LETTER OF DEVELOPMENT POLICY

Palestinian National Authority
Office of the Prime Minister

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Mr. Robert B. Zoellick
President
International Development Association
1818 H Street, N.W.
Washington, D.C. 20433

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Dear Mr. Zoellick,

1. In December 2007, we published the Palestinian Reform and Development Plan. This document lays out our vision of an independent Palestinian state. It highlights steps we have already taken to restore good governance and the rule of law to the West Bank - steps we believe demonstrate our commitment to realizing this vision. Whilst the stalled peace process and the tightening grip of the occupation have played a powerful role in shaping events, we acknowledge we had given insufficient attention to shortcomings in governance, law and order, and basic service delivery. We are now absolutely determined to rebuild the trust of our citizens and our international partners in the Palestinian National Authority by embarking on a challenging reform and development agenda for stabilization and recovery.

2. We are not complacent about the scale of the task ahead. Progress must be made to upgrade all Palestinian institutions of government. We intend to create a secure and stable internal environment in which social and economic development can take place, and in which the institutional infrastructure of a Palestinian state can develop and thrive. This must go hand in hand with sustained and serious political dialogue, and concrete steps and commitments by all parties towards a lasting peace. We are committed to bringing safety and security to the West Bank and Gaza. Our immediate goal is to return to the status quo ante before the escalation of conflict in September 2000 by resuming full security control in Area A. Our ultimate goal is to assume full authority and responsibility for security within and at the borders of the future Palestinian state.

1. Background

3. Throughout the post-Oslo period, the unstable political environment has undermined our capacity to develop and sustain effective government institutions and policies. The embargo on international assistance in 2006 and early 2007 contributed to the reversal of progress that had been made in reforming the PNA. The ensuing fiscal crisis shattered our citizens' and public servants' confidence in the PNA. The PRDP document sets out our broad priorities for improving governance in this challenging context. It sets out how we will reform the security sector and re-establish the rule of law, improve access to justice, move toward a more fiscally sustainable
position, improve our management of public finances, strengthen the capacity of the public sector, and improve local governance.

4. We are aware that the PNA’s fiscal policy has been problematic in the past and that we must act fast to avert a fiscal crisis. We have embarked on a series of fiscal reforms to put ourselves on a path to financial stability – a path that will create space for increasing capital investment and development expenditure. We anticipate that these reforms will help us reduce the current budget deficit by 11.3% of GDP over the next three years, bringing it to the 2005 level. Our macroeconomic and fiscal forecasts assume modest improvements in the political and security environment, yielding a gradual reduction in movement and access restrictions, and a gradual increase in trade and private sector confidence. This is our baseline scenario. If a combination of political progress and an improved security environment accelerates the lifting of the occupation regime beyond current expectations, the level of public investment and private sector activity could increase more significantly. However, if the occupation regime remains unchanged, the economic outlook is extremely poor. It would make it very difficult to increase public investment and to finance a substantive reconstruction effort. Any reluctance on the donor side to finance the budget deficit would lead to a deepening fiscal crisis that would almost certainly take the PNA to the point of financial and institutional collapse. It would also lead to rising unemployment, increasing poverty, declining health and education indicators, and further, perhaps irreversible, degradation of the private sector.

5. Our forecasts are based on the assumption that donors will provide substantial levels of predictable aid over the next three years to support the recurrent budget and public investment program. In 2008 we need $1,361 million to finance our recurrent costs and $427 million to finance development investment. These amounts are large but they are, we believe, the minimum we need to implement our reform and development plan and begin serious preparations for statehood. We had appealed to donors to provide this assistance as direct, un-earmarked budget support through the single treasury account. This would give us control over the targeting and timing of disbursements and enable us to execute our reform and development plan more effectively. However, for those donors unwilling to contribute directly to the single treasury account, we have asked the World Bank to establish an un-earmarked, multi-donor trust fund mechanism.

II. The Reform Plan

Fiscal sustainability

6. The Palestinian National Authority is committed to these reforms and we understand the need to make rapid progress in order regain the confidence of the Palestinian people and our international supporters. Two areas stand out as being particularly important for the reform agenda: fiscal sustainability and improved accountability and transparency of the Government budget. Without steady and significant progress in these areas, we can not expect the required high level of support from our friends and supporters.

7. Fiscal Reform: Political instability and insecurity have created a state of almost permanent socio-economic distress in the occupied territory. In the periods of greatest instability, public expenditure has played a major role in maintaining consumption in a fragile economy, and averting a complete breakdown in law and order. In the face of a growing population, a rising labor force and a contracting private sector, public sector employment has served as a safety valve to relieve escalating unemployment. Indeed, in the absence of a free and export-oriented private sector, the Palestinian public sector and donors have become the main source of employment and personal income.
8. Over time, however, rising public expenditure has created structural fiscal problems which are compromising our ability to govern effectively. Rapid growth in the wage bill has crowded out non-salary expenditure and the budget deficit has risen sharply. Consequently, we have become increasingly dependent on international aid to fund development expenditure, and even the operating expenditure required to deliver basic services. Also, a liquidity crisis, precipitated by economic sanctions and institutional degradation during 2006, led to the accumulation of a large stock of arrears due to public sector employees (i.e., unpaid salaries) and to private sector suppliers. The accumulation of these arrears, which reached a peak of $1.3 billion during 2007, has shaken the confidence of the people and markets in our long-term financial viability.

9. During the second half of 2007 we have launched a series of policy actions to address these fiscal problems:

i. **Wage bill reduction** – Little more than two years ago, the number of public sector employees stood at just under 137,000 and, during 2007, reached a peak of 189,000. We have implemented a bold plan to reduce this to 150,000. This has been done through the elimination from the payroll of employees who were not legally appointed, leading to an 8% reduction of the wage bill in NIS terms. Going forward, we are committed to a containment policy to ensure that the previous irresponsible hiring practices are not repeated. The containment policy is premised on a baseline employment figure of 150,000, with a modest level of necessary recruitment – particularly in the Education and Health sectors – to meet the basic service needs of a population growing at approximately 4% per year. Additional recruitment will be subject to a firm upper limit of 3,000 per year. Also, in order to constrain real wage bill growth, there will be no general public salary increases over the next three years. As a result, the wage bill is projected to decrease from 27% of GDP to about 22% by 2010, a level similar to 2004. To achieve these goals we will implement modernized human resources management systems and procedures, that emphasize merit and performance as the basis for hiring and promotion.

ii. **Net lending** - The cost of subsidizing citizens' consumption of energy and utilities represents 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 municipalities and other electricity service providers) of consumers' electricity bills. This forces the central government to fund payments to the Israel Electricity Company (IEC) for bulk purchases of electricity in order to avoid service disruption. The cost of net lending accelerated rapidly in 2006. It is currently accumulating at a rate of approximately $50 million per month and is expected to reach a total of $511 million for the year 2007. The Ministry of Finance is working with local government officials to implement a plan that will progressively reduce net lending significantly from 10.6% of GDP in 2007 to 7.8% of GDP in 2010 (reaching 9.0% and 8.5% in 2008 and 2009 respectively). This plan, which incorporates enforcement measures such as a requirement for citizens to present a 'certificate of payment' of utility bills in order to receive key government services, will progressively bring an end to the non-payment of electricity bills by all consumers. These regulations will, however, be accompanied by provisions to ensure continued access to utilities services for those suffering extreme poverty. These 'poorest of the poor' will be identified through an objective and transparent process implemented by the Ministry of Social Affairs, whereby a specific 'lifeline' level of electricity will be provided to ensure that poor and vulnerable families are not deprived of access. We will also reform the social safety net system by establishing a targeting database to ensure that cash payments are targeted at the most needy. Beyond this, utility provision will be based on economic principles and will be moving toward a full cost-recovery basis. It should be noted that, under the current circumstances, the plan to reduce net lending cannot be implemented in Gaza.
Accordingly, whilst implementation of the plan is expected to yield a substantial reduction in net lending for electricity consumption in the West Bank (approximately 70% by 2010), these savings are partially offset by projected increases in net lending related to growth in electricity and water consumption in Gaza, and higher oil prices.

iii. Tax administration reforms – Despite an already strong revenue performance, we will implement administrative reforms directed at further increasing the collection of tax and customs revenues. These will include a variety of administrative and technical measures, including the creation of a ‘Large Taxpayer’s Office’, focused inspections on fast-growing businesses with high cash incomes, strengthened supervision at crossings, automation of administrative procedures, and specialized training.

iv. Payment of arrears – We intend to repay a substantial proportion of the arrears due to the private sector, government pension schemes and government employees by the end of 2010. This will help jump start an economic recovery by injecting approximately $ 500 million into the economy during the next three years. It will also restore levels of confidence in the PNA and the domestic market place.

10. Municipal Finance Reform: Controlling the PA budget requires actions to ensure fiscal sustainability of local governments. As net lending is reduced, local governments must be able to develop alternative sources of revenue to fund their services. Consequently the ‘Accountable Local Government’ (ALG) program will: introduce new legislation to clarify and regulate the relationship between central and local government; establish a policy framework which promotes fiscal autonomy and discipline at the local level; and build the operational, administrative and financial management capacity of local government bodies. The Municipal Development and Lending Fund (MDLF) is expected to be the primary source of development-linked assistance to municipalities, and to support essential administrative and financial management reforms. Several donors have already programmed significant assistance to the MDLF, and are likely to increase their assistance over the three-year period. The MDLF is the PNA’s preferred mechanism for channeling reform and development assistance to local government and disbursements must be coordinated with the Ministry of Finance.

11. During 2008, we will launch a thorough institutional review of the pension system, with a view to establishing appropriate arrangements and plans for reforms that will ensure its fiscal sustainability, whilst maintaining a reasonable level of social protection for pensioners.

Accountability and transparency

12. Accountability and transparency are core guiding principles informing our approach to strengthening public institutions. Substantial progress has already been made in restoring accountability and transparency to public financial management through reconstituting the single treasury account, preparing budgets for 2007 and 2008, and preparing the Palestinian Reform and Development Plan 2008-10.

13. With effect from March 2008, an Accountant General will be appointed to supervise treasury, cash and debt management, budget execution, payroll, and accounting and financial reporting. We commit to institutionalizing a Medium Term Expenditure Framework system for developing the budget. For increased transparency we will ensure that revenue and expenditure statements are published monthly and that year end performance reports are published in a timely manner.

14. An upgraded accounting system, including commitments control and cash flow management functionality, will also be implemented in early 2008, initially in the Ministries of Education and Health (the major spending ministries). The system, which will also allow for less
centralized budget execution (and hence greater accountability), will be rolled out to the remaining ministries through 2008.

15. We are committed to building on these achievements in order to deliver more open government and greater accountability to citizens. We are also committed to the principle of separation of powers and strengthened oversight of the executive branch by the legislature and the judiciary. In relation to the former, we look forward to moving beyond the current political deadlock and the resumption of normal functioning of the Palestinian Legislative Council. Whilst the current situation clearly constrains our ability to pass primary legislation, we believe that this should not prevent us from developing new legislation.

16. The ‘Open and Accountable Government’ (OAG) program will consist of three sub-programs:

- **System and process re-engineering** - including capacity-building in implementing integrated policy-making, planning, budgeting and accounting processes (from the Prime Minister’s Office through to line ministries and agencies), capacity-building for the office of the Accountant General, implementation of a government-wide accounting and financial management information system, and strengthening of internal financial control functions;

- **Building effective oversight institutions** - including capacity-building for independent audit functions and the Palestinian Legislative Council secretariat; and,

17. The Palestinian Authority expresses its full commitment to the implementation of the program described above along with the Palestinian Reform and Development Program from which it was derived. However, its ultimate success depends upon parallel actions by the donors and the Israelis. If the Israeli authorities do not relax restrictions and improve movement and access, the private sector will not be able to deliver the growth needed to reach the deficit targets. Likewise, if the donors do not fully support the program or if the Israel does not regularly transfer clearance tax revenues, the PRDP goals will not be attainable. The Palestinian National Authority appreciates the help and support the World Bank has consistently shown in our efforts to build an independent Palestinian State. Hence we request that the World Bank establish a multi-donor trust fund for budget support and to provide a Development Policy Grant of $40million to assist us as we pursue the goals of fiscal sustainability and increased government transparency and accountability.