by the PA in the first half of 2011, this alone would result in an additional gap of US\$140 million.

D. INSTITUTIONAL CAPACITY

21. Given the necessity of both sustainable economic growth and effective institutions for a future viable state, this section reviews the PA's achievements in institution-building¹⁰. Of course, no study could be comprehensive in examining all aspects of WB&G public institutions, nor is institution-building a completed agenda for the PA. As the PA itself has observed, there are several domains where new reform efforts are needed, or where reforms have only just begun. Indeed, there is hardly a state that does not struggle with challenging reform measures, many similar to the ones facing the PA today. The below analysis indicates, nonetheless, that WB&G public institutions perform as well as a number of World Bank client countries of similar income level. This despite the existing Israeli restrictions and controls, which have a detrimental impact not only on economic growth but also constrain the PA's ability to develop its institutions as well as limit politically its room for maneuver on tougher reforms. Given the positive track record, it is all the more important that the current fiscal crisis is contained and efforts are made to remove constraints to private sector development so as not to jeopardize the gains made in institution-building.

22. This section utilizes the OECD framework described in the introduction to examine more closely the functioning of PA institutions and their success in implementing reforms. Thus, the OECD finds that several key capabilities are common to all effective states, including providing security, enforcing the law, and protecting citizens; making laws, providing justice, and resolving conflict; raising, prioritizing, and expending revenues effectively, which requires a sound and transparent public financial management (PFM) system; delivering basic services, including equal access to health, education, water, sanitation, communications, and infrastructure; and facilitating economic development and employment by creating an enabling framework for trade, investment, employment, and economic growth¹¹. The PA's success in these various areas is assessed below and compared in some instances with the performance of other countries.

D.I. SECURITY AND JUSTICE

D.I.A. SECURITY

23. Security was one of four national goals espoused by the 2008-10 Palestinian Reform and Development Plan (PRDP) and considered a linchpin reform for improving the business environment. The PA has made major progress in bringing safety and security to the West Bank in recent years. It has deployed a large number of newly trained security forces

¹⁰ This section focuses on reforms and results achieved by the PA in the West Bank as well as Gaza insofar as the PA is able to implement programs in Gaza.

¹¹ OECD. 2011. *Supporting Statebuilding in Situations of Conflict and Fragility*, Policy Guidance, DAC Guidelines and Reference Series, pages 33-34.

throughout the major cities who have helped restore security and create a sense of normalcy. The improved security situation has led the GoI to reduce some of its internal security restrictions and is often cited by businesses as an important reason for the increasing economic activity. Public employment figures indicate a total number of 63,515 persons on the PA security forces payroll in early 2010, of which slightly more than half are assigned to Gaza. In addition, there is a further number of security employees hired and paid directly by the *de facto* authorities in Gaza. Security personnel in the West Bank have been extensively trained by US and other Western government teams, and their capacity has been greatly strengthened. A remaining challenge is ensuring that the PA's security forces continue to apply proper legal procedures in the arrest and detainment of citizens¹².

24. According to the 2011-13 Palestinian National Development Plan (PNDP), the Palestinian Center for Policy and Survey Research reports that as of the last quarter of 2009, 63 percent of Palestinians felt secure as opposed to 32 percent in March 2008, while two thirds of Palestinians rate the provision of security services as good. A study by the Fafo Institute for Applied International Studies also reports that nearly 60 percent of respondents felt that the PA had improved the security situation in the West Bank¹³.

D.I.B. JUSTICE

25. The Palestinian justice sector has witnessed significant reforms during the last five to ten years. These reforms are backed by the PA, as well as generous support from the international community. Assistance from the donor community has been considerable over last decade, and was notably increased following 2007. Multiple projects aimed at supporting the Ministry of Justice, the Supreme Judicial Council (SJC), the Public Prosecution, the Palestinian Bar Association, and civil society organizations active in the field.

26. The SJC, the Ministry of Justice, and the Attorney General Office have been transformed from person-centered bodies into real institutions with clear mandates, modus operandi, and strategic visions. The Ministry of Justice has started conducting regular exercises on annual strategic planning. In an attempt to realize and expedite capacity building and institutional development, the Ministry of Justice has succeeded in obtaining funding for top notch experts and consultants to be housed at the Ministry. In February 2011, the Ministry organized a three-day workshop in Jericho to discuss, brainstorm, and obtain expertise on best practices in criminal law, as part of the Ministry's endeavor to draft and pass a modern criminal code. This is part of a broader effort, highlighted in the 2009 Program of the 13th Government,

¹² Independent Commission for Human Rights (ICHR). 2010. *The Status of Human Rights in Palestine, the Sixteenth Annual Report, Executive Summary*.

¹³ Tiltnes, Åge A., Jon Pedersen, Silje Sønsterudbråten, Jing Liu. 2011. *Palestinian Opinions about Governance, Institutions and Political Leaders, Synthesis of Results of Fafo's Opinion Polls in the West Bank and Gaza Strip, 2005-2011*, Fafo Institute for Applied International Studies, Oslo, Norway.

to modernize the legal framework and is being done in a consultative manner, involving civil society, the private sector, and academic experts.

27. The SJC has also taken impressive steps towards increased institutionalization, anchored in a series of reform strategies developed in a consultative manner. New departments were created and activated within the SJC with clear mandates and powers, such as the Court Administration Department, IT Department, Planning Department, Inspection Department, and Technical Department. Appointment and promotion of judges and public prosecutors is reportedly being undertaken through more transparent and objective processes, including written and oral exams/competitions. Coordination with donors, as well as with other justice sector institutions, has reportedly improved. Efforts to promote the independence of judiciary were undertaken, as well as efforts to address judicial bottlenecks and delays in resolution of disputes. The SJC has also taken steps to reduce conflicts of interest in the judiciary by rotating judges to different governorates.

28. As a result, services rendered by the justice sector have significantly improved, as have perceptions of Palestinians towards the courts and the justice sector in general. The PNDP reports that according to the High Judicial Council, Magistrate and First Instance Courts handled 67 percent more cases in 2009 than in 2008. The number of judges on bench has almost tripled in the last ten years; specialized courts were established (such as the Anti-Corruption Court in 2010 and the Customs Court in 2011); and specialized chambers within regular courts were also established (e.g. separate criminal and civil chambers, specialized labor cases chambers). Multiple new courthouses were constructed and refurbished (in Jenin, Nablus, Jericho), and efforts to construct other courthouses are underway. All courts are currently automated, and modern case management software (Mizan I and Mizan II) is currently utilized. Manuals for case management and for other justice sector-related services (e.g. notarization, enforcement) have been written and are being used. Notary public offices in several districts have also been refurbished, adequately staffed, and automated, and advanced archiving systems have been introduced as well. The Sharia Court system, which addresses personal status issues for Muslim Palestinians, has introduced an Alimony Fund to ensure alimony and child support payments are made on time.

29. Litigants are now witnessing much more speedy trials; and, unlike the case seven to eight years ago, court decisions are being more regularly enforced and honored. As a result, the public's confidence in the justice sector has increased, as evident by the increasing numbers of cases filed before courts nowadays, compared to a few years ago. Disputants are now less likely to resort to parallel means for resolving disputes. Of course, there is still room for improvement: continued conflict with Israel and the obstacles often imposed by the Israeli authorities on freedom of movement and access for Palestinians, as well as on the liberty of security forces to mobilize and operate in Area C, still hinder the delivery of justice. In addition, the jurisdictions and powers among the main justice sector institutions -- the Ministry of Justice and the SJC -- have not yet been clearly delineated in law. Coordination among justice sector institutions could also be improved and enhanced.

30. The figures below show that the West Bank compares favorably to other countries in the Middle East and North Africa (MENA) on judicial accountability indicators, with the exception of asset disclosure. The PA has an asset declaration regime de jure but not yet in practice. The regime will be the responsibility of the new Anti-Corruption Commission which is currently working on an asset disclosure process.

FIGURE 1: GLOBAL INTEGRITY SCORES ON JUDICIAL ACCOUNTABILITY IN SELECT MENA COUNTRIES

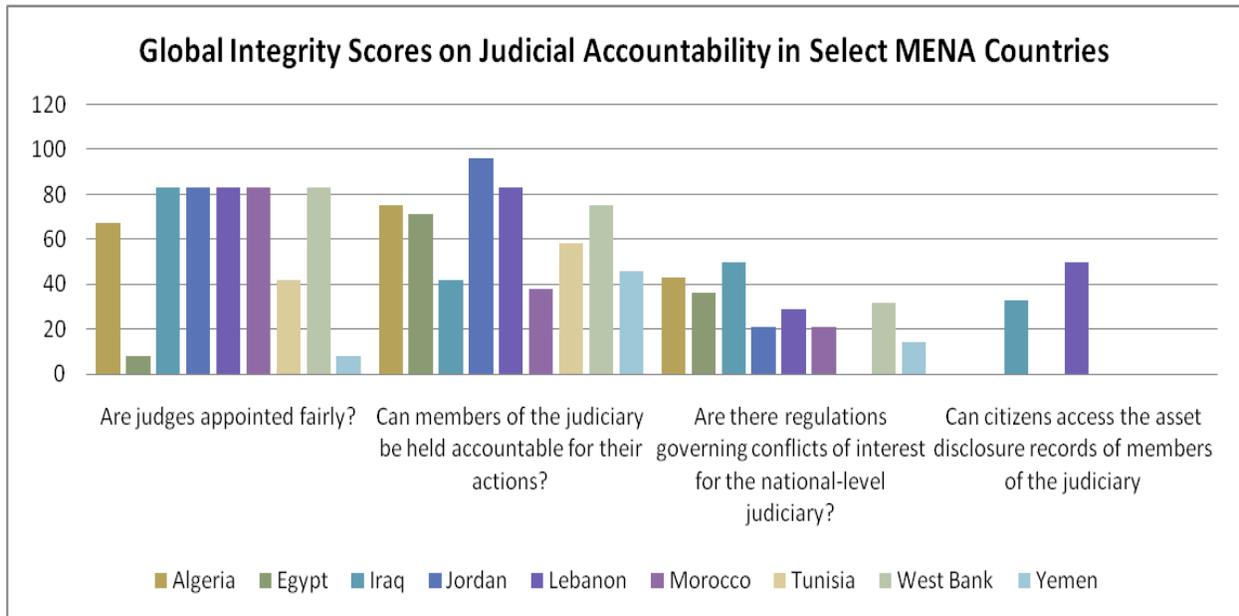
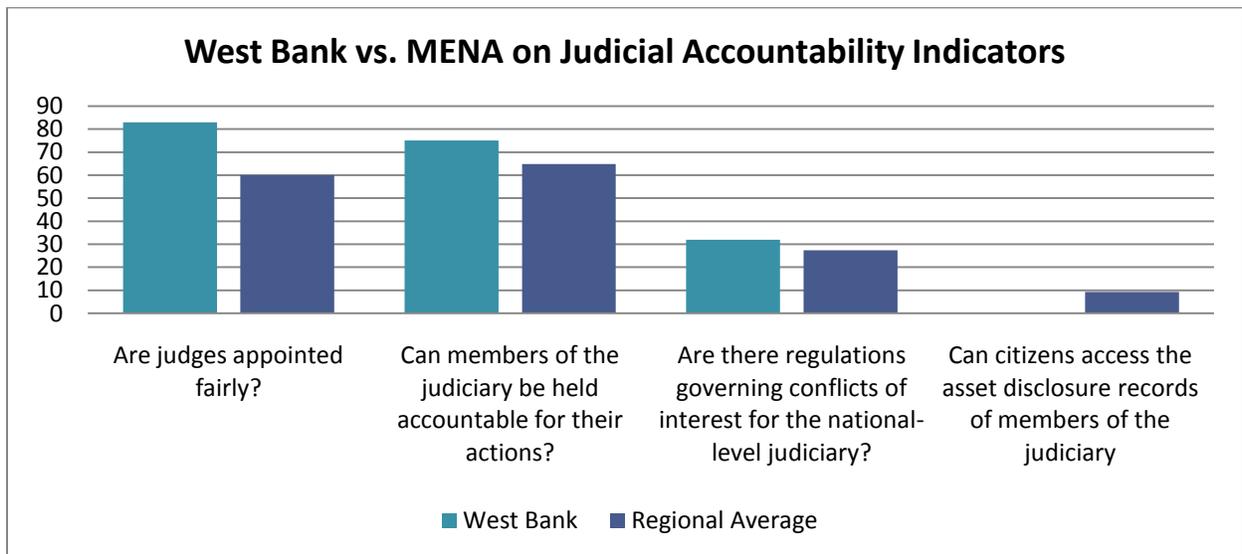


FIGURE 2: WEST BANK VS. MENA ON JUDICIAL ACCOUNTABILITY INDICATORS



Source: Global Integrity. 2008. *Global Integrity Report: Judicial Accountability*.

D.II. REVENUES AND EXPENDITURES

31. **At the end of the 1990s, the condition of PFM in WB&G was very weak, but things started to change for the better when a reform program was initiated following the appointment of a new finance minister in 2002.** Since then, the PA has implemented a remarkably strong program of PFM reform, with a clear emphasis on “getting the basics right”, beginning with budget execution and the establishment of central control of revenues and spending. This has proceeded in 2 stages, beginning in 2002, with interruption and partial reversal between 2006 and 2007, followed by restoration of systems and processes in 2008, and their further development to the present.

32. **Progress on tax administration reform has moved slowly until recently.** It should be remembered that the PA operates under a number of constraints in the tax domain. For example, the PA is constrained in its control of customs revenues by lack of access to border control points, lack of information on imports from the Israeli customs service, and restrictions on imports to Gaza, which also limit customs revenues. Nevertheless, the PA has designed and launched a three-year plan aimed at broadening the tax base and raising compliance, with a priority in 2011 on strengthening supervision of border crossings. This agenda will allow a greater collection of clearance revenues from VAT and a better assessment of potential VAT revenues through comprehensive data compiled by Gol on imports from Israel. Progress in this regard requires, therefore, stronger cooperation between the relevant Gol and PA authorities -- a cooperation that has been interrupted but was recently restored again. During the last year, the Palestinian authorities have also launched the unification of VAT and income tax administrations for large taxpayers. Finally, based on the experience to date in 2011 with regard to income and property tax in particular, efforts to broaden the tax base and improve administration remain a priority.

33. **The PA has made important progress in reducing net lending to municipalities by taking steps to place electricity distribution on a commercial basis.** It has also taken steps to manage property taxes and improve local revenues. The PA has also created the Municipal Development and Lending Fund (MDLF) to further address municipal finance and capacity building. Through the MDLF, funds for capital expenditures are transferred to municipalities using a formula based on population, need, and performance. The transfer is financed by seven donors and the PA and has improved transparency in the municipal allocation process. And this year the PA has provided guidelines to the newly amalgamated municipalities on how to raise revenues to ensure financing for amalgamated services.

D.II.A. PUBLIC FINANCIAL MANAGEMENT

34. **On the expenditure side, at the beginning of the reform period budget controls were ineffective, resulting in indiscriminate spending by line ministries.** These had multiple bank accounts, significant off-budget revenues and spending, and incurred payment arrears leading to large overall deficits. Financial accounts were not produced, there was no internal audit, and external audit was not effective. Most importantly, the MoF lacked both the tools and the political authority to manage public finances well, in an environment where formal rules were frequently overridden.

35. **Things changed markedly for the better with the reform dynamics launched in 2002, and today reforms in the West Bank are a best practice example of what can be done to establish good PFM in a post-conflict setting.** Indeed, these PFM reforms have been the foundation for building the confidence of external donors, bringing aid on budget -- increasingly as general support -- and greatly expanding it. Domestic revenues have strengthened, and, in turn, the reforms have underpinned a rapid expansion of the WB&G economy.

36. **The first stage, launched at a time of acute fiscal crisis in 2002, was aimed at asserting central control over revenues and spending.** This was done through closing a range of revenue bank accounts and the establishment of a treasury single account (TSA) enabling the central management of cash. Salary payments were brought under the MoF, thereby curbing unauthorized hiring. Extra-budgetary revenues and spending were brought into the budget, making the budget more transparent and comprehensive. Expenditures were largely centralized at the MoF and this was supplemented by having financial controllers reporting to the MoF installed in each ministry. An internal audit unit was also established at the MoF. Monthly reports of revenues and spending were published on the MoF's website. These steps provided the tools for the MoF to increase its control of spending, increase revenues, reduce arrears, and begin to check the growth of fiscal deficits. Although a Public Expenditure and Financial Accountability (PEFA) exercise carried out in 2006 still rated performance critically, there is no doubt that the foundations of a well performing PFM system were laid down in this first period.

37. **The elections in 2006 and the formation of a Hamas government precipitated a fiscal crisis, as donors stopped direct financial support, and the Israeli authorities withheld clearance payments.** The TSA was undermined as alternative financing arrangements were established by donors including supporting civil servants through direct payments. Increased hiring both before and after the election without regard to proper procedures increased the payroll by about 35,000. Public finances collapsed and arrears to suppliers and employees ballooned.

38. **With the advent of the Caretaker Government, the PFM measures of the earlier period were reinstated, and reforms accelerated.** The first requirement was to create a new central accounting capacity in Ramallah, since the Accountant-General's Department had been located in Gaza. A new financial management system was established that consolidated the accounting

and expenditure control functions. The system was gradually rolled out to line ministries as some of the earlier centralization of expenditure was unwound. In 2010 the system was further developed with the inclusion of a procurement module to support commitment control. With the benefit of the new system, for the first time, the public accounts for 2008 were completed on time and submitted to the newly created state audit agency for external audit. The accounts met international accounting standards¹⁴ in most respects and the MoF expects to fully comply with the international standards with the 2010 accounts. The quality of monthly revenue and expenditure reports has also advanced over the earlier period. To make annual budgeting more strategic, the Government announced the introduction of program-based budgeting, and the 2009 budget was the first presented in this way, bringing together recurrent and development budgets. Since 2008, a Medium Term Financial Framework has been presented annually in the budget speech and a medium term fiscal strategy was incorporated into the PNDP. As part of the PNDP process a strategic plan was also drawn up to guide the further development of PFM. Finally, a new procurement law was signed by the President on July 31, 2011, which will serve to improve the efficiency, accountability, and transparency of public spending.

39. Arguably, the most impressive part of the financial management reforms has been the establishment of the authority of the MoF to supervise public finances, and the building of systems and staff capacities to do so. This has translated into greater trust in the way public finances are managed, and this has helped improve service delivery. Challenges remain. Attention to budget execution rightly was given priority over budget preparation. Now the task is to make annual budgeting less incremental and more strategic, focusing programs on the core functions of government. The new accounting system also provides an opportunity to further extend the transparency of budget reporting. The PA will also have to continue the winding down of exceptionally large fiscal deficits, which have been running at over 20 percent of GDP in recent years. This should come through the careful management of the relative reduction of international aid flows, tight control of recurrent and capital spending, increased focus on strategic priorities, and enabling domestic revenues to rise through the impact of economic growth on the tax base. And if the private sector is to grow rapidly, there will be need to continue the relative shift in public expenditures from spending on wages and transfers (85 percent of the recurrent budget) to greater emphasis on capital spending through development projects, all the while keeping deficits on a downward trend relative to GDP. These changes are outlined in aggregate terms in the PNDP, and in turn are highly dependent on rapid growth broadening the tax base, and for the medium term, donors maintaining aid flows, both as general budget support and supporting public investment projects. Any reductions in external financing need to be carefully calibrated and managed – as the current fiscal crisis facing the PA makes clear.

¹⁴ The International Public Sector Accounting Standard on a cash basis.

D.II.B. CIVIL SERVICE

40. **The public civil service has followed much the same trajectory as public finances.**

From the formation of the PA after the Oslo Accords in 1993 until 2002, government payrolls expanded rapidly, with largely uncontrolled hiring and with insufficient attention paid to merit. Although a civil service law was passed in 1998 that defined the parameters by which the public service should be run, implementing regulations were not passed until 2004, and hiring by line ministries was regularly approved without regard either to justified need or budget funding. The law was updated in 2005, introducing a range of additional controls on hiring new staff – although also making the recruitment process more extended.

41. **From 2002, the payroll was brought under progressively tighter control through financial reforms.** Nonetheless, by 2006 total public service employment, including teachers, health workers, security services, and general civil servants, totaled around 150,000 – including 17,000 who had been hired in late 2005 without following the proper procedures. This was a large number for a population of around 3.5 million, particularly in the security area. Underlying this was a widespread view that, in light of reduced Palestinian employment in Israel and constrained job opportunities in WB&G, it was the responsibility of the PA to provide jobs directly.

42. **Between 2006 and 2007 PA employment expanded again, through the recruitment of almost 20,000 staff by Hamas, resulting in a total public service by the time the Caretaker Government was established of about 170,000.** With the formation of the Caretaker Government in mid-2007, numbers were quickly reduced through dismissal of the additional hires, deemed illegal. Since then, the public service has grown slowly, within an annual cap of 3,000 additional positions, mostly teachers and health workers, not all of whom are recruited within the year (partly because of security clearance delays). Payroll data for mid-2011 show a total of over 152,000 permanent staff, with close to 88,000 in the West Bank and 63,000 in Gaza¹⁵. Within this total are close to 64,000 security staff (30,000 in West Bank, 34,000 in Gaza), roughly 45,000 teachers (34,000 in West Bank, 11,000 in Gaza) and over 12,000 health workers (close to 6,000 in West Bank, 7,000 in Gaza). A number of staff hired directly by the *de facto* authorities in Gaza since 2007, of all categories, are outside the PA payroll.

43. **Public service grades and pay scales, including allowance categories, are, like in some other governments in the region, prescribed in the Civil Service Law, rendering pay adjustments inflexible, which have mostly come in the form of changes to allowances.** Present pay levels are mostly in line relative to per capita income, but considered low alongside the cost of living for many staff, and scales are fairly compressed. To compensate for what is seen to be inadequate pay, grading of positions has been inflated: there are more officers in the security forces than other ranks, and director-general positions are often created to enable professional staff to be employed, rather than matched to departmental responsibilities.

¹⁵ A further 900 staff are employed outside WB&G.

44. **Currently, the PA, led by the General Personnel Council (GPC) has embarked on a job classification exercise, based upon job descriptions for each post and the development of approved staffing structures for all ministries, departments, and agencies.** A technical committee is revising the 2005 Civil Service Law, with a mandate to address inconsistencies between the law and the regulations, fill gaps, and define processes better. There are plans afoot to create a public administration college. At the same time, the Government has begun looking at the mandates and structures of ministries and agencies, with a view to streamlining (though, at this point, there are no plans for downsizing). Reviewing the organizational structure of the government is one of the core institutional development objectives of the Program of the 13th Government. The aim is to eliminate duplication, clarify roles and responsibilities, and improve the machinery of government for efficient service delivery. Finally, under the leadership of the GPC, the government is looking at how existing recruitment and promotion processes could be made more merit-based, supported by improved staff performance management, and a greater emphasis on training. This is work in progress, but critical to greater efficiency and effectiveness of the civil service, and fully in line with the Program which commits the Government to “implement professional, merit-based systems and processes that will ensure equal opportunity and fairness in recruitment and promotion decisions”¹⁶.

45. **Gains from undertaking a job classification exercise are limited if the newly classified jobs are to be fitted into the existing pay and grading structure, and not a new one.** But to introduce a new pay scale, which provides for wider differentials and integrates most allowances into base pay, could have fiscal implications for the wage bill and the Government’s nominally funded but in practice cash-based pension scheme. There is a need to move from incremental staff budgeting, which the 3,000 hiring cap promotes, to one in which line ministries are challenged to meet needs by redeploying existing staff or modifying policies and programs. To keep a viable age structure for the public service, and equitably retire unqualified staff, there may be a need for some sort of early retirement scheme. Updating of the Civil Service Law could be an opportunity to spell out in clear terms the principles that will underpin the civil service of a sovereign state, and clarify the roles and responsibilities of the main institutional players, and the essential features of a modern human resource management system.

46. **By far the most pressing challenge today is the size of the public service wage bill, which is very high by global standards at around 22 percent of GDP.** This is a challenge for both the PA and for donors, who effectively are funding the wage bill through general budget support. In many respects the large wage bill share of GDP is a reflection of the exceptional circumstances of WB&G, its tradition of using the public sector as an instrument of social policy, and the geographically truncated and Israeli-constrained nature of the WB&G economy. At the same time, the public sector wage bill will need exceptionally careful management, to ensure the number of posts remains under control and, increasingly, line ministries are challenged to

¹⁶ Palestinian Authority. August 2009. *Palestine: Ending the Occupation, Establishing the State – Program of the Thirteenth Government*, page 16.

ensure existing staff are used effectively. And if some staff are to be retired early, the separation costs and pension plan implications will have to be monitored closely.

D.III. ECONOMIC DEVELOPMENT

47. **In recent years, economic growth has revived along with donor support and greater freedom of movement, but the PA has actively nurtured this growth in a number of ways.** The PA has exercised sound economic management by formulating realistic budgets and managing aggregate spending to stay within the macroeconomic plan. The improvement in security, noted above, has demonstratively bolstered the confidence of the private sector. The PA has also worked to develop and put in place regulations and mechanisms to promote private sector growth. In addition, the PMA has instituted a solid regime of supervision and regulation of the financial sector. Moreover, the PA has designed and begun implementing comprehensive plans in infrastructure, including regulatory and legal structures.

48. **The PA has exercised sound economic management by maintaining a tight fiscal stance, controlling the wage bill, and reducing dependence on donor financing.** Structural reforms implemented by the PA have worked to keep the wage bill in check and improve revenue collection. Net lending to localities has also been reduced through improvements in energy bill collections and support to raising local government revenues. As described above, the PA has instituted steady reforms in PFM systems, including budget preparation and execution practices, and established fiscal transparency and accountability in line with international standards. The IMF notes the major improvements in the quality, transparency and timeliness of economic and financial statistics, expected to meet Special Data Dissemination Standards and comparing favorably with other countries maintaining high data management and dissemination standards¹⁷.

D.III.A. INVESTMENT CLIMATE

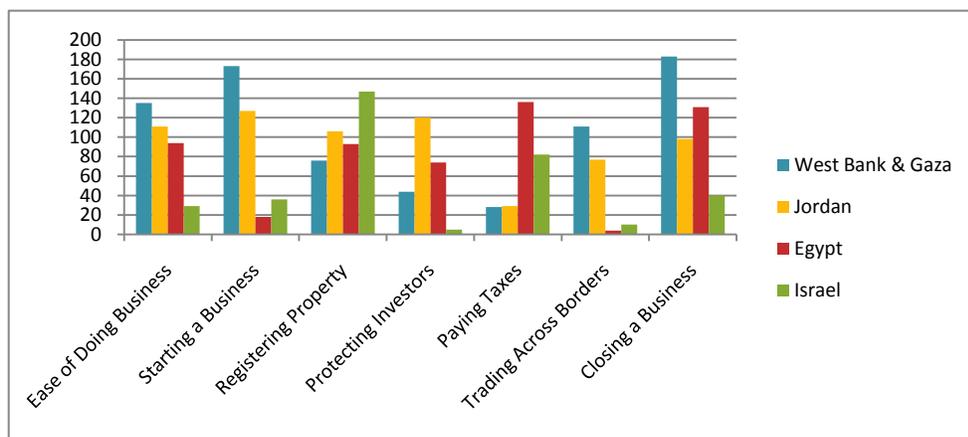
49. **The improvement of the investment climate in WB&G has been severely hampered by the closures imposed by the Israeli government on both the West Bank and Gaza.** These restrict the movement of goods and people both within and across borders, thereby increasing labor and transportation costs and strongly discouraging private and foreign direct investment. This has created a fragmented private sector that is driven by low-cost, labor-intensive products such as garments, furniture, and shoes for the heavily protected domestic and Israeli markets.

¹⁷ IMF. April 13, 2011. "Macroeconomic and Fiscal Framework for the West Bank and Gaza: Seventh Review of Progress," Staff Report for the Meeting of the Ad Hoc Liaison Committee.

In the past 40 years, Palestinian firms have had to adapt themselves to the environment imposed on them by the Gol. Therefore, the Palestinian private sector remains dominated by small, family-owned businesses that serve their local community, town, or city.

50. **The investment climate in WB&G benefits from low corruption, low taxes, and good investor protection mechanisms.** According to Transparency International’s Global Corruption Barometer 2010¹⁸, 59 percent of those surveyed in WB&G say corruption has declined in the last 3 years, and only 22 percent say it increased. This compares to Lebanon, where only 6 percent say it declined, and 82 percent say it increased. Thus, while many countries in the region suffer from high corruption, it does not seem to be a significant problem for doing business in WB&G. Indeed, the PA and private sector associations backing anti-corruption reforms should be given due credit, particularly in light of the fact that many governments far more sophisticated than the PA continue to struggle to develop effective governance arrangements regarding the relationship between the public and private sector¹⁹. The 2011 Doing Business report ranked WB&G ahead of its neighbors Jordan, Egypt, Lebanon, and Syria in 4 out of its 9 core indicators (Figure 3), including taxes and investor protection. In contrast, WB&G’s rankings in starting and closing a business were near the bottom. As the Doing Business report makes clear, the PA has made good progress, but there is much left to do.

FIGURE 3: SELECT DOING BUSINESS INDICATORS, 2011



Source: World Bank. 2011. *Forward-looking Priorities for Investment Climate Reform in the West Bank and Gaza*.

51. **Most recently, the PA has been issuing as well as amending laws in order to improve the regulatory framework of the private sector.** The laws below, assuming final approval, will

¹⁸ See on-line tables at http://www.transparency.org/policy_research/surveys_indices/gcb/2010/results

¹⁹ World Bank. 2011. *West Bank and Gaza: Improving Governance and Reducing Corruption*.

facilitate for the Palestinian private sector the transition to the manufacture of higher value goods as well as the search for potential new markets:

- **Investment Law:** An amendment to the original 1998 law was signed into law in January 2011 by presidential decree. The new law is viewed favorably by the private sector and is meant to provide incentives for both smaller businesses and the service sector in particular. This law has raised the tax break minimum from US\$100,000 to US\$250,000 in new investment, but has also created new tax breaks for investments that are lower than US\$250,000 but higher than US\$100,000. This law also allows the Cabinet of Ministers to create new incentives for projects that will bolster job creation or export potential without having to change the law itself – thereby providing the Government with an additional tool to provide investment incentives.
- **Companies Law:** This law is still in draft form and would remove minimum capital requirements, as well as permit sole proprietorship under certain limited conditions, and limit the role of the government.
- **Competition Law:** This law, still in draft, would establish an independent agency to regulate competitive behavior.

D.III.B. BANKING AND FINANCE

52. **The PMA was established in 1994 by presidential decree, and the Legislative Council PMA Law Number (2) in 1997 outlined the full authority and autonomy of the PMA.** Despite not being able to regulate monetary policy as the Israeli shekel is the main currency in WB&G, it has quickly developed the capacity needed to become a central bank. As the IMF has documented, the PMA has developed in just a dozen years into an institution providing rigorous supervision and regulation of the financial sector, consistent with international practice. It looks to become a full-fledged central bank and is building the institutional capacity in order to be ready for the new challenges that a more prominent role in monetary policy would bring. Strengthening of regulatory framework as well as supervision are top priorities for the PMA, where it has improved the supervision and operational climate of the banking sector in both West Bank and Gaza. This was further consolidated by the Strategic Transformation Plan which was developed by the PMA in 2006 in order to fulfill its mandate of ensuring the soundness of banking operations, maintaining monetary stability, and encouraging economic growth in WB&G. The PMA continues to institute regulation and supervision of the financial sector in WB&G. These regulations are applied to all Gaza and West Bank banks through regular on-site and off-site supervision of the banking sector. In 2010, a law ensuring the independence of the PMA was under review by the Cabinet and is pending presidential approval.

53. **The PMA has been able to operate in a difficult environment that uses multiple currencies, establishing a financial sector that offers most services, such as banking, a**

securities market, and insurance. The banking sector has 18 banks, 7 of which are listed on the stock exchange. These banks are licensed and supervised by the PMA; 10 of the banks are branches of foreign banks, with Jordanian banks dominating the sector, and with no state owned banks. The 8 other banks are locally owned, 2 of which are Islamic banks. The WB&G financial sector operates through 198 branches, with total assets that amounted to US\$8 billion in 2010, and with deposits of over US\$7 billion and loans of over US\$2 billion. In contrast to most developing countries, the role of banks in financing the WB&G economy remains low; this is mostly due to the political instability as well as the depressed economic activity. The PMA can be credited with maintaining bank operations in Gaza intact as well as fully integrated with the West Bank. The banking sector is the only institution with such limited impact from the separation between the West Bank and Gaza. The PMA monitors the sector with a broad range of prudential instruments that it has been working towards bringing in line with international standards. These tools include: (i) required reserves ratios; (ii) minimum capital requirements; (iii) minimum liquidity ratios; and (iv) limits on credit concentration and currency exposure.

54. In addition to these monitoring tools, the PMA has been monitoring banks' compliance with a corporate governance code in line with Basel II standards since 2008. Most recently, in 2010, the PMA issued Basel II compliant regulations governing the disclosure of information by financial institutions. In addition to enacting regulations, the PMA has enforced Basel standards and procedures when liquidating 2 banks in 2010 (one insolvent bank and one OFAC²⁰-listed bank). In addition, the PMA has based its code of good governance on the OECD's 2004 Corporate Governance Principles. This code, which was recently enacted, outlines both requirements and sanctions for non-compliance for the guidelines that the PMA monitors and enforces. These guidelines include good governance practices concerning composition, structure, and the role of the board of directors; compliance, internal, and external audit; disclosure and transparency; and risk management.

55. Finally, the PMA has sought to strengthen the banking sector's capital base by passing certain measures, including the following most recently in December 2010: (i) an increase in the minimum capital requirement to US\$50 million (from US\$35 million); and (ii) new "counter-cyclical" reserve requirements according to which banks should add 15 percent of their net (after tax) income to their Tier I capital as an additional "bad times" buffer. These measures strive to bring the banking sector further in line with international standards²¹.

D.III.C. INFRASTRUCTURE

56. In the infrastructure sector, the forward agenda is extensive, but the PA has also made important progress. The Palestinian Water Authority (PWA) is the central agency in the water

²⁰ Office of Foreign Assets Control of the US Department of Treasury.

²¹ IMF. April 13, 2011. "Macroeconomic and Fiscal Framework for the West Bank and Gaza: Seventh Review of Progress," Staff Report for the Meeting of the Ad Hoc Liaison Committee.

sector in WB&G. This sector includes water resource management and water supply and sanitation activities. In a context of overall inefficient institutional capacity and governance, the PWA copes with ad-hoc strategy, planning, regulation, and infrastructure program implementation agendas and with donor coordination challenges. The PWA Chairman, in place since March 2008, has engaged PWA in a series of reform initiatives such as i) a critical review of projects and operations; ii) an in-house governance clean-up; and iii) a campaign to negotiate a more equitable distribution of water resources. The PWA has also initiated the spin-off of its West Bank Water Department to create an autonomous bulk water utility. Two years into the changes, PWA initiatives are making moderate progress, and the agency has yet to fully recover from the initial loss of morale and capacity felt in its ranks as a result of the 2008 management shake-up. Nonetheless, PWA is impressively pushing ahead with a solid PWA-drafted Action Plan for Reform to define and implement an institutional and legislative reform program in the water sector. The Action Plan has been endorsed by the PA Cabinet of Ministers and there is considerable political pressure on the PWA to follow through.

57. Considering the institutional framework for the water sector in WB&G from a comparative perspective, it fares well relative to other developing countries. The fact that water is the critical, limiting resource in the area has played an important role in establishing relatively strong (though still fundamentally weak) institutional arrangements for the water sector. Other countries with more extensive institutional structures, such as Indonesia, show much less cohesion and policy consistency in the water sector than there is in WB&G.

58. In energy, the PA has implemented much of its medium-term power development strategy set out in the 1997 policy statement through the Palestine Energy Authority (PEA)²² and embarked on policies to reduce net lending in electricity. It has created 3 electricity distribution companies: NEDCO, established in the northern region of the West Bank on January 14, 2008, began operating the electricity services in Nablus and Jenin in 2010; and the Hebron Electric Power Company (HEPCO) and Southern Electricity Company (SELCO), created 2003-2004 in the southern region of the West Bank. NEDCO and SELCO are taking over the electricity operating assets and staff of the municipalities and village councils in their areas. This process has been slow and will take another 2 years to complete. These utilities and HEPCO join the long-established utility serving the central area around Jerusalem - the Jerusalem District Electricity Company. The Gaza Electricity Distribution Company is responsible for electricity transmission and distribution in Gaza.

59. In addition, the Electricity Law was approved and enacted in May 2009, and in February 2010 the President approved the establishment of the Palestinian Electricity Regulatory Commission (PERC), which has since made significant progress in its operations. PERC has issued licenses to 2 of the electricity utilities, and completed a cost-based tariff methodology for a unified tariff structure for the electricity utilities, which was recently issued.

²² Palestinian Authority. August 7, 1997. "The Palestine Energy Authority, the Power Sector, Letter of Sector Policy".

D.IV. SERVICE DELIVERY

60. **WB&G is a stellar performer with regards to various achievements it has made in human development outcomes**²³. WB&G's progress to date can be seen across all human development sectors including health, education, social protection, pension reform, and local development. As a result of the challenging political circumstances, there has been some decline in the provision and quality of services in certain sectors. This has required the PA to provide additional support to these sectors which would, in the long term, be unsustainable. However, as indicated in the PNDP 2011-2013, the PA remains committed to addressing current challenges and further strengthening its achievements in human development outcomes, and equity of and access to services.

61. **Mortality rates, including maternal mortality rates, are lower than other countries in the region, life expectancy is considered high for a country with the same income level, while high immunization rates and relatively strong childhood nutrition indicators also prevail**²⁴. Current education indicators are also favorable, reflecting the PA's systemic emphasis on human capital development as essential to future economic growth. The enrollment rate has been high overall in the last several years (on average approximately 90 percent) with notable growth in student numbers since 1994. The secondary gross enrollment rate is also high: approximately 20 percentage points higher than the rate found on average in middle-income countries and 15 percentage points higher than that found in other countries in the MENA region²⁵. School attendance rates are also high. WB&G also has one of the highest literacy rate of any country in the MENA region (and the highest female literacy rate -- over 90 percent) while very low repetition rates are also observed²⁶.

62. **The PA has demonstrated its commitment and capacity to assist the poorest and most vulnerable while achieving economic growth and human development gains.** The PA, with the support of donors and other organizations, has provided assistance to a large number of poor and vulnerable households. As part of the cash transfer program (CTP), currently more than 63,000 households receive cash benefits on a quarterly basis, while thousands of others are receiving food aid and other kinds of assistance. The PA also provides needed health insurance and other types of support to thousands, including targeted assistance to various vulnerable groups. In order to ensure the population's future well-being, major reforms of the existing pension scheme have been agreed and set in motion to address key issues that jeopardize the program's sustainability (e.g. overly generous pensions, high level of

²³ World Bank. July 29, 2011. *West Bank and Gaza: Coping with Conflict? Poverty and Inclusion in the West Bank and Gaza.*

²⁴ World Bank. April 13, 2011. *Building the Palestinian State: Sustaining Growth, Institutions, and Service Delivery*, Economic Monitoring Report to the Ad Hoc Liaison Committee.

²⁵ World Bank. July 29, 2011. *West Bank and Gaza: Coping with Conflict? Poverty and Inclusion in the West Bank and Gaza.*; World Bank. April 13, 2011. *Building the Palestinian State: Sustaining Growth, Institutions, and Service Delivery*, Economic Monitoring Report to the Ad Hoc Liaison Committee.

²⁶ World Bank. September 2006. *West Bank and Gaza Education Sector Analysis: Impressive Achievements under Harsh Conditions and the Way Forward to Consolidate a Quality Education System.*

fragmentation). Further, to strengthen local government capacity, community participation, and government responsiveness, the PA has focused on and achieved significant progress in the area of local development.

D.IV.A. HEALTH

63. The PA has been actively engaged to ensure services are accessible and of high quality, and to promote the equitable distribution of human development gains. Today, within the health sector a wide range of services are provided, and there has been a positive trend in terms of public's level of satisfaction with health services²⁷. Though access to health services appears to be equitable, the closure and political situation has negatively impacted health in a number of ways – and in some places more than others. The closures have contributed to an increase in the prevalence of specific health issues (e.g. mental health disorders), while also exacerbating basic health needs²⁸. Together, these have contributed to an overall increase in the demand for health services.

64. In the face of such challenges, the PA has worked to provide equitable services in primary, secondary, and tertiary care. To cope with current demands, as well as the epidemiological transition whereby the burden of disease shifts from primarily infectious diseases to non-communicable and/or chronic diseases expected in countries experiencing economic growth and transition, the PA is focused on strengthening capacity to meet current and future population health needs. Specifically, the PA is in the process of undertaking a construction and maintenance plan for all levels of health care infrastructure and has committed to continuing investment in preventive health care measures including immunizations, screening efforts, and public education campaigns; promoting human resource development and specializations (particularly in tertiary care); encouraging increased private sector participation in the health sector to secure the quality and sustainability of services; and continuing outreach of basic services to all population groups, particularly among the most vulnerable.

²⁷ Tiltnes, Åge A., Jon Pedersen, Silje Sønsterudbråten, Jing Liu. 2011. *Palestinian Opinions about Governance, Institutions and Political Leaders, Synthesis of Results of Fafo's Opinion Polls in the West Bank and Gaza Strip, 2005-2011*, Fafo Institute for Applied International Studies, Oslo, Norway.

²⁸ Espie, Emmanuelle, Valerie Gaboulaud, Thierry Baubet, German Casas, Yoram Mouchenik, Oliver Yun, Rebecca F Grais, and Marie Rose Moro. 2009. "Trauma-related psychological disorders among Palestinian children and adults in Gaza and West Bank, 2005-2008," *International Journal of Mental Health Systems* 3(21).

WHO (2008). Health conditions in the Occupied Palestinian territory, including east Jerusalem, and in the occupied Syrian Golan. A61/18 Rev. 1.

Giacaman, Rita, R. Khatib, L. Shabaneh. 2009. "Health status and health services in the occupied Palestinian territory," *Lancet* 373: 837-849.

D.IV.B. EDUCATION

65. **In education, achievements have remained steady at high levels, with 30 percent of young adults enrolled in higher education (more than half of whom are women) -- a figure that is high in comparison to other middle-income countries.** The PA's efforts to promote equitable access to education and to improve education quality throughout WB&G are highly visible on the ground. Since 1998, it has put in place a national curriculum, accompanied by editing and distributing of textbooks and in-service teacher training; achieved high enrollment rates and diversified education options (e.g., increasing number of areas that can be studied, further developing technical and vocational education); and has focused on quality and outreach including promoting early childhood care and education. Efforts to strengthen the education sector have also been observed at the community level, where, for example, additional teacher training has been provided. In addition to an increasing level of private sector investment in education, the PA, through the Ministry of Education and Higher Education (MoEHE), has also provided US\$23 million as loans and grants to needy students and has invested significantly in quality improvement to promote and secure development of skills relevant to labor market needs among Palestinian students. To date, US\$11 million has supported the first round of the Quality Improvement Fund which focused on initiatives to further strengthen the quality, relevance, and international competitiveness of tertiary institutions.

66. **To further promote human capital investment through the education sector, and in the context of the Teacher Education Strategy and the MoEHE Five Year Development and Strategic Plan, the PA has emphasized the importance of pre-service, in-service, and general teacher training, and of improvements in the quality and relevance of education.** To strengthen administrative capacity within the education system, nearly 5,000 individuals from the administration were provided with training in several areas including leadership, planning, and computer skills. The PA continues its commitment to modernize the approach and type of education, improve standards, and encourage increased enrolment in specific areas. To ensure these changes, particularly those in tertiary education, are institutionalized throughout WB&G, a higher education council and a quality assurance commission have been established and are fully functional. Still, education quality requires continued attention.

67. **Despite the restrictions on movement and access which negatively impact school attendance rates and children's access to schools, the PA has made notable progress in education.** It has articulated a long-term vision of education sector development and aims to restore WB&G as a center for excellence in higher education and academic research. The population has indicated a high level of satisfaction with the education system and the services it provides. The comprehensive strategy for the education system is characterized by significant coordination and is articulated in the recently issued Education Sector Strategy 2011-2013. The PA continues to facilitate the capacity of tertiary education institutions to access financing from the private sector and overseas while aiming to strengthen local capacity and gain visibility by establishing a national fund for scientific research, supporting tertiary

education institutions in building international networks, and continuing to provide student lending to those with limited financial means.

D.IV.C. SOCIAL PROTECTION

68. To protect the more vulnerable households, social protection support mechanisms are increasingly sophisticated, well-targeted, and far-reaching. In fact, the PA is currently poised to have one of the most advanced cash assistance mechanisms, one which can be easily scaled up in crisis situations to help extremely poor and vulnerable households. The recent merger of the European Union-funded and Bank-funded cash assistance mechanisms into a unified CTP became a reality in June 2010 when almost 63,000 households in WB&G were provided cash assistance by applying the same benefit level and using the same payment modality. The Ministry of Social Affairs (MoSA), responsible for the CTP, has strengthened its capacity in the past several years to manage and implement this large and complex CTP using proxy means test-based targeting. By demonstrating its ability to manage and implement this program using a poverty-targeting database, collaboration with other partners has increased as they increase their reliance on this database and mechanism. It has placed MoSA at the forefront of critical reforms in the area of social protection. The PA is now aiming, in the context of the CTP, to reach out to all poor households and increase the number of CTP beneficiaries to approximately 95,000 in the coming months. Apart from the CTP, the PA also provides assistance to various other groups, including assistance to families of prisoners, wounded individuals, orphans and foster children, and victims of domestic and community violence. The PA has also acknowledged diversity of need by providing, often in cooperation with others, various types of support (monetary/insurance, economic empowerment through income generation activities, and psychosocial assistance). In its recently issued paper on the Social Protection Sector Strategy, the PA further articulated its long-term commitment to this sector by strengthening the CTP mechanism and in the MoSA Business Strategy Paper the importance of honing its capacity to assist some of the most vulnerable, including persons with disabilities and the elderly, was underscored.

69. Pension reform is another area with an extensive agenda and significant challenges. Currently, pension schemes exist for public sector and security force employees that are administered by MoF with some Palestinians contributing to Israeli social insurance programs. Additionally, employees of some large companies and international organizations are covered by company social schemes. There are, however, no mandatory insurance programs and the existing pension scheme is in the process of being reformed to address high levels of fragmentation and overly generous pensions which threaten its sustainability. In 2005, the Unified Pension Law was enacted which set the stage for major pension reform to ensure that the pension system would be financially viable and sustainable in the long-term. The Pension Reform Action Plan was approved last year by the Cabinet to reduce pension liabilities and establish a unified pensions scheme that is sustainable in the long term. The PA has committed

itself to achieving a number of milestones by end-2011 including extensive reform of the existing pensions law.

D.IV.D. LOCAL DEVELOPMENT

70. **WB&G has made significant progress in strengthening local development with capacity-building efforts targeted towards the local level.** The PA's program of community-based projects has made major contributions to upgrading of services in previously neglected areas. While municipalities are foreseen as key providers in meeting basic needs through the 27 functions they are legally required to provide, serious deficits remain. With assistance from the PA, municipalities are taking steps to improve their internal management. Several, with the help of community participation, are undertaking Strategic Development and Investment Plans to help identify priorities and align their investments with them. Municipalities have also undertaken several steps to improve their PFM. These improvements have allowed municipalities to more easily disclose their financial data. An estimated 56 percent publicly disclose their financial data and budgets, and 60 percent disclosed their performance ranks (in accordance with the MDLF ranking system). Finally, municipalities are increasing the focus on their citizens as customers. Through establishing citizen services centres, municipalities are trying to serve their citizens using a private sector approach, treating citizens as customers who should receive efficient and transparent services.

71. **The establishment of the MDLF has proven to be an effective mechanism for financing local development.** One of the most important initiatives supported through the MDLF has been the development of an Integrated Financial Management System to ensure standardization of management, accounting, and operating procedures across WB&G municipalities when it is completed. This has been complemented by development of unified procedures for policy and physical planning as well as the amalgamation of various local government units, to increase the visibility and accountability of local government and encourage community participation and input. This important task will promote community development and participation in the long term in WB&G. These mark some of the most significant achievements in WB&G in the last several years.

72. **A diversity of actors including donors and NGOs have been assisting and supporting the PA.** Even so, various institutions within the public human development sector have furthered their capacity to manage services more effectively and to meet basic needs of the population, even during the worst points of crisis across WB&G. Despite continued closures, violence, and political uncertainty, the PA has demonstrated its capacity and commitment to continue providing relevant and needed services to a large portion of the population.

E. CONCLUSION

73. **This report has surveyed the record of the PA on building institutions in WB&G -- examining the domains of public institutions where government effectiveness matters most – and the record demonstrates that WB&G institutions are reasonably effective, both by any absolute standard one might have, and especially in comparison to other countries, in the region or elsewhere.** While the PA faces a number of challenges in improving its administration of certain domains, WB&G institutions have improved rapidly in a short period of time. One factor that imposes a negative influence in every sector is the closures and restrictions imposed, suppressing economic as well as institutional development in WB&G. Israeli control of all international borders inhibits the import of raw materials and the export of finished products. The restrictions controlling the internal and international movement of goods and people discourage foreign investment vital to economic growth and job creation. The lack of access to land and local water sources has devastated the agriculture sector. Restrictions on movements of materials and people hinder the supply and distribution of health and education services, as well as the access of workers to their jobs. Yet, recent progress achieved at the technical level regarding clearance revenues is encouraging, and a political decision to implement agreed steps would enhance revenue mobilization and budget execution in WB&G. Thus, the impressive achievements of WB&G institutions, comparatively with countries in the Middle East and other regions, come at the high cost of overcoming these restrictions. Going forward, a continuation of these restrictions will further constrain the good functioning of WB&G's accomplished institutions.

74. **The private sector remains hampered due to Israeli restriction, so that external assistance plays a very large role in the sustainability of WB&G institutions.** To a great extent, this assistance compensates for the severe economic constraints under which WB&G operates. The need for such assistance could be expected to decline if the external constraints on private sector development were removed. However, even with the significant growth dividend that peace would bring, and the associated growth in the size of the tax base, it is likely that the WB&G would need continued external assistance to maintain current security and civil service commitments. The PA recognizes this and is taking steps to reduce donor dependency. The PA's experience with reducing net lending, and the positive effect this has had on the budget, indicates that further structural reforms, e.g. in the civil service or pensions, would serve to improve the PA's fiscal stability.

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