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From Crisis to Greater Fiscal Independence

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ABBREVIATIONS AND ACRONYMS

CSR	Civil Service Reform
CTA	Central Treasury Account
DFID	Department for International Development
FACB	Financial and Administrative Control Bureau
FAO	Food and Agricultural Organization
GHI	Government Health Insurance
GOI	Government of Israel
GPC	General Personnel Council
GPIC	Gaza Pension Insurance Corporation
IDA	International Development Association
MDF	Municipal Development Fund
MENA	Middle East and North Africa
MIS	Management Information System
MOD	Ministry of Detainees
MOEHE	Ministry of Education and Higher Education
MOF	Ministry of Finance
MOH	Ministry of Housing
MOL	Ministry of Labor
MOP	Ministry of Planning
MOSA	Ministry of Social Affairs
MTDP	Medium Term Development Plan
NHSP	National Health Strategic Plan
NIS	New Israeli Shekels
NPC	National Pensions Committee
NPV	Net Present Value
OFAC	U.S. Office of Foreign Asset Control
OOP	Office of the President
PA	Palestinian Authority
PCBS	Palestinian Central Bureau of Statistics
PECDAR	Palestinian Economic Council for Development and Reconstruction
PEFA	Public Expenditure and Financial Accountability
PER	Public Expenditure Review
PLC	Palestinian Legislative Council

PIF	Palestine Investment Fund
PLO	Palestine Liberation Organization
PFM	Public Financial Management
PMA	Palestine Monetary Authority
RCSU	Reform Coordination Support Unit
SHC	Special Hardship Case
SSPL	Security Service Pensions Law
SSR	Security Sector Reform
TIM	Temporary International Mechanism
UNRWA	United Nations Relief and Works Agency
UPL	Unified Pensions Law
TEP	Teacher Emergency Package
VRS	Voluntary Retirement Scheme
WBG	West Bank & Gaza
WFP	World Food Program

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West Bank and Gaza

Public Expenditure Review

Volume 1

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Note: Individual Background Chapters on the Macro and Fiscal Context, Public Financial Management, Civil Service Reform, Reforming Intergovernmental Fiscal Relations, Education, Health, Social Policy and Social Safety Nets can be found in Volume 2.

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EXECUTIVE SUMMARY

The Palestinian Authority (PA) is currently confronting a fiscal crisis that could threaten its very existence. During the first six months after the new Palestinian government was sworn into office in March 2006, tax revenues (on a cash basis) amounted to only \$17 million per month, compared to \$104 million during the same period a year earlier. Expenditures for the same period in 2005 (including wages and allowances, transfers, operating and capital expenses, and net lending) stood at around \$172 million per month; by 2006, they had fallen by more than half.¹ By December 2005, the wage bill alone was running at around \$93 million per month and some estimates placed it significantly higher. The proximate causes are the Israeli decision to withhold clearance revenues and the U.S. threat to prosecute any banks engaged in financial transactions with the PA in the wake of the January 2006 election. The structural roots of the crisis run deeper. By late 2005, the PA had already reached a position that was fiscally unsustainable in which assets were being liquidated or mortgaged to meet current expenditure needs.

Under these circumstances, and given the political complexities, it is difficult to think about a public expenditure review (PER) in the traditional sense. Implicit within a PER is the belief that a government faces options and tradeoffs in how it uses its financial resources—that it has control over its revenues and the flexibility to choose between competing expenditure priorities. At first glance, beyond developing a carefully prioritized schedule of expenditures to be paid as resources become available, it is hard to see what else can be done.

Yet the current crisis also provides an opportunity to take a longer term and more strategic view of Palestinian public finances. Throughout 2005, the PA was running an average monthly deficit in excess of \$60 million, nearly 60 percent above the average monthly revenues it was receiving. With unchanged policies, the fiscal deficit for 2006 would in all probability have exceeded \$900 million and perhaps gone over \$1 billion. This is two to three times the amount secured in external budget support in 2005.

The dynamics behind the PA's increasingly precarious financial position—and particularly, the failure to curb the rapid expansion in the wage bill—have been well-understood for a decade or more. More than seven years ago, the Bank warned in a major publication that the PA's top priority was to manage public employment so as to control the wage bill and avoid unsustainable levels of expenditure:

The Palestinian Authority has been unsuccessful in attempting to cut back in its own hiring...A consequence of the inability to meet these public employment targets is that the PA Executive does not have the same issues of choice facing cabinets in other governments, such as whether incremental resources should be spent on bricks and mortar for buildings or paving for roads, whether they should be used to raise public sector wages or even whether they should be given back to taxpayers in tax relief. These choices are effectively preempted in WBG by the

¹ Unless otherwise noted, all references to dollars (\$) denote U.S. dollars.

domination of spending by new public service hiring. A less obvious but ominous consequence is that future policy choices of the PA, and its capacity to handle future responsibilities, will be severely restricted by uncontrolled public hiring.²

At that time, civil service employment stood at slightly more than 48,000, and staffing in the security services was at just under 41,000, for a total of 89,000. As of 2006, these figures stood at over 81,000 for the civil service and 77,000 for the security services (including trainees), for a total of 158,000. Since 1999, there has been an average annual increase in staffing of just under 9 percent a year—a rate of increase that is over twice the rate of population growth. Even in the midst of acute financial crisis in the first quarter of 2006, the PA has added over 1,300 into the civil service and 6,800 into the security services.

These increases have severely exacerbated the PA's current financial woes. In nominal terms, the Ministry of Education and Higher Education's salary budget has increased by nearly 80 percent since 2000, while the number of teachers has increased by 36 percent. The Ministry of Health's salary budget increased by nearly 73 percent, and the number of medical personnel (physicians, dentists and pharmacists) nearly doubled from 1,631 in 2000 to 2,999 in 2005. To pay for this rapid expansion, non-wage expenditures on supplies and maintenance have been radically curtailed on the assumption that donors would fund the balance (see Table 1). This approach made the PA extraordinarily vulnerable to disruptions in donor funding, with the result that service delivery was significantly degraded when external aid was curtailed in March 2006.

Table 1: Budget and Funding for Non-Salary Recurrent Expenditure in Health
(millions of dollars)

	2001	2002	2003	2004	2005
Budget Allocation	49.9	45.3	51.3	51.9	50.3
Funds Received from MoF	16.1	10.3	0	0	0
Funds from Other Sources	16.1	31.2	45.9	43.5	14.4
Financing Gap	17.7	3.8	5.4	8.4	35.9
% Financing Gap	35%	8%	11%	16%	71%

Source: Oxford Policy Management Health Sector Expenditure Review (2005) and Bank Staff Estimates, 2006

Accordingly, two critical and fundamental issues confront the PA and its partners. First is the challenge of bringing aggregate expenditure closer to likely revenues and available financing. Second, but no less important, is the issue of the composition of expenditure, and hence its overall efficiency. These two issues are closely interrelated. Without substantial improvement in expenditure efficiency, it is difficult to envisage continued financing to the extent required in the short and medium term. Without adequate financing, it is difficult to envisage continued improvements in the composition and efficiency of expenditure. Central to both issues is resolute and realistic action to reduce government employment and wages while improving internal incentives.

² *West Bank & Gaza: Strengthening Public Sector Management* (Washington D.C., World Bank, 1999), p. 18.

It would be unfair to place responsibility for the PA's current dire fiscal and administrative condition solely upon the Palestinians. No administration could easily cope with the massive collapse in revenues that the PA was confronted with in 2006. Domestic revenues were constrained by severely limited job opportunities in the private sector and the substantial economic cost of widespread restrictions on internal movement of goods and services. In the public sector, employment is driven by a host of complex and powerful dynamics. Some are understandable, such as the relatively high levels of unemployment and demographic pressure to create jobs for new entrants into the labor force; the precipitous collapse in remittances from workers in Israel; a highly constrained private sector's inability to absorb surplus labor; and the pressure to incorporate irregular militia into the security forces in Gaza. Others are less so, such as the extensive use of employment within the PA for purposes of political patronage, payments to non-existent and/or non-attending workers, and illicit payments to double dippers. Certain donor practices and approaches have also contributed to the current dire fiscal situation and, in some cases, contributed to the erosion of important reforms in areas such as public financial management.

It is clear that the effort to place the PA back upon a sustainable fiscal trajectory and solid administrative footing is going to require coordinated effort on the part of all relevant parties around a shared strategic approach. It will also require a significant change in PA financial and administrative practices. The PER examines areas where the bulk of PA expenditures occur—the wage bill, net lending to local governments, health, education and social services—and makes a number of recommendations for streamlining them and improving their efficiency and effectiveness. (See Table 2) It also dwells extensively upon cross-cutting issues of public sector management, including both public financial management and civil service reform, given their importance in helping to realize the PA's broader developmental objectives.

Table 2: Selected Palestinian Authority Budgetary Expenditures, 2005

	Millions of US\$	Millions of NIS	Percent of GDP
Total Wages	1,001	4,493	22.4
Net Lending 1/	344	1,545	7.7
Education 2/	274	1,229	6.1
Health 2/	153	688	3.4
Transfers	375	1,681	8.4
o.w. Social Safety Net	176	791	3.9
<u>Memorandum:</u>			
GDP	4,479		

1/Includes purchase of fuel for electricity generation, transfers to the General Petroleum Company and loans to municipalities for the delivery of water.

2/Includes wages, operating expenditures, transfers and PA-financed capital expenditures.

Source: data supplied from the Palestinian authorities.

Macro and Fiscal Challenges. Beset by closures, violence and a fiscal crisis, the Palestinian economy is declining from its already low level. According to preliminary Palestine Central Bureau of Statistics (PCBS) data, real GDP per capita is estimated to have declined by 8-10 percent in 2006, bringing the cumulative decline in average

incomes since 1999 to over 30 percent. About a quarter of the Palestinian labor force is out of a job. The situation is particularly tenuous in Gaza, where the unemployment rate increased to 36 percent as compared to 29 percent one year earlier. At the same time, stepped-up donor support has played a major role in preventing the economy and household incomes from falling much more rapidly in 2006.

The economic outlook is highly precarious. In the short term, continued high levels of donor assistance would be critical for sustaining the Palestinian economy. A solid foundation for future growth depends critically on two factors. The first is a radical improvement in Palestinian movement and access; under the current set of restrictive measures the Palestinian economy will remain moribund. The second is stabilization of the PA's fiscal situation. This would require both a resumption in the transfer of clearance revenue and significant fiscal adjustment on the part of the PA.

The Government of Israel's decision to suspend the transfer of clearance revenue, which accounts for over 60 percent of the PA's revenues, has made it virtually impossible to achieve the objective of sustainable fiscal management. However, the PA's past irresponsible spending policies have exacerbated the current crisis. In particular, despite a revenue crunch during the *intifada*, the PA's wage bill continued to increase unabated at a rate of around 9 percent per annum between 2000 and 2005. Moreover, since 2003 the PA has increasingly been the "financier of last resort" to cover unmet obligations for other public entities. In 2005, such payments drained the public resource envelope by \$344 million, or more than 5 percent of GDP. New social benefit programs were launched and pension laws adopted which have also increased the burden of social transfers for the PA. The resulting increase in the deficit was mostly covered through domestic financing (including the Palestine Investment Fund and bank loans), but this source of financing has reached its limits. If not addressed, these three major fiscal challenges—first and foremost the wage bill, but also net lending to municipalities and other government entities, along with pensions and social transfer programs—will continue to be a source of instability and uncertainty to the detriment of future growth.

Public Financial Management. From 2000 to 2004, the PA implemented a host of public financial management (PFM) reforms that have reduced corruption and significantly improved the transparency, taking it from being a relative laggard in many respects to setting an example for the MENA region. These reforms include setting up a Central Treasury Account (CTA) through which all government revenue is collected and payments are made; formulating an annual budget that is approved by the Palestinian Legislative Council (PLC) and forms the basis for budget execution allocations; putting into place a basic accounting system that provides a basis for orderly budget appropriations and budget execution; establishing tight controls over expenditure through placing MOF financial controllers in every line ministry; transferring payroll responsibilities to the MOF and paying public sector salaries through bank accounts; undertaking structural reforms to improve the operation and oversight of Palestinian public investments through the establishment of the Palestine Investment Fund (PIF); and enhancing fiscal transparency by posting the Budget Speech, approved annual

expenditure estimates and actual expenditure data for previous fiscal years, and monthly expenditure reports on budget implementation on the MOF's website.

Unfortunately, these reforms are now at risk. By 2005, momentum for PFM reforms was beginning to run out, and a number of important initiatives—particularly those involving financial reporting and internal audit—were experiencing delays. More importantly, the CTA, which had provided strong central management and transparency for PA finances, has been a casualty of the broader political standoff between the donor community and the Hamas government. The reversal of donor support for this mechanism and donor refusal to finance the PA directly but to instead channel funds through the Office of the President (OOP) has made the CTA inoperable and raised the risk that this achievement may be undermined. The extent to which the PA's financial control and internal audit arrangements are currently being applied to payments now made through the OOP is also unclear. Anecdotal evidence has raised concerns of a significant reduction in transparency and accountability because of erroneous reporting and a failure to submit financial reports regularly. There are hopes that this slide may be reversed if a broader political compromise is obtained and donor funding resumes through normal channels. Clearly, the top priority for PFM reforms bar none is to ensure that the earlier reforms, particularly the CTA, are fully restored. However, the prospects for doing so, and the extent to which PA capacity has been degraded and will require additional strengthening to bring the earlier reformed practices back on line, remain open questions.

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

- Reform of the accounting system, in particular reforming the chart of accounts and the classification system, and ensuring that the redevelopment of the central accounting system as far as possible meets the needs of line ministries.
- The need for line ministries to be more responsible for their own expenditure management and to locate this responsibility at the level of spending units within ministries.
- The need for the Palestinian Investment Fund's recent lapse in financial transparency to be rectified and for improvement in financial transparency in the two major state owned enterprises: the Petroleum Corporation and Cement Company.

- There is also a need for international donors to harmonize their project financial management requirements and as far as possible make use of the CTA and the PA's accounting system.

Civil Service Reform. The civil service reform agenda is one of the most important developmental and administrative challenges currently confronting the PA. Issues surrounding the wage bill and what could potentially be done about it are discussed separately below. In addition, there are a number of important civil service reforms in areas ranging from the legal environment to the machinery of government to anticorruption and human resource management. Any near-term reform effort would involve measures to strengthen establishment control, such as the implementation of a comprehensive payroll audit, the use of biometric systems (i.e. "electronic fingerprints"); the development of computerized human resource information management systems capable of sharing information between the MOF, GPC and MOI; consolidation of payroll authority for all security service personnel under the MOF; and clarifying the roles of the GPC and the MOF under the new civil service legislation for managing human resources. These steps will help reduce abuses in the payroll system and provide for greater transparency.

Another important civil service reform track involves strengthening the institutions and legal framework for combating corruption. Until now the PA has not adopted a comprehensive national anti-corruption strategy, and the limited anti-corruption activities undertaken appear to have been *ad hoc* in nature rather than a part of a comprehensive approach to combating corruption. The anti-corruption agenda could be expanded in several directions. The first would be developing an anticorruption strategy and conducting empirical work on the nature and causes of corruption. The need for establishing an independent anticorruption agency should be carefully examined that would focus upon prosecution, prevention and public awareness. Steps could be taken to promote greater transparency and access to information, as well as to improve compliance with the *Law on Illicit Gains*. The general inefficiency of the court system hampers the investigation of cases of corrupt practice in the civil service. In the medium term, strengthening of the court system and the office of the attorney general should be considered a priority.

Finally, assuming that a sustainable fiscal configuration can be achieved, medium term efforts should focus on institutional restructuring. There is scope for rationalizing PA administrative structures to reduce overlap and duplication and improve policy coordination. Detailed functional reviews should provide the basis for reorganization and help eliminate duplication. The temporary re-assignment of staff to other government institutions where the demand for staff is greater should be considered. As Chapter 7 (Volume 2) indicates, the areas of social policy and social protection are a prime candidate for rationalization. But others exist as well. The design of the PA institutions should reflect the Palestinian aspirations for a viable and comprehensive state apparatus capable of providing a wide range of public services. Therefore, the process of rationalizing the number of government ministries and agencies should be a subject to a thorough review that establishes the guidelines for institutional development planning in

the long term. This effort should be linked to a new staffing structure with defined job descriptions and qualifications, as discussed in the section on controlling the wage bill below.

Intergovernmental Fiscal Relations and Municipalities. Palestine has one of the more vibrant local government sectors within MENA. In a region dominated by unitary systems and strong central governments, municipalities and villages within the West Bank & Gaza are among the most autonomous. Central government transfers are modest by regional standards, and local governments have a great deal of control over their own revenues. They also have responsibility for at least 22 functional areas—one of the broadest sets of expenditure assignment in the region. Preliminary survey data indicates impressive levels of satisfaction among residents regarding the quality of local survey delivery.

Yet some areas of concern have emerged during the second *intifada* relating to the problem of spiraling municipal financial arrears, heavy reliance on utility service surcharges as a source of revenue, and an increasing share of local expenditures for general administration and wages. Over the past few years, capital expenditures have declined in relative terms. This raises important questions about service delivery quality and coverage in the future, and whether Palestinian municipalities will be able to invest in the infrastructure required to maintain and expand network services, particularly given high population growth rates.

The PER reviews the Palestinian intergovernmental fiscal system, with particular focus on public expenditure management. It considers legal framework and policy issues, expenditure and revenue assignment authorities, structural and functional relationships within the system, and the impact of these factors on policy outcomes and service delivery. One of the key recommendations is the need to realign and consolidate the legal and administrative framework and to ensure greater coordination among national and local agencies in policy formulation and implementation. Current inconsistencies in the law and divergent practices among local governments in Gaza and the West Bank will continue to undermine the establishment of an effective public expenditure management system if not addressed in the near term. Other recommendations include rationalizing the number of local governments, which has expanded significantly in recent years; setting up a variety of mechanisms to help coordinate policies and standardize practices; and reviewing incentive frameworks to reduce certain dysfunctional practices, such as the use of pre-paid metering to reduce the propensity for municipalities to default on their utility payments.

Education. In spite of the harsh conditions in which schools have had to operate, impressive achievements have been made during the past five years. The education system has experienced massive expansion and attained equitable access, reaching a level of development that by most accounts is comparable with middle-income countries. Enrolment in basic education is universal, and the enrolment rate for secondary education is above 80 percent. These figures put the West Bank & Gaza in the lead in the MENA region. Equally important is the high enrolment rate in tertiary education—above

40 percent for the 18-24 age group—which is high when compared with middle-income countries. The fact that for the first time Palestinian children participated in international tests and scored above the average for MENA countries is another major accomplishment. To the PA's credit, access to basic and secondary education is highly equitable with respect to gender, location, refugee status, and household income.

In the education sector, total expenditure as a percentage of GDP increased in the past 3 years from 7.5 percent in 2000 to 11.5 percent in 2003. However, the government's share of total education spending for the same period fell from 42 to 34 percent by 2003. Donor partners funded the bulk of capital expenditures after 2000, while UNRWA, which enrolls 25 percent of students in basic education, covered 20 percent of total expenditures. Also, private funding increased to 46 percent of all education expenditure (including tertiary education). The bulk of PA expenditure for education—around 90 percent—is allocated for salaries.

Fortunately, there is scope for considerable savings in several areas. Much of the increase in employment in this sector has been driven by assumptions of rapid demographic growth. However, shifting demographic trends are likely to result in the need to recruit significantly fewer teachers in the future. Savings can also be realized by changing the mix of staff. A benchmark comparison of the PA education function against that of UNRWA, for example, reveals that on average the PA employs over twice as many support personnel. The PA's practice of procuring new textbooks annually results in unnecessary spending. Current expenditure on vocational education is inefficient and in need of thorough overhaul. Most importantly, it is necessary for the PA to build upon past accomplishments and reorient its expenditure from recruiting more teachers and building more schools to qualitative improvements, such as developing pedagogical methods and practices, improving the quality of teacher training, and enhancing capacity to monitor performance.

Health. Prior to the second *intifada*, the West Bank and Gaza also witnessed impressive gains in the health sector that are reflected in relatively good indicators in comparison to countries at comparable income levels. Official statistics show that over the last two decades infant mortality rates steadily declined. In 2004, the infant mortality rate (IMR) was 22 deaths per 1,000 live births, a number well below the regional average of 44. Life expectancy also increased significantly for females and males. In 2004, total life expectancy at birth was 73 years, on average 4 years longer than the typical person in the MENA region. The under 5 mortality rate (U5MR) has also steadily improved. With 24 deaths per 1,000 under 5, it is less than half of the regional average of 56.

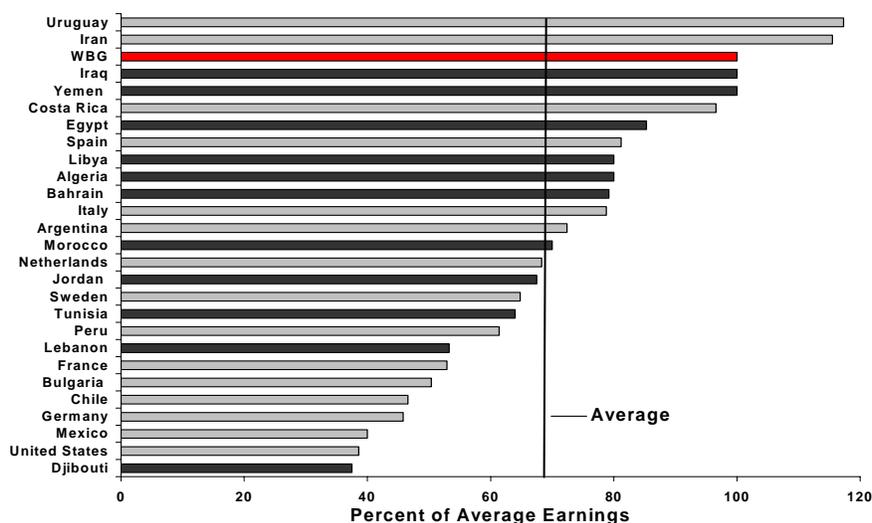
These achievements have come at a relatively high cost, with total health spending (including direct household spending) at about 13 percent of GDP—among the highest rate in the MENA region. PA expenditure on health services has been driven by increasing public employment and wage expenditures, with close to zero funding for capital expenditures and a diminishing share allocated to operating costs. At the same time, the PA has expanded the volume and types of contracts with Palestinian NGO health care providers through the Government Health Insurance (GHI) coverage. In the face of the current fiscal crisis, the MOH has been unable to reimburse the NGOs and is

accumulating arrears on these commitments. The PA's expansive wage bill and expenditure for contracted services has left little fiscal space for critical non-wage expenditures such as pharmaceuticals, medical supplies and operations and maintenance. Rationalization of other critical functions in health, including the adoption of new procedures for pharmaceutical procurement and curtailing specialized treatment abroad, will yield significant savings.

Social Services. Despite current difficulties, the PA providers of social protection services have pressed on with their tasks. Some social programs are still operating, albeit in a limited form. Food rations from the World Food Program (WFP) continue to be distributed, the UNRWA Special Hardship Case (SHC) program and other services are functioning, and food rations for newly poor families in Gaza are being issued from contributions from Egypt. The Ministry of Social Affairs is currently working with the World Bank to improve the targeting of social assistance benefits.

Yet reforms are needed in this sector along several dimensions. Public sector pension reform is another top priority from a fiscal perspective. When viewed as a ratio of average employee earnings, PA pension schemes are among the most generous in the world—indeed, far more generous than those in many donor countries who are being asked to help support them. (See Figure 1)

Figure 1: A Global Comparison of Average Pension Gross Replacement Rates



Source: World Bank Staff Estimates, 2006

Implicit debt accumulated from the current civil service schemes are nearly twice current GDP, and even making payments to current recipients requires an ever-larger share of the budget, estimated at nearly 3 percent of GDP in early 2006. Given the relatively small number of pensioners, the Gaza Pension Insurance Corporation's (GPIC) financial assets have been sufficient to pay current benefits. However, the continuing accrual of arrears, the use of pension contributions for other budgetary needs, and the generous benefit formula and early retirement provisions collectively imply that the GPIC fund could be

bankrupt within a few years. The situation may, in fact, be worse. Because of the halt in both employer and employee contributions to the GPIC in 2006, it may have sufficient assets to pay pensioners for only six to twelve months. At that point, the PA, as guarantor of the scheme, will be responsible for assuming the costs of all pension benefits.

Fundamental reform is not a short term undertaking. However, an initial step would be to strengthen the administrative capacity of the GPIC and to ensure that financial assets are adequately protected for beneficiaries. It would include analyzing and revising the Unified Pension Law to adjust the parameters of the current public system to ensure long term sustainability. The pension law for security services, passed in 2005, is at once excessive and simply unaffordable. Currently, there is little or no pension provision for private sector workers. Addressing this problem will entail changes to the 2003 Social Security Law, which cannot not be implemented as written.

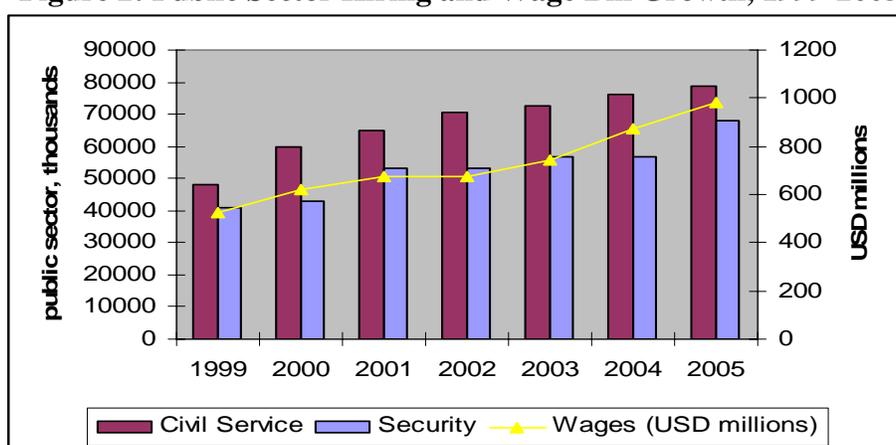
Beyond pension reform, there is scope for significant savings through better social safety net program coordination and targeting. Currently the West Bank & Gaza are utilizing a variety of ad-hoc programs often operating independently of each other and covering overlapping beneficiaries. At a minimum, there should be regular forums for exchanging information; policy planning, budgeting and fiscal management practices will need to be improved; and MIS systems need to be updated to allow the sharing of data on beneficiaries and better monitoring of performance. Beyond that, there is scope for program rationalization in several areas, such as vocational training, cash transfer programs and in-kind food rations. Improvements are also needed in reducing relatively high leakage rates to the non-poor through improved targeting and expanding self-targeted approaches such as workfare.

Towards a Sustainable Wage Bill. While the end of the recent strike is an encouraging sign, the situation remains highly precarious. Since March 2006, the government has been unable to pay most of its salary commitments owed to PA employees. Several partial salary payments have been made to public sector employees from March 2006 to January 2007. Total payments made to date (through the MoF and OoP) are estimated at around \$350 million, with another \$100 million being paid through the Temporary International Mechanism (TIM). The specific totals vary between categories of employees, but on average employees have received around 40 percent of their normal incomes. A recent poll indicated that 95 percent of public sector employees believe that it has become more difficult to make ends meet in the last 3 months, as compared to 67 percent in the private sector and 83 percent of the general public. Around 71 percent of government employees fall below the poverty line defined as income level of less than \$460 per month for an average household of six as compared to 35 percent in June 2005.³

³ Source: Near East Consulting Monthly Bulletin on Palestinian Perceptions Towards Political, Economic, and Social Conditions, Bulletin No. 11, November 8, 2006. The poll was conducted between November 1 and 4, 2006 based on telephone interviews with 790 respondents. For the total sample, the margin of error is (+/-) 3.4 percent based on a 95 percent confidence interval. Government employees comprise 17 percent of the sample. The poverty analysis is not based on detailed consumption/expenditure household survey, but on responses to questions regarding overall household income.

While it is impossible for the PA to cover its establishment costs under current circumstances, this analysis has argued that the wage bill was already at unsustainable levels even before the current fiscal crisis. (See Figure 2) No realistic amount of donor funding or increase in tax and clearance revenues could or should be expected to bridge the gap. The PA is therefore confronted with a binary choice. It can continue along the current path, making promises to employees that it cannot afford to keep, paying partial salaries in an ad-hoc manner as resources become available, and hoping that revenues will materialize from sources now unknown that will allow it to bridge the gap. Or as circumstances permit, it can work out a carefully crafted plan with the donor community to place its finances on a more sustainable basis.

Figure 2: Public Sector Hiring and Wage Bill Growth, 1999-2005



Source: World Bank Staff Calculations, 2006

A sustainable plan would involve a number of components. The first step would be a comprehensive payroll audit, followed by the immediate termination of all ghost workers, double dippers, staff serving past retirement, and persons “not at post”. The estimated numbers would not be great, probably around 6,000, but it is necessary both to send a strong signal that “business as usual” is over and to ensure that subsequent salary payments go only to legitimate employees. The PA should also initiate a policy prohibiting overtime payments for all staff except those working in front-line service delivery in the Ministry of Health (and even those should undergo careful scrutiny). These measures should be combined with a second component, which would include improvements in establishment control (particularly placing the MoF in charge of security service payroll) and an across the board hiring freeze for the next two years, with a defined procedure for case by case exceptions to be authorized at the highest level. If the wage reduction plan goes well, the hiring freeze could eventually be relaxed to allow replacement recruitment for front line staff in the Ministries of Health and Education.

The question of salary arrears is a particularly thorny one with major fiscal implications. The open-ended strike that began in September 2006 was ended with an agreement on 14 January 2007 that the PA would resume regular monthly salary payments to all employees (including the security services) and pay salary arrears in four consecutive

monthly payments from February to May 2007. An exact figure for the accumulated arrears is currently unknown, but estimates place it in the range of \$520 to \$608 million. The total cost (including salaries) of implementing this agreement fully could be over \$1 billion by May 2007—or roughly 30 percent more than the entire amount of foreign assistance that flowed to the PA in 2006.

Fiscally, this burden is unsustainable unless donor financing materializes at levels heretofore unknown. It also raises important concerns about equity and burden sharing. Many Palestinians have suffered during the recent strike, including PA suppliers and contractors (a number of whom are NGOs involved in the provision of basic services), as well as the general public. It is not clear why employees should be given a priority claim upon PA resources and assurance of full reimbursement, whereas others will be asked to take a deep discount in the obligations they are owed. A better approach would be to phase in the partial repayment of arrears slowly over time as increased resources become available, and/or to offer employees the option of a heavily discounted "up front" payment in lieu of arrears. But before this is done, any consideration of back salary payments needs to be placed in the context of a comprehensive approach to arrears, in which all creditor claims against the PA are quantified, verified and prioritized.

Beyond these steps, the PA could pursue a number of options in the search for long-term wage sustainability. The simplest approach would be to roll-back the salary increases that took place in 2005 for the civil and security services, or to "claw back" these increases by imposing a compensating payroll tax on PA employees. With no corresponding staff reductions, the level of such roll-backs would need to be significant—around 15 to 18 percent for civil service and security service personnel. Bank calculations indicate that, if wages were rolled back to levels prevailing in mid-2005, the PA could save around \$238 million annually over the first two years and a net present value of \$970 million over five years. Although such an approach may appear draconian, as Chapter 3 (Volume 2) indicates, since prevailing Palestinian public sector wage rates are now around 15 percent greater than those in the private sector, there is justification for it.

A second approach would be to offer voluntary retirement packages to civil and security services to induce them to leave. There are a number of challenges with such programs that are discussed in the broader PER, particularly the risk of adverse selection (i.e. the wrong people leave) and avoiding problems of re-entry. But properly designed and implemented programs could help to reduce the number of employees and generate considerable fiscal savings. Their targeting towards older PA workers could reduce the possibility that they would contribute to higher levels of unemployment, since most workers would probably take their packages and leave the workforce. (Although experience from Morocco and elsewhere has indicated that a limited number could start businesses and generate employment.) The design and composition of such programs could vary. A target of \$80 million in monthly wages would entail a reduction of approximately 13,000 civil servants and 12,000 security service personnel. Depending upon the nature of the program and the design of the severance packages, the cost could

be around \$172 million. Preliminary calculations indicate that the discounted value of potential savings could be in the range of \$812 million over a five year period.

The third approach would involve agreement between the PA and donors on a wage bill cap at a specified absolute figure to be allocated over a fixed number of employees according to an agreed upon formula. A target could be \$80 million per month or \$960 million per year—approximately the level that existed prior to the major civil service salary increases in July 2005. This sum would equal approximately 84 percent of the formal public sector wage bill as of December 2005 and represent a savings of roughly \$240 million per year over current salary obligations. The PA would be requested to contribute a fixed sum to the wage bill, and either individual donors or a consortium of donors would pledge to contribute the additional amount. (Payments for salary arrears would need to be negotiated, with the understanding that employees will not receive all of their accumulated pay.) Should the PA make additional progress in retiring staff and/or reducing the number of employees in the aggregate pool, a higher proportion of salaries would be paid to the remaining employees. Any violation of plan conditions would lead to a suspension of donor payments.

An interesting addendum to this approach would allow specific agencies to “break out” of the aggregate salary pool and have their salaries fully funded if they met certain established criteria. (To provide further incentives, non-wage funding for these agencies could also be increased.) Currently, 22 ministries have prepared ministerial development plans, which seek to replace organizational structures and staffing practices that are largely ad-hoc and idiosyncratic with those that have been developed in a more rigorous and professional manner. This involves the development of organizational structures laid out along clear functional lines; the preparation of job descriptions for all posts; a clear separation of political and professional appointments; and the preparation of a detailed manpower plan, all of which would be subject to an independent third party review. Such ministries would be able to migrate to the full salary scale and even be allowed to recruit new technical staff to fill critical skills gaps once they implement the agreed-upon plan, provided that they can demonstrate clear cost savings with no reduction in services. Staff who are made redundant through this exercise will remain within the central civil service pool and continue to draw a portion of their salaries, or they could elect to receive a severance package. But they will no longer work for the ministry.

The details of such an approach would need to be carefully worked out between the PA and donor community, along with the mechanism through which restructuring plans are to be approved and their implementation monitored. But this approach has three major advantages. The first is that it would support a major realignment in the existing dysfunctional incentive system between the PA and donor community. Current donor practices have in essence subsidized both wage and (to an even greater extent) non-wage spending, allowing the PA to shift resources away from non-wage expenditures towards salaries. Donor efforts to contain the wage bill through vehicles such as the Public Financial Management Reform Trust Fund made the mistake of linking specific wage bill targets to a percentage of revenue, which allowed the PA to expand recruitment as revenues went up. The proposed strategy will create incentives to reduce the number of employees, which would allow the payment of increased salaries to those who remain.

The second is that it will give impetus to ministries to implement reforms so that they can transition over into a leaner organizational structure in which all remaining employees will be paid at their full salaries. Finally, the proposed system does not involve compulsory redundancies and would continue to provide partial salary payments to all bone fide civil servants, with the understanding that such payments could eventually be shifted into social welfare payments. This would allow the core of an efficient, effective public administration to emerge from the broader PA structure.

The challenge of reducing the burden of wage expenditures for the security services will be a particularly difficult one. As noted in Chapter 3 (Volume 2) on civil service reform, even at current staffing levels of around 65,000 (excluding trainees), the PA security services are not particularly overstaffed in comparison with regional norms, which vary widely. However, they are unaffordable and the value for money received from these forces is poor. Few would argue that their expansion or generous pay increases and pension plan have made a significant contribution to improving security on the ground in Gaza or the West Bank. First steps would include a careful and transparent accounting of their numbers; a reduction of the 14,000 or so “non-compliant” officers recently identified by the MoI; and the elimination of certain categories such as “political” or “honorary” officers that provide little tangible benefit. Around 6,000 officers are nearing or past retirement age and could also be induced to leave (there is likely to be some overlap between these various categories). In light of the risks involved, such efforts would need to be carefully developed and coordinated with ongoing efforts to reduce the number of security services from 13 to 3.

The chances of success of security sector reform (SSR) are greater if such a strategy is part of a comprehensive political framework that includes reconciliation, the rebuilding of institutions, support to disarmament, demobilization and reintegration, and measures to improve the rule of law. Transparency in SSR implementation is critical: on a macro level with regard to security expenditures and an adequate macroeconomic and fiscal framework; on a micro level to eliminate “ghost” soldiers, equipment and maintenance and the siphoning off of resources allocated for them. SSR and demobilization operations need to be timed carefully in order to complement each other and support the overall peace process. Linkages and interdependencies between the two need to be well understood before implementation.

Conclusion. For a decade or more, the PA has been able to avoid hard choices with regard to its public employment policies. While the temptation among many Palestinians is to view overstaffing as a long-term problem to be addressed once the private sector is able to absorb the additional labor, the reality is that short term fiscal imperatives will deny the PA that lengthy time frame for adjustment. Recent events have underscored that the status quo is no longer tenable. One way or the other, salary rationing will take place. The question confronting the PA is whether it will take place in a coherent, transparent and equitable fashion leading towards a desirable medium-term goal, or in a series of uncoordinated, ad-hoc adjustments punctuated by weak performance, unfulfilled expectations, employee hardship and acute labor unrest.

Sadly, lost within this broader story are some very important successes that the PA has been able to achieve, often against daunting odds. PA accomplishments in the area of public financial management, municipal governance, education, health and the social services have been noted above. The PA has also been able to attain other important achievements. It has conducted three sets of elections—municipal and presidential elections in late 2004 and early 2005 and parliamentary elections in 2006—which were widely perceived to be fair and transparent by various international observers, with turnout rates in the range of 70 to 80 percent. Even in the relatively problematic area of civil service reform, some important steps forward have been made. The PA passed a Civil Service Law which identified stricter recruitment rules and outlined measures for non-compliance. The role of General Personnel Council (GPC), the chief body responsible for oversight of civil service statutes, has been strengthened. Much of the lax administration that characterized earlier human resource management efforts has been cleaned up. Improved MOF control over the payroll has reduced fraud. Some important reforms have also started regarding the security services.

All of this progress is at risk unless the PA and the donor community can come up with a collective plan for restoring PA finances, with which Israel would be expected to cooperate. Such a plan will have several components. For the PA to be viable, it needs to receive the clearance revenues it is entitled to from Israel under the 1994 Paris Protocol of Economic Relations between the Government of Israel and the Palestinian Authority. Such revenues provided \$757 million into PA coffers in 2005 (around \$63 million per month), or 61 percent of PA revenues. The CTA needs to be re-established and the practice of routing aid flows through the Office of the President shut down. Arab donors need to continue their high levels of support, and mechanisms such as the Economic and Governance Strategy Groups need to play an important role in coordinating donor assistance.

In the near term, the framework for such an effort needs to be articulated and agreed upon, in anticipation that the broader political environment will ultimately evolve in a manner that will facilitate its eventual implementation. Strategic decisions will need to be made regarding optimal strategies for dealing with the wage bill. Work can also move forward along important technical and administrative dimensions, such as conducting a comprehensive audit of the payroll and developing a detailed plan for bringing the wage bill within affordable limits. In the medium term, the true heavy lifting can begin in implementing such an approach.

OVERVIEW AND CONCLUSIONS

The Palestinian Authority (PA) is currently confronting a fiscal crisis that could threaten its very existence. During the first six months after the new Hamas-led government was sworn in on March 29, 2006, tax revenues (on a cash basis) amounted to only \$17 million per month, compared to \$104 million during the same period a year earlier. Expenditures for the same period in 2005 (including wages and allowances, transfers, operating and capital expenses, and net lending) stood at around \$172 million per month; by 2006, they had fallen by more than half. By December 2005, the wage bill alone was running at around \$93 million per month and some estimates placed it significantly higher. By March 2006, the wage bill was almost three times total revenues.

Under these circumstances, it is difficult to think about a public expenditure review (PER) in the traditional sense. Implicit within the idea of a PER is the belief that a government faces options and tradeoffs in how it uses its financial resources—that it has considerable control over its revenues, the flexibility to choose between competing priorities, and the ability to structure its finances in such a way as to free up resources for redeployment elsewhere. It assumes that a government has latitude to develop institutions and deploy human and financial resources in ways that will maximize efficiency while achieving their developmental objectives. On each of these fronts, the PA faces severe constraints, fiscal or otherwise. At first glance, beyond developing a carefully prioritized schedule of expenditures to be paid as resources become available, it is hard to see what else can be done. This in fact is just what the PA has been doing. As a recent IMF mission noted that the limited financial resources available have been used largely for payments to government employees and social hardship cases and, to a lesser extent, to ensure the continued supply of fuel and utilities.⁴

The proximate causes are the Israeli decision to withhold clearance revenues and the U.S. threat to prosecute any banks engaged in financial transactions with the PA in the wake of the January 2006 election. The structural roots of the crisis run deeper. By late 2005, the PA had already reached a position that was fiscally unsustainable in which assets were being liquidated or mortgaged to meet current expenditure needs. Throughout 2005, the PA was running an average monthly deficit in excess of \$60 million, nearly 60 percent above the average monthly revenues it was receiving. With unchanged policies, the fiscal deficit for 2006 would in all probability have exceeded \$900 million and could have gone over \$1 billion. This is clearly unsustainable, as it is two to three times the amount of external budget support secured in 2005. By late 2006, the wage bill alone roughly equaled all of PA revenues (including clearance revenues) prior to the election, making the PA entirely dependent upon external funding sources for all other categories of expenditure.

Yet the current crisis also provides an opportunity to take a longer term and more strategic view regarding Palestinian finances. The dynamics behind the PA's

⁴ See International Monetary Fund Mission Statement for West Bank & Gaza, December 17, 2006. <http://www.imf.org/external/np/wbg/2006/eng/rr/pdf/121706.pdf>.

increasingly precarious financial position—and particularly, the failure to curb the rapid expansion in the wage bill—were well-understood for a decade or more. The major public sector strike, which lasted for four months in the fall and early winter of 2006, has concretely underscored the danger that unmet wage and salary promises can hold and the folly in assuming that current commitments to public employees are affordable. The fragile agreement with the Union of Public Sector Employees, and the threat of further disruptions in public service delivery in the future, underscores the urgent necessity of placing the PA on a sustainable fiscal path.

Notable PA Accomplishments

Sadly, lost within this broader story are some very important successes that the PA has been able to achieve, often against daunting odds. In spite of the harsh conditions in which schools have had to operate, impressive achievements have been made during the past six years. The education system has experienced massive expansion and attained equitable access, reaching a level of development that by most accounts is comparable with middle-income countries. Enrolment in basic education is universal, and the enrolment rate for secondary education is above 80 percent. These figures put the West Bank & Gaza in the lead in the MENA region. Equally important is the high enrolment rate in tertiary education—above 40 percent for the 18-24 age group—which is high when compared with middle-income countries. The fact that for the first time Palestinian children participated in international tests and scored above the average for MENA countries is another major accomplishment. To the PA's credit, access to basic and secondary education is highly equitable with respect to gender, location, refugee status, and household income.

Prior to the *intifada*, the West Bank and Gaza also witnessed impressive gains in the health sector that are reflected in relatively good indicators in comparison to countries at comparable income levels. Official statistics show that over the last two decades infant mortality rates steadily declined. In 2004, the infant mortality rate (IMR) was 22 deaths per 1,000 live births, a number well below the regional average of 44. Life expectancy also increased significantly for females and males. In 2004, total life expectancy at birth was 73 years, on average 4 years longer than the typical person in the MENA region. The under 5 mortality rate (U5MR) has also steadily improved. With 24 deaths per 1,000 under 5, it is less than half of the regional average of 56.

Palestine has one of the more vibrant local government sectors within MENA. In a region dominated by unitary systems and strong central governments, municipalities and villages within the West Bank & Gaza are among the most autonomous. Central government transfers are modest by regional standards, and local governments have a great deal of control over their own revenues. They also have responsibility for at least 22 functional areas—one of the broadest sets of expenditure assignments in the region. Preliminary survey data indicates generally high levels of satisfaction among residents regarding the quality of local survey delivery.

Despite current difficulties, the PA providers of social protection services have pressed on with their tasks. Perhaps most impressively, most civil servants have not received their full salaries since February 2006, yet they continue to report for work and attempt to perform their jobs with a minimum of disruption except for the strike period. Some social programs are still operating, albeit in a limited form. Food rations from the World Food Program (WFP) continue to be distributed, the UNRWA SHC program and other services are functioning, and food rations for newly poor families in Gaza are being issued from contributions from Egypt. The Ministry of Social Affairs is currently working with the World Bank to improve the targeting of social assistance benefits and to link receipt with strengthening human development of children in health and education through a conditional cash transfer under the Social Safety Net Reform Project.

In the broader area of governance, the PA has also been able to achieve some important accomplishments. The PA has conducted three sets of elections—municipal and presidential elections in late 2004 and early 2005 and parliamentary elections in 2006. These elections were widely perceived to be fair and transparent by various international observers, with turnout rates in the range of 70 to 80 percent.⁵

With regard to public financial management, the PA has implemented a host of reforms between 2002 and 2004 that have reduced corruption and significantly improved transparency. It has gone from being a relative laggard in many respects to setting an example for the MENA region. These reforms include setting up a Central Treasury Account (CTA) through which all government revenue is collected and payments are made; formulating an annual budget that is approved by the Palestinian Legislative Council (PLC) and forms the basis for budget execution allocations; putting into place a basic accounting system that provides a basis for orderly budget appropriations and budget execution; establishing tight controls over expenditure through placing MOF financial controllers in every line ministry; transferring payroll responsibilities to the MOF and paying public sector salaries through bank accounts; undertaking structural reforms to improve the operation and oversight of the PA's public enterprises through the establishment of the Palestine Investment Fund (PIF); and enhancing fiscal transparency by posting the Budget Speech, approved annual expenditure estimates and actual expenditure data for previous fiscal years, and monthly expenditure reports on budget implementation on the MOF's website.

Even in the relatively problematic area of civil service reform, some important steps forward have been made. The PA passed a Civil Service Law which identified stricter recruitment rules and outlined measures for non-compliance. The role of General Personnel Council (GPC), the chief body responsible for oversight of civil service statutes, has been strengthened. Much of the lax administration that characterized earlier human resource management efforts has been cleaned up. Improved MOF control over the payroll has reduced fraud. Some important reforms have also started regarding the security services.

⁵ See "Preliminary Statement of the NDI/Carter Center International Observer Delegation to the Palestinian Legislative Council Elections," *National Democratic Institute and the Carter Center*, January 26, 2006.

Recent Economic and Fiscal Trends

Macro Developments. The economic recovery that began in 2003 continued through 2005, with growth being particularly robust in the first half of 2005. However, with the imposition of strict closure during the period preceding the removal of Israeli settlements from Gaza and the lack of a “Disengagement Dividend” due to their continuation through the remainder of 2005 and into 2006, economic growth slowed considerably. Continued restrictions on movement between Gaza and the West Bank and, in particular, on goods both to and from Gaza through Israel, as well as reductions in the number of Palestinian workers granted permits for work inside Israel (in line with stated Government of Israel policy), ultimately exacted a powerful toll upon this fragile recovery and pushed the Palestinian economy into decline.

Quarterly GDP data recently released by the Palestinian Central Bureau of Statistics show that GDP (in real terms) declined steadily during the first three quarters of 2006.⁶ Calculated as an average over the year, the decline is equal to 5–6 percent—adding population growth of 3–4 percent, the decline in per capita GDP amounts to 8–10 percent. This is a sharp reversal of economic trends for the past three years, in which the Palestinian economy recovered from its precipitous decline during the first three years of the *intifada*. A decline of this magnitude would leave GDP per capita around \$1,000 and real GDP per capita some 32 percent lower than in 1999.

Stepped-up donor support has played a major role in sustaining the economy and household incomes. Following the inauguration of the Hamas’ government in March 2006, donors were unwilling or unable to provide direct financial flows to the PA government. At the same time, however, donors significantly increased the flow of rapid-disbursing assistance flowing to the West Bank and Gaza through channels outside the government. The IMF estimates that a total of \$700 million was provided in budget support in 2006, compared to \$349 million in 2005. Data for other types of donor support (emergency/humanitarian assistance, mainly development aid) are notoriously more difficult to measure. Indications are that disbursements of emergency/humanitarian assistance have increased in 2006, while disbursements of development aid have declined.⁷ The Bank estimates that \$100 million in additional donor support increases Palestinian GDP by 2–3 percent—therefore, the increase in budget support alone may have prevented a further fall in GDP of 8–10 percent.

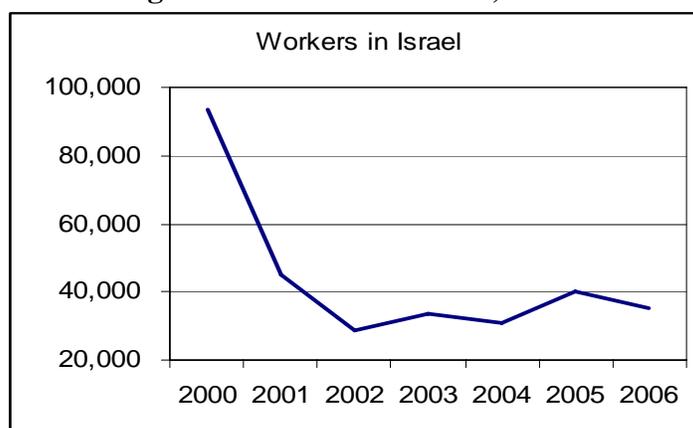
Closures remain tight, to the detriment of Palestinian export. Movement restrictions and border closures continue to stifle the normal conduct of commercial activities. In interviews for the Bank’s forthcoming West Bank and Gaza Investment Climate Assessment, more than 60 percent of Palestinian businesses reported that instability and

⁶ The Quarterly National Accounts data are only preliminary and may be revised later. Due to difficulties on the ground, the quality of the underlying data is deteriorating. PCBS estimates of indirect taxes—which determine the difference between GDP at factor costs and GDP at market prices—is particularly subject to uncertainties, as the clearance revenue is not being transferred.

⁷ For example, as of September 30, 2006, the UN’s Refugee and Works Agency (UNRWA) had received pledges worth \$129 million against their emergency appeal, an increase of 15 percent over the pledges for the full year in 2005.

transportation issues are the most important impediments to Palestinian private sector activity. The Bank's ongoing monitoring of Palestinian movement and access shows that the number of trucks carrying exports from Gaza have dropped 40 percent from an already low level at the beginning of 2005, and remain far from the targets set in the November 15, 2005 Agreement on Movement and Access. In their monthly business survey, the Palestinian Central Bureau of Statistics reports that conditions continue to worsen for business owners. In 2005, when economic growth was relatively strong, perceptions leaned toward the positive, with only 10 percent of firms on average indicating month to month that conditions had deteriorated. In 2006, that proportion more than tripled to 34 percent. Palestinian export to Israel, the main market for Palestinian exporters, declined by 15 percent in nominal terms during the first half of 2006 compared to the previous six-month period.⁸

Figure 3: Workers in Israel, 200-06



As Figure 3 indicates, movement restrictions have reduced the number of Palestinians working in Israel. An average of 35,000 Palestinians worked in Israel and Israeli settlements during the first six months of 2006, compared to 40,000 in the year 2005—a decline of 12 percent.⁹ The decline was especially large for workers without permits, indicating increasing difficulties for clandestine workers in circumventing Israeli checkpoints and other restrictions, including the Separation Barrier. The number of Palestinian workers with permits declined 7 percent. Virtually no Palestinians from Gaza work in Israel anymore.

Although employment declined in Gaza, it held steady in the West Bank. During the first nine months of 2006 the number of jobs in Gaza declined 11.2 percent compared to the same period a year before. Between the third quarter of 2005 and the third quarter of 2006 almost 20,000 jobs were lost in Gaza. At 166,924, the number of jobs in Gaza has fallen close to its level six years ago, on the eve of the *intifada*. The unemployment rate (by ILO definition) in Gaza reached 36.3 percent. By contrast, in the West Bank

⁸ While this is a large decline and an indication of a further tightening of the closure regime, it is still smaller than assumed in the March 15 “Worst Case” Scenario.

⁹ The numbers exclude an estimated 24,000 Palestinians residing in East Jerusalem who can work unhindered in Israel.

employment levels during the first 9 months of 2006 have increased moderately compared to the same period a year ago, partly as a result of increased employment in the service, manufacturing and transport sectors. Consequently, the unemployment rate in the West Bank remained roughly unchanged and reached 19.1 percent in the third quarter of 2006.

Fiscal Developments. The PA was established when the Government of Israel and the PLO signed the so-called Gaza-Jericho Agreement on May 4, 1994. In its early years, the PA's revenues increased rapidly. During the five-year period from 1995 to 1999, the PA's revenues almost doubled, from \$510 million in 1995 to \$942 million in 1999. The main driver was a rapid increase in clearance revenue, which in 1999 reached \$580 million, equivalent to 62 percent of the PA's total current revenues. Domestic revenues also increased strongly, a testimony to the rapid establishment of tax collection capacity. By 1999, the revenue-to-GDP ratio had reached 22.6 percent, up from 15.8 percent in 1995.¹⁰

The outbreak of the second *intifada* and the associated economic crisis had an immediate negative impact on PA revenues. In July 2000, PA revenues reached their pre-*intifada* peak at \$95 million equivalent. By December 2000—three months into the *intifada*—revenues had dropped to \$49 million, equivalent to a decline of roughly 50 percent. The steep decline mainly reflects tightened restrictions on the movement of goods in and out of the WBG which, together with cutbacks in Palestinian consumer spending, reduced imports. Compounding this drop, in January 2001 the GOI suspended the regular transfer of clearance revenue even though it continued to collect import taxes on behalf of the PA. During 2001 and 2002, revenues actually received in the PA treasury account included only domestic collected tax and non-tax revenue, equivalent to approximately \$20 million per month. Regular transfer of clearance revenue was resumed in December 2002 and continued until its recent suspension in February 2006. The moribund economy kept PA revenues at an average of \$52 million per month through 2002. Beginning in 2003 revenues started to gradually recover and by December had reached pre-*intifada* levels for the first time.

The PA witnessed relatively strong revenue performance in 2004 and 2005, buoyed by access to clearance revenue and dividends paid out by the PIF. In 2004, gross revenue at \$965 million had increased by 27 percent over 2003 (from 21.5 to 25.4 percent of GDP), outperforming budget projections by about 3 GDP percentage points. The main factors behind the strong performance were improvements in operation and governance at the petroleum agency along with strengthened tax administration. Non-tax revenue also increased considerably. In particular, dividends transferred to the budget from the PIF

¹⁰ In step with the increase in revenue collection, concerns about transparency in public finances emerged, in particular in relation to diversion of tax revenues to accounts outside the control of the Ministry of Finance, the growth in semiprivate PA investments, and unauthorized revenue collection by various PA entities, notably the security services. See *Public Finance, Conflict, and State Building: the Case of Palestine*, Brynen 2005, and *West Bank and Gaza: Economic Performance and Reform under Conflict Conditions*, IMF 2003. Significant improvements in public financial management were carried out from 2002 onward and redressed many of the past deficiencies (see *Country Financial Accountability Assessment*, World Bank 2004).

rose from \$39.2 million in 2003 to \$51.6 million in 2004, reflecting an advance of about \$16.6 million on 2005 profits on top of the \$35 million envisaged in the 2004 budget.

This positive trend continued in 2005. Clearance revenues increased by 32 percent. Non-tax revenue increased by almost 70 percent, due to a large increase in dividends paid to the PNA by the PIF and to a substantial increase in licensing fee collections from telecommunications. Domestic tax revenue collections increased by 21 percent, partly due to higher income tax collections on higher wages and changes in revenue administration procedures. In January-March 2006, despite a boost in domestic tax collections, budgetary revenue suffered significantly because of the drop in March clearance revenue transfers. Revenue dropped by 5 percent between the first quarters of 2005 and 2006 and by 44 percent between October-December 2005 and January-March 2006. The interruption in clearance revenue transfers by the GOI deprived the PA Treasury of a monthly average of over \$60 million during 2006.

In the initial Oslo period, the PA's recurrent expenditures increased rapidly but were broadly in line with revenues. But in the wake of the *intifada*, a significant gap emerged. As Table 3 indicates, the PA's monthly budget deficit widened substantially from \$48 million in 2004 to \$60 million in 2005. Expenditures averaged about \$138 million per month, mostly the result of increased public sector employment and higher public sector wages. The wage bill alone averaged \$83 million monthly in 2005, almost two-thirds of budget expenditures, and had climbed to \$93 million per month by December 2005. It is now estimated to be around \$100 million per month, and informal estimates have placed it as high as \$130 million per month.

In addition, there was higher "net lending" than anticipated (primarily payments to Israeli utility companies to cover PA municipality contracts), which averaged \$29 million per month due to higher energy costs. These expenditures more than offset strong revenue performance (\$101 million per month) in 2005. Only \$350 million in external budget support was received in 2005, just slightly more than half the \$663 million foreseen in the budget. (As noted above, this figure has rebounded strongly to over \$700 million in 2006.) The budget also anticipated a further \$240 million in donor support for a special social safety net fund. The resulting gap was financed mainly by borrowing from domestic banks, often collateralized with assets of the PIF, advances from the PIF, and the receipt of tax revenues withheld in preceding years by the GOI.

Table 3: Summary of Monthly Revenue and Expenditures for 2005

	Budget		Actual
	Full Year	Monthly Average	Monthly Average
(million US dollar equivalent)			
Gross Revenues	1,073.46	89.46	102.70
Domestic Revenues	411.69	34.31	39.65
<i>Tax Revenues</i>	239.04	19.92	19.26
<i>Non-Tax Revenues</i>	172.64	14.39	20.39
Clearance Revenues	661.78	55.15	63.04
Total Expenditures and Net Lending	1,961.52	163.46	165.18
Total Expenditures	1,831.63	152.64	136.49
Wages and Salaries	938.00	78.17	83.43
<i>Civilian Ministries and Agencies</i>	567.45	47.29	51.17
<i>Ministry of Interior and National Security</i>	370.55	30.88	32.27
Transfers	625.05	52.09	31.22
Operating Expenditures	244.00	20.33	18.16
PA-Financed Development Expenditures	24.58	2.05	3.67
Net Lending	129.89	10.82	28.69
VAT Refunds			.99
Balance	-903.57	-75.30	-63.48
Deficit Financing	903.57	75.30	63.46
External Financing for Budget Support	903.57	75.30	29.06
Other Financing	0.00	0.00	34.40
<i>Transfer of previously withheld clearance revenue</i>	91.95	7.66	11.44
<i>Net domestic bank financing</i>	-68.97	-5.75	25.37
<i>Palestinian Investment Fund</i>	0.00	0.00	14.42
<i>Net change in arrears; other (residual) financing</i>	-22.99	-1.92	-16.83
Average Exchange Rate: USD 1 = NIS	4.35	4.35	4.49

Source: IMF and World Bank Calculations

In light of these expenditure trends, despite major improvements in the revenue-to-GDP ratio since the low points of 2001 and 2002, the PA has been running very large budget deficits for the past five years. During 2000–05 the average budget deficit was 17.7 percent of GDP, for a total deficit of \$3.7 billion during the past five years.¹¹ Such large deficits are in sharp contrast to the pre-*intifada* period, when the deficit averaged a modest 1.3 percent of GDP.

¹¹ The numbers concern only the *recurrent* budget. Since the PA's inception, capital expenditures have been financed almost exclusively by donors and have not been incorporated in the budget. Since 2000 the budget has included a small amount of PA-financed capital expenditures.

Deficit Financing. The PA has financed its deficit through a variety of means, the most important of which has been budget support from the international community.¹² After having practically ceased in the last few years before the *intifada*, budget support (including soft loans) was \$2.01 billion during 2000–05, an average of almost 10 percent of GDP. The second most important source of financing has been borrowing from domestic commercial banks. By the end of 2005, the PA’s debt to commercial banks reached \$600 million, the equivalent to 16 percent of GDP with an average annual borrowing of 3 percent of GDP.¹³ Exceptional transfers of profit from the PIF and accumulation of payment arrears added financing equivalent to 2.1 percent of GDP.

Focusing solely on central government debt does not offer a comprehensive assessment of the general public sector debt, because that would also include the liabilities of local governments, state-owned enterprises, and the Palestinian Monetary Authority.¹⁴ Furthermore, the PA’s *explicit* debt does not consider the implications of the current debt equivalent of the PA’s implicit guarantees—notably the vast contingent liabilities of the PA’s public pension scheme.

PA Liabilities. The PA’s total liabilities stood at about \$2.1 billion, or some 53 percent of GDP, at the end of 2005. Approximately half of the PA’s liabilities are made up of concessional debt, of which about 90 percent is debt to multinational creditors. The largest concessional creditor is the Islamic Development Bank, which provided a total of approximately \$400 million in budget support to the PA in the early years of the *intifada* through the so-called Jerusalem and Al-Aqsa funds. Those funds were established by the Arab League at the Arab League Summit in Cairo, October 21-22, 2000. The World Bank is the second largest creditor, with an outstanding loan amount equivalent to \$326 million (on IDA terms). The PA’s debt to the World Bank has mostly been contracted to finance infrastructure investments and capacity-building activities since its inception in 1994. The government of Spain is the largest bilateral creditor to the PA in the amount of \$67 million.

Borrowing from commercial banks makes up about 30 percent of the PA’s liabilities. The Palestinian Monetary Authority (PMA) reports monthly to the IMF the amount of the PA’s outstanding debt to commercial banks. (The WBG has no state-owned banks.) The terms of commercial bank borrowing are not publicly available. Informal discussions

¹² In general, a government can finance its spending through three means: taxes, borrowing, and money printing. Considering the comparatively high revenue-to-GDP ratio in WBG, the scope for further tax increases appears modest at best. Printing money is similarly not an option, since WBG does not have its own currency. Also, the PA’s debt instruments are much more restricted than other countries because it cannot issue sovereign debt.

¹³ Source: IMF. Quality data on borrowing from commercial banks are only available for the most recent years. It is thought that the PA’s debt to commercial bank at the beginning of the Intifada was minuscule. Consequently, it is assumed that the entire \$600 million debt was contracted since 2000.

¹⁴ Local government’s ability to contract debt is limited both for reasons of low credit worthiness and for lack of institutional framework. Specifically, local governments in the West Bank and Gaza do not issue bonds or other debt instruments. Some local governments may be able to tap domestic commercial banks, but in line with local banks’ highly precautionary lending strategies, it is unlikely that lending to local governments would not be fully collateralized. An ongoing Bank study (“*Intergovernmental Fiscal Relations Policy Note*”) is expected to contain an analysis of local governments’ arrears.

with Ministry of Finance officials suggest that the debt generally is denominated in U.S. dollars, it has a maturity of one year (probably in some cases considerably shorter) and carries a 5 percent rate of interest. The commercial bank debt exposes the PA not only to considerable exchange rate risks but also to refinancing risk, because the PA has to roll the bank debt over at short intervals.

In addition, the PA accumulated a sizable stock of payment arrears during the *intifada*. The stock of arrears is not known with certainty at any point in time, partly because of delays in line ministry reporting of spending commitments and partly because of the cash-based financial management system used by the PA. At the end of 2005, the estimated stock of arrears was approximately \$440 million. Arrears include payments to private Israeli companies, notably DOR, the supplier of fuel to the Gaza Electricity Generating Company, and the Palestinian Petroleum Corporation, the publicly owned Palestinian monopoly importer of fuel products. During 2006, the PA has accumulated extensive payment arrears to suppliers of goods and services necessary for public sector operation and maintenance.

A significant part of the arrears (around \$200 million) was incurred to the Gaza Pension and Insurance Company because the PA defaulted on the employer contribution to the civil service pension scheme. Taken together various obligations incurred under the WBG, Gaza and security services pensions schemes, estimates suggest that the current system has accrued pension liabilities to-date worth some NIS 32.9 billion (\$7.3 billion), or over 180 percent of 2005 GDP. This stock of implicit debt, or the current value of future liabilities for the pension system is among the highest in the world.

On top of this, the PA is also facing massive salary arrears from 2006, when employees were paid on average only about 40 percent of the total obligations owed them. As part of the recent agreement to end the strike with the Union of Public Sector Employees, the PA has agreed to pay all accumulated salary arrears (which could be as high as \$600 million) through a series of four consecutive monthly payments commencing on February 15, 2007.

PA Assets. The PA holds sizable liquid assets in the PIF, whose most recent audited statements are for 2005 and made public in January 2007. According to these, PIF assets amounted to \$1.14 billion as of December 2005.¹⁵ In 2005, significant transfers were made from the PIF to the PA budget in the form of dividend payments and advances for an estimated total of approximately \$225 million (of which \$173 million were “exceptional profits”). Interviews with PIF management suggest that shares worth approximately \$561 million have been used as collateral for loans at commercial banks. (According to the Ministry of Finance, the value of collateralized loans to the PA amounts to only approximately \$215 million.) For the purposes of this analysis, the value of the PIF assets at the end of 2005 is assumed to be \$967 million, equivalent to the end-2004 value less the transfer of the exceptional dividends. However, throughout 2006, the PIF has come under serious pressure. Around \$50 million of its collateralized assets have

¹⁵ The audited statements could previously be found at www.pa-inv-fund.com. However, the PIF is now constructing a new website at www.pif.ps, which includes audited statements for 2005.

been liquidated by creditors to cover outstanding loans and interest. Another \$100 million was spent in a one-time payment, mostly to cover the fuel bill. The PA is currently looking to PIF resources to help meet its outstanding commitments for wages and other arrears. There is a serious possibility that, if PIF resources continue to be utilized to meet these pressing fiscal demands, it will cease to exist within the next year or so.

Areas of Focus for the PER. This analysis of PA expenditure focuses on five major categories, whose relative magnitude is laid out in Table 4 below. The first is the wage bill, which during 2005 comprised 22.4 percent of GDP and was clearly the largest as well as the most pressing area where reform is needed. It will be discussed in detail below. The other areas are transfers to municipalities; health and education expenditures; and social policy and social protection.

Table 4: Selected Palestinian Authority Budgetary Expenditures, 2005

	Millions of US\$	Millions of NIS	Percent of GDP
Total Wages	1,001	4,493	22.4
Net Lending 1/	344	1,545	7.7
Education 2/	274	1,229	6.1
Health 2/	153	688	3.4
Transfers	375	1681	8.4
o.w. Social Safety Net	176	791	3.9
<u>Memorandum:</u>			
GDP	4,479		

1/Includes purchase of fuel for electricity generation, transfers to the General Petroleum Company and loans to municipalities for the delivery of water.

2/ Includes wages, operating expenditures, transfers and PA-financed capital expenditures.

Source: data supplied from the Palestinian authorities.

Since 2003 the PA has increasingly been the “financier of last resort” to cover unmet obligations for other public entities. These obligations fall mainly into three categories. First, they settle utility bills from Israeli suppliers that municipalities have not paid (municipalities, in particular in the West Bank, are the main retail providers of water and electricity). These payments are “netted out” from the monthly transfer of Palestinian customs revenue and amounted to a total of \$132 million in 2005 (\$11 million/month). The second significant category is the PA’s contractual obligation to supply fuel for power generation by the Gaza Electricity Company, which cost \$119 million in 2005 (\$9 million/month). Finally, the third significant category is PA payment to the Petroleum Company, the PA-owned monopoly importer of petroleum products. The Petroleum Company sells its product at a loss, which has to be covered by the PA. In 2005 this amounted to \$98 million, or \$8 million/month.

The health system in WBG achieved high levels of immunization coverage, prenatal care, and effective basic health services. However, these achievements have come at a relatively high cost, with total health spending (including direct household spending) at about 13 percent of GDP—among the highest rate in the MENA region. PA expenditure

on health services has been driven by increasing public employment and wage expenditures, with close to zero funding for capital expenditures and a diminishing share allocated to operating costs. At the same time, the PA has expanded the volume and types of contracts with Palestinian NGO health care providers through the GHI coverage. In the face of the current fiscal crisis, the MOH has been unable to reimburse the NGOs and is accumulating arrears on these commitments. The PA's expansive wage bill and expenditure for contracted services has left little fiscal space for critical non-wage expenditures such as pharmaceuticals, medical supplies and operations and maintenance.

In the education sector, total expenditure as a percentage of GDP increased in the past 3 years from 7.5 percent in 2000 to 11.5 percent in 2003. However, the government's share of total education spending for the same period fell from 42 to 34 percent by 2003. This is the reflection of donor partners funding the bulk of capital expenditures after 2000, while UNRWA, which enrolls 25 percent of students in basic education, covered 20 percent of the total expenditures. Also, private funding increased to 46 percent of all education expenditure (including tertiary education). The bulk of PA expenditure for education—around 90 percent—is allocated for salaries.

In 2004, the PA spent about 3.5 percent of GDP on social protection, with the major items including pension benefits and cash transfers from the Detainee's Fund for the detainees in Israeli jails and their families. Cash transfers collectively constitute the biggest expenditure component of social protection spending, amounting to 1.8 percent of GDP, excluding pensions. In 2005, spending increased massively. Preliminary estimates are that social protection spending nearly doubled in 2005, to 6.5 percent of GDP. The major source of the increase comes from the program for Temporary Employment (5 times the level in 2004) and from pensions (nearly 2.5 times the 2004 expenditure). The annual financing burden for public pensions has been estimated at between \$140 and \$150 million for each of the next five years if all legislated schemes were enforced.

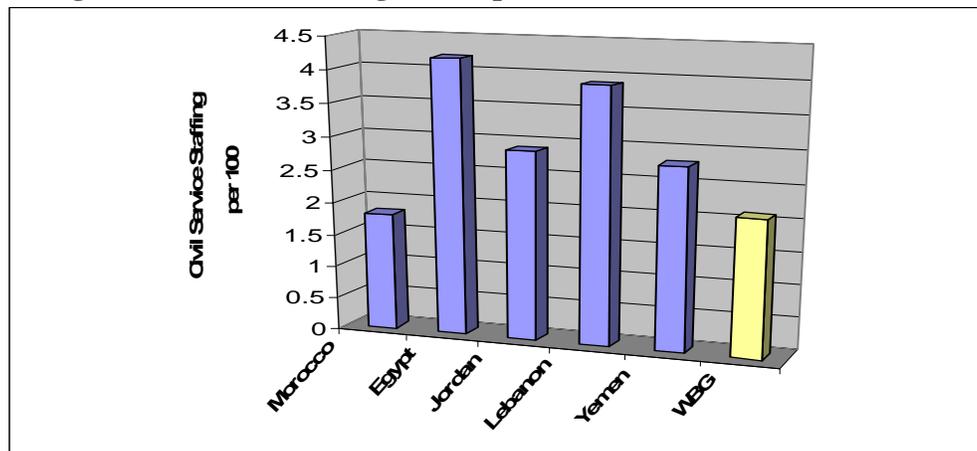
Understanding Growth in the Wage Bill

As the discussion in Chapter 3 (Volume 2) indicates, if one focuses only upon the aggregate number of public employees, the PA does not appear to be significantly overstaffed. At 2.2 civil servants per hundred population, the PA compares favorably to its neighbors. Lebanon, Egypt, Jordan and Syria all have higher ratios—although it should also be noted that, on average, the MENA region has the largest public sectors and highest per capita staffing ratios of any developing region of the world. (See Figure 4)

Until recently even the security services—widely perceived to be the area where the most overstaffing and patronage based recruitment has taken place—did not appear to be particularly overstaffed by international norms. As of 2005, the ratio of military and police to the population in WBG was around 1:143 and 1:70, respectively. Comparable ratios for Jordan include 1:67 for the military and 1:94 for the police, and figures for Lebanon are 1:53 for the military and 1:239 for the police. Decisions in late 2005 and early 2006 to recruit nearly 14,000 additional trainees have significantly degraded these numbers for the PA, and such comparisons provide only a rough starting point for

analysis. Yet the basic point remains: in terms of pure numbers of staff employed, the PA is not wildly overstuffed vis-à-vis its neighbors.

Figure 4: Service Staffing Per Capita for Selected MENA Countries



Lest this conclusion appear overly sanguine, several other factors need to be taken into consideration. First, the PA is not a state and does not deliver all of the services that a government typically would, such as maintaining an air force or collecting customs revenue. Even domestically, it does not provide services to all Palestinians. UNRWA provides health, education and urban social welfare services to as many as 1.4 million Palestinians listed as refugees. Another 300,000 Palestinians live in East Jerusalem, where services are provided by the GOI. By some estimates, after these factors are taken into consideration, WBG civilian employment increases to around 4 civil servants per hundred population, which does put it on the upper end for staffing in MENA.¹⁶

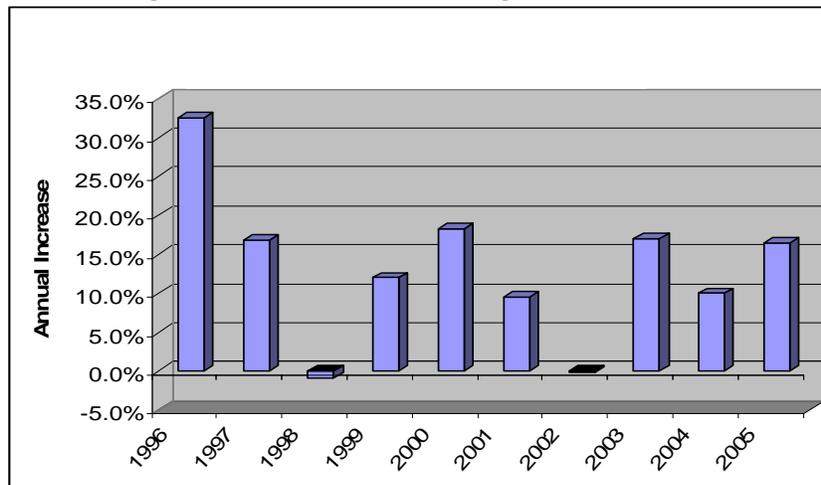
Furthermore, the long-term trend in public employment has been particularly worrisome. When it was formed in 1993, the PA had 20,000 employees who came largely from the Israeli Civil Administration. It now has eight times that many. Between 1995 and 2000, the number of PA employees grew at an annual rate of over 12 percent. In the early years, the expansion could have been justified as the PA was acquiring new responsibilities and assuming greater control over service provision and security in the Palestinian territories. Over time, it became clear that the rate of hiring was outpacing the PA's capacity to provide improved public services. By 1998-99, serious concerns had emerged among the donor community about the PA's long-term fiscal sustainability. The situation got worse after the second *intifada* erupted, when public sector employment was used to soften the rapid growth in unemployment and decline in GDP. Between 1999 and 2004, the number of staff on the payroll increased by around 31,000, or nearly 30 percent.

¹⁶ This analysis does not include the GCC countries, which have by far the highest staffing ratios per capita in the MENA region. However, for many GCC countries, civil service staffing is viewed not in terms of service delivery but as a way of redistributing revenues from oil and natural gas.

In addition to the pronounced increase in staffing, the PA has granted its employees generous wage increases and benefits that have further compounded its fiscal problems. From 2000 to 2003, the average PA employee wage increased by about 3.5 percent per year. From 20004 through July 2005, civil servants received a phased increase of 15 percent surrounding the implementation of the 1998 Civil Service Law. In June 2005, a decision was taken to further increase the wages of security personnel by 28 percent. During the last quarter of 2005, the average salary for a PA employee reached \$676 per month, up from \$559 during the same period a year before and equivalent to an annual increase of 21 percent. The average wage increase between 2000 and 2005 is 7.5 percent—a rate significantly higher than average private sector wages, which have been stagnant in nominal terms since 1999.

From an administrative vantage point, there is limited justification for such increases. After controlling for differences in age, level of education, marital status and skills, these wage increases have been so extensive that public sector workers now earn a significant premium over their private sector counterparts. In 2000, public sector workers were, on average, earning around 13 percent below Palestinians working in the private sector. By 2005, the differential had shifted to 15 percent above. Ironically, the public sector wage premium is highest for low wage earners and diminishes for high wage earners—the exact opposite of what one would expect if the goal is to compete with the private sector for staff with strong technical and/or managerial skills. Given the low rates of attrition within the PA and the lack of viable private sector alternatives, this pay policy is difficult to understand beyond the obvious political rationale of catering favor with influential constituencies.

Figure 5: Growth of PA Wage Bill 1996-2005



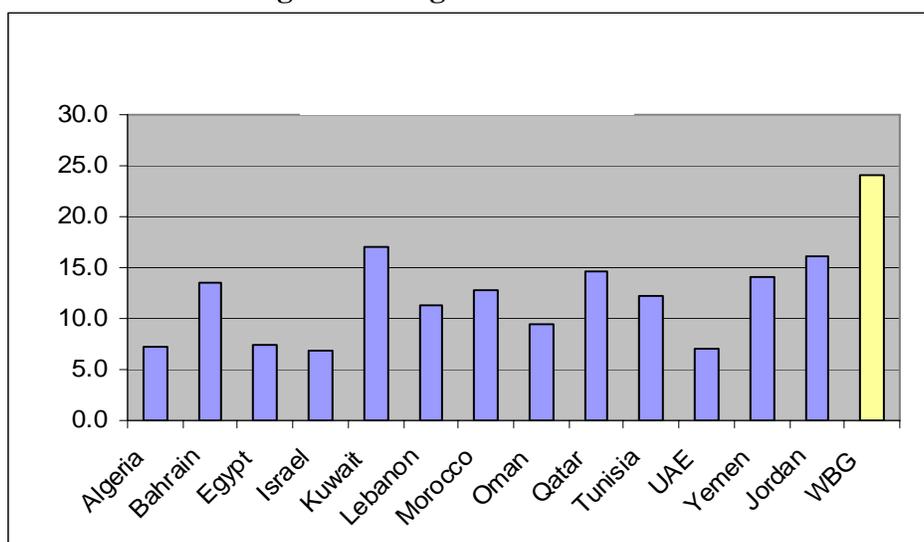
Most importantly, the issue of civil service staffing is ultimately one of affordability. The size of the public sector needs to be linked to what any given government can afford to pay for, and it is here that the twin dynamics of rapid growth in staff and rapid growth in salaries have had their most pernicious impact. Figure 5 provides a breakdown of the annual growth in the wage bill over the last decade. It indicates that, on average, the rate of growth was over 13 percent throughout this period (although this rate masks

considerable annual fluctuation). Over the course of the last decade, the aggregate size of the wage bill has increased by more than 3.3 times from \$304.3 million in 1995 to over \$1.02 billion in 2005. In fact, in spite of the revenue crunch during the *intifada*, the PA's wage bill continued to increase at an average rate of 8.6 percent per annum between 2000 and 2005.

By 2005, the size of the wage bill as a proportion of current expenditure stood at 55 percent and the wage bill made up 23.3 percent of GDP—figures that are high for MENA (Figure 6). Given the unique environment in which the PA operates and the problems that the Palestinian private sector has experienced under occupation, it is not surprising that the public sector occupies a larger proportion of GDP than elsewhere in the region. Yet both the size of this variation and the rapid growth in public sector salaries as a percentage of GDP, which has increased from 10.9 percent in 1996, are cause for concern.

The increase in public sector salaries is linked to another rapidly expanding liability for the PA. Pension benefits for former public sector employees represent the largest single source of social protection expenditures. Chapter 7 (Volume 2) notes that NIS 126.6 million (USD \$28.2 million) were paid to beneficiaries in 2004, and this amount is expected to jump to NIS 312.1 (USD \$69.4 million) when final expenditures for 2005 are determined. Future costs are forecast to increase even more in the coming years, with liabilities running well into the billions. The system is simply not fiscally sustainable as currently designed and implemented.

Figure 6: Wage Bill as % of GDP



The good news for the PA is that robust revenue performance contributed to a decline in the wage bill as a proportion of recurrent expenditure. Having peaked at nearly 70 percent in 2002, it declined to 64 percent in 2004 and then to 55 percent in 2005. The bad news is that, when viewed as a proportion of PA own-source revenues (which includes tax and non-tax revenues and clearance revenues, less tax refunds), current

wages are running at 92 percent at the end of 2005. By 2006, it stood at roughly 100 percent. Because of the extensive growth in its wage bill, even if Israel resumed the transfer of clearance revenues, the PA would now be unable to finance any transfers, capital expenditures, debt service, non-wage expenditures and net lending from its own revenues. As noted above, this allocation of expenditure compromises the PA's capacity to deliver public goods and services, fosters fiscal dependency and makes the PA extraordinarily vulnerable to fluctuations in external finance.

Nor is this problem limited to central administration in the West Bank & Gaza. An analysis of local government expenditure reveals a major shift in its composition between 2001 and 2005. In the wake of the *intifada*, municipalities in the West Bank cut back on per capita wage expenditures by 10.5 percent while those in Gaza cut back by 1.8 percent. They cut back on their wage expenditures by 20.5 percent in the West Bank and 60 percent in Gaza. Throughout the WBG, municipal development expenses declined from 16 percent to one percent during this period.

Beyond issues of affordability, the productivity of PA salary expenditure merits careful scrutiny. As noted above, salary increases have been targeted disproportionately at lower end staff with limited options elsewhere rather than employees with marketable managerial and technical skills. There are also indications that, within various sectors, the PA is not receiving optimal value for money for its expenditure on wages. Specifically:

- Benchmarking of the PA education function against that of UNRWA, for example, reveals that on average the PA employs over twice as many support personnel. Even though UNRWA teacher salaries are 40 percent higher than those of the PA, the unit costs are roughly comparable at about \$370 per student for the PA and \$391 for UNRWA in 2005. The proliferation of support personnel has driven up the per student cost of education and not allowed the PA to take advantage of efficiencies in lower teacher salaries.
- Assessments of the increase in staffing in the health sector reveal the absence of any comprehensive manpower planning. During the past decade, total staffing in the sector has increased by 156 percent. Some specializations have witnessed massive expansion far beyond any reasonable absorptive capacity. In 2003, for example, the number of paramedics increased from 978 to 2,199, an increase of 125 percent in one year. On the other hand, the nurse-to-doctor ration decreased substantially between 2002 and 2004, raising the specter of a serious shortage in nursing staff that could have negative implications on the cost and quality of care.
- In municipalities throughout the WBG, during a period where capital and non-wage expenditures declined precipitously, spending on general administration increased from 14 percent to 22 percent. Even though utility expenditures dropped significantly for both West Bank

and Gaza, salaries associated with these categories are on average higher compared to their pre-*intifada* levels. Similar stories are true for water and solid waste.

The security sector is the area where the productivity of expenditure is particularly open to question. In 2005, the Ministry of Interior identified 14,000 non-compliant security service personnel out of a total staff complement of 59,207—nearly 24 percent. By some estimates, as many as 40 to 50 percent of total security service employees were not regularly showing up to work even prior to halt in salary payments in March 2006. Substantial numbers of employees belong to categories with a limited role to play in the actual day-to-day work of enhancing peace and security, such as approximately 2,800 “honorary officers.” Estimates regarding the optimal number of police and security officers can vary, with the number of 30,000 agreed upon at Oslo serving as a minimum figure.

The recent increase in public employment has not occurred in a vacuum, but has been driven by a combination of powerful economic and political imperatives and lax fiscal discipline. Economically, hardships confronted by the Palestinian private sector and the sharp curtailment of access to the Israeli labor market has had a devastating impact. While closures existed prior to the outbreak of the second *intifada*, their duration and frequency increased dramatically, creating a significant brake upon the Palestinian private sector and reducing its aggregate demand for labor. Before September 2000, Palestinian workers were generally free to enter or exit Israel without interference and around 146,000 were working in Israel (or 23 percent of the labor force). This figure has subsequently declined to around 10 percent, leading to an estimated loss in revenue from remittances of \$571 million. A further complication is that the relatively high rate of population growth around 3.5 percent annually has created around 45,000 new entrants to the labor market each year. As noted in Chapter 1 (Volume 2), the result of these dynamics has been that, during the peak periods of unemployment, joblessness in the West Bank reached 31 percent and rates in Gaza approached 45 percent. Compounding these pressures are the high dependency ratios in the West Bank & Gaza, which multiply the impact of loss wages between five to eight times. Under such circumstances, it is understandable that the public sector would come under tremendous pressure to absorb at least some of this excess labor.

Beyond the economic pressures, powerful political and security arguments exist for expanding recruitment into the security services. This is particularly true in Gaza, where numerous private militias and large numbers of armed and unemployed youths pose a significant threat to the PA’s ability to monopolize the use of force within the territory it controls (an essential prerequisite for any state). Occasionally with the assistance of international advisors, the PA has sought to improve security by expanding recruitment into the security services and reducing the scope for independent action. In the words of one international advisor, “our goal is to take them off the streets, put them in structured units with a clear system of command and control, and send them home each night tired, proud and with a paycheck.” In the wake of a recent June 2006 agreement between to integrate Hamas militia into the Fatah dominated security services, thousands more are

likely to be recruited. The fiscal implications of such a strategy may be unsustainable, but the motivations are entirely understandable.

Yet beyond these understandable pressures is the broader truth that a significant proportion of public sector recruitment has been patronage driven. Abundant anecdotal evidence exists that leading Palestinian political figures made extensive use of civil service employment as a tool for rewarding supporters, co-opting adversaries and building a solid political base. These perceptions are so strong among Palestinians that a public opinion poll from June 2005 revealed that fully 95 percent of the population believed that *wasta* or “connections” are necessary to secure a job in the public sector.¹⁷

Finally, at least some responsibility for the expansion in civil service staffing can be laid at the feet of the donor community. As noted above, donors have been concerned about the rapid expansion of the civil and security services for the last decade or more. But until late 2005, when a serious effort was made by a consortium of donors under the Reform Trust Fund to curtail budget support because of major violations of the Wage Bill Containment Plan, the donor community continued to provide both budget and project support for the PA. As noted in both the education and health chapters, the donor propensity for dealing bilaterally with sector ministries has undermined fiscal discipline and the search for expenditure efficiency. The willingness of donors to fund capital and non-salary recurrent expenditures has allowed the PA to redirect resources towards salaries.

Near Term Measures

As noted above, the magnitude of the PA’s current fiscal crisis, in which revenues are coming in at less than a quarter of total expenditures and net lending, makes rational expenditure management strategies are all but impossible. In recognition of this fact, in early June 2006 the PLC passed a law delaying the submission of an annual budget to Parliament. The PA’s financial options are currently limited to making a list of priority expenditures and releasing whatever revenues it receives as they come in. There are signs that it is already pursuing such an approach. In early June the new Finance Minister, Omar Abdul Raziq, announced that approximately \$55 million, which had been raised through internal revenue collection and “some good financial management,” would be used to pay the salaries of 40,000 lowest paid workers (those earning NIS 1,500 or less). Abdul Raziq also stated that the PA’s other 125,000 workers would receive a pay advance but did not specify when.¹⁸

One of the few silver linings in the current financial implosion is that options that were heretofore viewed as politically unsustainable are now subject to open discussion and debate. In February 2006, the outgoing acting Minister of Finance proposed a number of cost cutting measures, including the removal of persons not at post (an estimated 3,500 security service staff and 1,500 civil service staff); gradual removal of an additional 8,000 security service staff; the retirement of 5,000 personnel from civil and security

¹⁷ Palestinian Survey Research Unit, *Public Opinion Poll No. 16* (June 9-11, 2005).

¹⁸ See “ Hamas to Pay Salaries on Monday,” BBC News, June 3 2006.

services; an end to overtime payment for all civil service personnel except those in Ministry of Health and Border Police; and an end to the practice of granting exceptional promotions within the civil service. Unfortunately, none of these measures were implemented with the exception of halting overtime payments.

As the current fiscal crisis has deepened, more serious measures have been contemplated. In June 2006, the new Minister of Finance proposed laying off 11,500 non-attending staff and the retirement of 5,000. He also recommended early retirement for 500 employees. In addition, he said the government would reduce fuel subsidies and purchase gas and fuel from Egypt to cover Gaza Strip requirements. Also under discussion are amending the agreement on electricity generation in Gaza Strip; reducing lending especially with respect to electricity and water bills through a program that encourages Palestinians to pay their bills; ensuring that all PA revenues flow to the treasury; and improved control of operating expenditures.¹⁹

Many of these measures, such as the termination of staff not turning up for work or past retirement age, mark the first step in any viable rationalization program. Article 90 of the 1998 Civil Service Law provides that a civil servant shall lose his or her job if they fail to turn up for work for 15 consecutive days without an acceptable reason. The immediate termination of 11,500 staff for cause could result in savings of over \$60 million per year and should be implemented immediately. The PA can take advantage of the current fiscal crisis to implement other important cost-cutting measures. It could negotiate an arrangement with public sector employees, for example, in which proposed increases in salaries are either rolled back or implemented in a phased manner. It could also negotiate arrangements whereby PA employees receive only a proportion of the salary arrears owed them.

Towards the Medium Term: Reforms in Core Government Systems and Practices

Moving away from the current crisis, there are a variety of areas where further reforms are necessary to improve the efficacy of government expenditure and help place the PA on the track of financial sustainability and fiscal independence. They are discussed in detail in the various chapters of this report and summarized below.

Public Financial Management. As noted in Chapter 2 (Volume 2), the PA made considerable progress between 2002 and 2004 towards the implementation of a PFM system which provides adequate financial control and transparency. Unfortunately there has been little further improvement over the past two years. From 2004 onwards, there has been some progress in developing the internal audit and financial control functions (particularly the former), but some continuing confusion in line ministries about their respective roles. There has been limited progress in establishing the new external audit institution—the Financial and Administrative Control Bureau (FACB)—since the new law was promulgated one year ago. Its president has been appointed and has begun work, but the organization is severely hampered by lack of capacity and resources. There

¹⁹ *Al Quds Daily*, June 1, 2006

has been slow progress in external financial reporting, with the audit report on the 2003 financial statements still not available and the 2004 financial statements not yet submitted for audit. The importance of audited aggregate financial statements in providing assurance that information is being correctly reported and that the underlying systems of control which produce this information are functioning adequately does not appear to have been sufficiently appreciated by the MOF. On the positive side, there has been some progress in developing a medium term development plan (MTDP) to better prioritize expenditures, and in particular to better integrate donor project funding into the budgetary exercise.

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

- Reform of the accounting system;
- The need for line ministries to be more responsible for their own expenditure management and to locate this responsibility at the level of spending units within ministries; and
- The need for improvement in financial transparency in a number of important public institutions.

Chapter 2 (Volume 2) also examines in more detail upstream budgeting issues only briefly addressed in the CFAA, namely the integration of planning and budgeting through the MTDP—reflecting the need to address the lack of any focus on performance, policy or priorities in budget development and execution, and to as far as possible integrate donor projects into a more comprehensive budget. Reforms in this area being pursued by the PA (mainly through the Ministry of Planning with technical support from DFID) are moving in the right direction, but there is a considerable way to go.

Finally, to establish a baseline on the quality of the PA's PFM system, this report assesses the system by using the set of performance indicators developed by the Public Expenditure and Financial Accountability (PEFA) secretariat.²⁰ These indicators are expected to come into general usage over the next few years as the basic mechanisms for identifying weaknesses and the rate of improvement in country PFM systems. The WBG scores under these indicators is set out as an annex to this chapter.

Civil Service Reform. The civil service reform agenda is a large one that under the best of circumstances is likely to take the PA a decade or more to achieve. In the near-term, the focus will regrettably need to be upon ensuring the affordability of the public sector

²⁰ Public Financial Management Performance Measurement Framework, June 2005, available on the PEFA website under www.pefa.org.

and sustainability of the wage bill. In the medium term, the focus can shift towards qualitative improvements in service delivery and maximizing the efficiency and effectiveness of expenditure.

The PA, assisted by donor partners, will need to make a number of important strategic decisions about how to proceed with civil service reforms. As noted above, some tasks should be done right away. One of the top priorities will be to initiate a comprehensive audit of the payroll. In the wake of this audit, action should be taken against various categories of employees who have, in one way or another, been abusing the system, including employees working abroad or out of post, those working past retirement age, double dippers and ghost workers. Such staff could be terminated with no or limited compensation. The PA should also initiate a policy prohibiting overtime payments for all staff except those working in front-line service delivery in the Ministry of Health.

In the near term, PA reforms should concentrate upon two additional tasks. The first would be assessing a sustainable size for the civil and security services and developing a viable strategy for getting there. Bank calculations indicate that under the most optimistic of scenarios—including a rebound of the economy and the receipt of tax revenues similar to those that were collected in late 2005, a resumption in the transfer of clearance revenues, strong external support and access to domestic financing—a sustainable wage bill would be at a level of around \$80 million per month.

Unfortunately, given that PA wages are now averaging around \$100 million per month, it would be impossible to achieve a sustainable base without a major rationalization program. The PA could pursue a number of options in the search for long-term wage sustainability. The simplest approach would be to roll-back the salary increases that took place in 2005 for the civil and security services, or to “claw back” these increases by imposing a compensating payroll tax on PA employees. Bank calculations indicate that, if wages were rolled back to levels prevailing in mid-2005, the PA could save around \$238 million annually over the first two years and a net present value of \$970 million over five years. As Chapter 3 (Volume 2) indicates, since prevailing Palestinian public sector wage rates are now around 15 percent greater than those in the private sector, the justification for such a strategy is strong.

A second approach would be to offer voluntary retirement packages to civil and security services to induce them to leave. There are a number of challenges with such programs that are discussed in the broader PER, particularly the risk of adverse selection (i.e. the wrong people leave) and avoiding problems of re-entry. (See Box 1) But properly designed and implemented programs could help to reduce the number of employees and generate considerable fiscal savings. In Morocco, for example, a Voluntary Retirement Program was recently implemented successfully that led to the departure of around 39,000 civil servants, or 8 percent of total civil service employment. This led to an annual savings on the wage bill of around .6 percent of GDP and a cumulative discounted savings of 3.7 percent of GDP, which will allow the Government to recover its initial net outlay of 1.9 percent of GDP within four years assuming no rehiring takes place.

Box 1: Issues and Tradeoffs Surrounding VRS Programs

VRS programs come in multiple varieties. General programs are open to all staff within a particular agency or organization, whereas targeted programs are open only to certain types of categories of staff. Some programs are open-ended, whereas others apply only for a limited time and have strict deadlines for applications. Some programs operate in two or more phases. During the initial phase, employees are offered a more generous package if they participate in the program, which will later be diminished if they fail to take advantage of it. Some programs combine VRS and targeted redundancies. Surplus staff are placed within a redundancy pool, where they can either accept a VRS package or try to find alternative employment within the public sector (typically within a limited time frame, such as free months). If they fail to accept either option, they are then either reassigned or terminated or compelled to accept a severance package that is significantly less generous.

VRS programs have a number of important virtues. Their primary advantage is their political viability. No one is forced to leave under a VRS program, so resistance from rank and file civil servants and the broader public is minimized (although unions can oppose such measures because they reduce their membership and perceived bargaining power).

While politically more palatable than involuntary or compulsory redundancy schemes, there are several potential drawbacks associated with VRS programs. The first is the risk of *adverse selection*. Unless such programs are carefully targeted, often the best and the brightest within the public sector will take advantage of them, leaving only those who had limited options elsewhere. Staff with skills in particular demand, such as IT or financial management specialists, can depart in the greatest numbers. The second is the risk of *re-entry* or *moral hazard*. Having received a package for leaving the civil service, staff will return either to another part of the public sector or continue to be reimbursed through various consultancy arrangements. A third risk is that of *sustainability*. Unless lasting measures are implemented to address the underlying causes of over-employment within the public sector, it is not unusual for countries to be back where they started—or worse—within a couple of years.

The success of such programs in the West Bank & Gaza could vary depending upon the design of the program and the number and type of staff targeted for severance packages. Firm numbers are hard to come by, since such programs depend upon a variety of assumptions that would need to be carefully probed and tested in the field. Preliminary calculations based upon an 18 month package (which is consistent with the Morocco case) indicate that the initial payout would be in the realm of \$172 million and the net potential savings could be in the range of \$812 million over a five year period for a retrenchment program covering close to 25,000 civil and security service employees—the amount that would need to be let go to hit the sustainable wage bill target of \$80 million per month.

There will no doubt be considerable resistance to the notion of public sector rationalization within both Palestine and some elements of the donor community, on the grounds that the private sector is not in a position to absorb excess labor. Yet this should not be an obstacle to a properly designed system. The reality of most rationalization schemes is that the majority of employees ultimately end up taking their package and leaving the labor force. It is likely that a carefully designed scheme, well resourced and targeted towards older workers, would be preferable to the current situation in which salaries are not being paid or will be paid unpredictably and/or only in part.

The third approach would involve agreement between the PA and donors on a wage bill cap at a specified absolute figure to be allocated over a fixed number of employees

according to an agreed upon formula. A target could be \$80 million per month or \$960 million per year—approximately the level that existed prior to the major civil service salary increases in July 2005. This sum would equal approximately 84 percent of the formal public sector wage bill as of December 2005 and represent a savings of roughly \$240 million per year over current salary obligations. The PA would be requested to contribute a fixed sum to the wage bill, and either individual donors or a consortium of donors would pledge to contribute the additional amount. (Payments for salary arrears would need to be negotiated, with the understanding that employees will not receive all of their accumulated pay.) Should the PA make additional progress in retiring staff and/or reducing the number of employees in the aggregate pool, a higher proportion of salaries would be paid to the remaining employees. Any violation of plan conditions would lead to a suspension of donor payments.

An interesting addendum to this approach would allow specific agencies to “break out” of the aggregate salary pool and have their salaries fully funded if they met certain established criteria. (To provide further incentives, non-wage funding for these agencies could also be increased.) Currently, 22 ministries have prepared ministerial development plans, which seek to replace organizational structures and staffing practices that are largely ad-hoc and idiosyncratic with those that have been developed in a more rigorous and professional manner. This involves the development of organizational structures laid out along clear functional lines; the preparation of job descriptions for all posts; a clear separation of political and professional appointments; and the preparation of a detailed manpower plan, all of which would be subject to an independent third party review. Such ministries would be able to migrate to the full salary scale and even be allowed to recruit new technical staff to fill critical skills gaps once they implement the agreed-upon plan, provided that they can demonstrate clear cost savings with no reduction in services. Staff who are made redundant through this exercise will remain within the central civil service pool and continue to draw a portion of their salaries, or they could elect to receive a severance package. But they will no longer work for the ministry.

Although such an approach would be complicated to establish and administer, it has three major advantages. The first is that it would support a major realignment in the existing dysfunctional incentive system between the PA and donor community. Current donor practices have in essence subsidized both wage and (to an even greater extent) non-wage spending, allowing the PA to shift resources away from non-wage expenditures towards salaries. Donor efforts to contain the wage bill through vehicles such as the Reform Trust Fund made the mistake of linking specific wage bill targets to a percentage of revenue, which allowed the PA to expand recruitment as revenues went up. The proposed strategy will create incentives to reduce the number of employees, which would allow the payment of increased salaries to those who remain. The second is that it will give impetus to ministries to implement reforms so that they can transition over into a leaner organizational structure in which all remaining employees will be paid at their full salaries. Finally, the proposed system does not involve compulsory redundancies and would continue to provide partial salary payments to all bone fide civil servants, with the understanding that such payments could eventually be shifted into social welfare payments. This would allow the core of an efficient, effective public administration to emerge from the broader PA structure.

The challenge of reducing the burden of wage expenditures for the security services will be a particularly difficult one. As noted in Chapter 3 (Volume 2) on civil service reform, even at current staffing levels of around 70,000+ the PA security services are not particularly overstaffed in comparison with regional norms, which vary widely. However, they are unaffordable and the value for money received from these forces is poor; few would argue that their expansion or generous pay increases and pension plan have actually contributed to improving security on the ground in Gaza or the West Bank. First steps would include a careful and transparent accounting of their numbers; a reduction of the 14,000 or so “non-compliant” officers recently identified by the MoI; and the elimination of certain categories such as “political” or “honorary” officers that provide little tangible benefit. Around 6,000 officers are nearing or past retirement age and could also be induced to leave (there is likely to be some overlap between these various categories). In light of the risks involved, such efforts would need to be carefully developed and coordinated with ongoing efforts to reduce the number of security services from 13 to 3.

The chances of success of security sector reform (SSR) are greater if such a strategy is part of a comprehensive political framework that includes reconciliation, the rebuilding of institutions, support to disarmament, demobilization and reintegration, and measures to improve the rule of law. Transparency in SSR implementation is critical: on a macro level with regard to security expenditures and an adequate macroeconomic and fiscal framework; on a micro level to eliminate “ghost” soldiers, equipment and maintenance and the siphoning off of resources allocated for them. SSR and demobilization operations need to be timed carefully in order to complement each other and support the overall peace process. Linkages and interdependencies between the two need to be well understood before implementation.

The second track in any near-term reform effort would involve measures to strengthen establishment control, such as the use of biometric systems (i.e. “electronic fingerprints”); the strengthening of efforts by the General Personnel Council to develop a computerized human resource database covering all PA employees; and the conduct of regular personnel audits. Probation and evaluation procedures can be tightened to ensure that only the best civil servant can become permanent employees at the conclusion of their evaluation period.

Assuming that a sustainable configuration can be achieved, medium term efforts would focus along several dimensions. There is scope for rationalizing PA administrative structures to reduce overlap and duplication and improve policy coordination. As Chapter 7 (Volume 2) indicates, the areas of social policy and social protection are a prime candidate for rationalization. But others exist as well. Another dimension would focus upon pay and employment policy, with particular attention to the rationalization of allowances. A third would look at long-term measures for improving the quality of human resource management, including manpower planning.

Finally, the PA should consider strengthening the institutions and legal framework for combating corruption. Along these lines, progress could be made in several directions.

The first would be developing an anticorruption strategy and conducting empirical work on the nature and causes of corruption. The need for an independent anticorruption agency should be examined that would focus upon prosecution, prevention and public awareness. Steps could be taken to promote greater transparency and access to information, as well as to improve compliance with the *Law on Illicit Gains*.

Sectoral Reform Measures

Local Government. As noted above, Palestine has one of the most autonomous systems of local government in the MENA region. However, there is room for improvement along several dimensions. The first challenge involves sorting out some of the conflicting and at times perverse incentives surrounding the system of inter-governmental transfers. Two problems are particularly important in this context. The first is the non-payment of utility bills and the “free rider problem,” in which municipalities do not enforce collection and in essence pass the bill for unpaid utility services on to the PA. (Israeli providers are directly reimbursed by deductions from clearance revenues prior to their being forwarded on to the PA.) The second is the so-called “Emergency Transfer” system, which has increased rapidly in the post *intifada* period and represented approximately 20 percent of aggregate local government expenditure in 2004, is relatively ad-hoc and non-transparent. Such transfers, which are often politically motivated, tend to undermine the MOF’s attempt to establish a rules-based intergovernmental fiscal system. The use of fiscal intercept as a policy tool can be rendered ineffective in inducing greater recovery of costs for water and electricity utility services.

A clear binding constraint is the GOI’s withholding of clearance revenues. Under such circumstances, there is little that the PA can do to enforce fiscal discipline upon many municipalities. However, for the medium term, several approaches hold promise. First, the policy of a “hard budget constraint” needs to be adopted by the PA and the practice of fiscal intercept reconstituted as an effective and utilized policy instrument, for there is evidence that it was effective (particularly with smaller municipalities) in fostering improved collection. Second, the development of the Municipal Development Fund in 2003 needs to be nurtured and sustained, recognizing the important contribution it has and can continue to make as a key feature of the evolving Palestinian intergovernmental fiscal architecture. Its role is particularly important in making the process of intergovernmental transfers more transparent and oriented towards performance, with the goal of ultimately influencing the ability of municipalities to access capital markets.

A second problem is the proliferation of local governments, which reflects a decision taken during the early years of the PA. Today there are nearly 500 local government units, all of which due to ambiguities in the 1997 Law on Local Authorities, have the same role and responsibilities in terms of service provision, budget preparation and implementation, reporting, and so forth. This arrangement has created a sense of entitlement and claims on scarce financial resources, while limiting the share of resources that larger municipalities can receive due to budgetary fragmentation. This issue has been clearly recognized by the PA as one to be addressed and resolved. One initiative

has been to limit access to financing to local governments of a particular size and capability (for instance, providing resource transfers only to municipalities that can effectively manage the funds), while encouraging the remainder to form Joint Service Councils in order to access funding.

Over the long-term, and only after there has been sufficient broad-based discussion and debate involving central and local governments representatives, a strategy for the local government sector will need to be articulated in sufficient detail to convey overarching policy objectives, the roles and responsibilities of key agencies, a clearer definition of expenditure assignments and corresponding linkages to an appropriate blend of own/shared revenue sources and central government transfers. On the basis of this framework, revisions to the 1997 Local Authorities Law will be required, first to bring the law into line with current practices where appropriate or with the aim of enforcing rules that currently are embodied in the law, and second to ensure sufficient specificity in assigning authorities and powers among different tiers of government. In particular, regulations would need to accompany the law to address the obvious asymmetries between larger and smaller LGUs. Other recommendations would include issuing standards and guidelines for local government accounting and financial management, including the adoption of a unified chart of accounts; adoption of standard reporting formats and financial planning and management tools, including a planned/executed budget format, standard balance sheet, as well as revenue-expense and cash-flow statement templates; and institutionalizing procedures and scheduling of external audits to be performed by the new FACB (or a certified local accounting agency under their direction), along with public disclosure of the results.

Finally, MOLG is in desperate need of a municipal finance database that could be used to monitor key financial performance ratios as a means of informing policy makers about the relative health and performance of the sector and when or where interventions may be needed.

Education. Chapter 5 (Volume 2) notes that the education sector in the West Bank and Gaza is at an important turning point. Impressive achievements have been made during the past five years. The system has experienced massive expansion and attained equitable access, reaching a level of development that by most accounts is comparable with middle-income countries. However, a major challenge lies ahead in building on these achievements and consolidating recent gains. Although almost all children up until the age of 12 are attending school, the quality of education is variable and there is clearly scope for improving the efficiency and effectiveness of expenditure.

Education expenditures have been increasing in the past five years. Although unit costs for the provision of basic schooling in West Bank and Gaza are high compared to neighboring countries, government funding for education as a share of national income is low by regional and international standards. Total education expenditure as a percentage of GDP has increased from 7.5 percent in 2000 to 11.5 percent in 2003. However, government's share of total education expenditure fell from 42 percent in 2000 to just 34 percent in 2003. Private funding has been increasing and has reached 46 percent of all

education expenditure (including tertiary education). UNRWA accounts for 20 percent of total expenditure and enrolls 25 percent of students in basic education.

Within the PA, the majority of recurrent expenditure—an estimated 90 percent or \$272 million—is for salaries. Around two thirds of non-salary recurrent expenditure is allocated towards textbooks and examinations. The MOEHE non-salary operational budget was halved by MOF in 2005, severely limiting the capacity to provide the system with resources needed for the provision of services. The rapid increase in the wage bill for government teachers is crowding out operational funding for schools.

Differing population densities between the West Bank and Gaza, combined with the toll that internal checkpoints exact upon the movement of students and teachers and the PA's ability to optimize the geographic distribution of schools, make it difficult to accurately compare costs between the PA and comparable educational systems. Class sizes and student teacher ratios vary significantly between the West Bank and Gaza, as well as between PA schools and those operated by UNRWA and other providers. During the period of the *intifada*, PA student teacher ratios have increased slightly from 23.3 to 26.3—a figure that compares favorably to UNRWA and less favorably to private schools. PA class sizes have decreased from 37.7 to 34.3—a figure that also compares favorably to UNRWA and less favorably to private schools. But the data is generally inconclusive. UNESCO data from 2001, for example, tentatively indicates that unit costs are higher in Palestine than in Jordan, Morocco and Tunisia, but considerably lower than in Syria.

Yet a few important conclusions emerge. First, the days of rapid expansion in PA education budgets are over. For the PA to achieve new qualitative goals, it will be necessary to introduce key policy changes. Education spending will need to shift from classroom construction, textbook procurement and the recruitment of more teachers towards a more sophisticated set of policies aimed at implementing more modern pedagogical methods and practices, introducing improved monitoring and evaluation, and developing a comprehensive strategy for human resource management.

Second, a closer look at the demographic profile within the West Bank & Gaza may allow the PA to recognize considerable savings. The PA appears to have encountered a demographic bulge rather than a sustained expansion, which will allow it to forgo the recruitment of thousands of new teachers each year. Enrolments were actually lower in grades 1-3 in 2005/06 than they were in 1999/200. (In contrast, enrolment in grades 10-13 increased by well over 60 percent during the same period.) If such findings are true, the PA could potentially save as much as \$17 million per year in reducing its intake from 2,800 new annually and limiting recruitment to replacements only (around 215 per year). More modest decreases projected on 2 and 4 percent per annum growth would also yield savings over current practices, albeit at reduced rates. Recruitment into education should focus exclusively upon front line service delivery in areas of critical need (such as secondary school teachers) and avoid categories such as administrative and support staff.

Third, the category of vocational education merits careful scrutiny and review. Vocational schools cost 10 times more than traditional schools; there is limited demand

for them; and their graduates often do not find jobs. The six-monthly activity profiles of secondary industrial school graduates between the beginning of 2002 and the end of 2005 shows that, for 56 percent of secondary industrial school and 31 percent of technical college graduates, their current employment is “completely unrelated” to their training specialization. Since these schools are intended to provide marketable skills that accrue directly to their students, they should be placed primarily on a fee for service basis. Increased emphasis on comprehensive secondary schooling and a diversified tertiary education system with advanced vocational training are a priority.

Fourth, although these items make up a relatively small component of PA education spending, there is likely to be scope for significant savings in several areas relating to capital and non-wage expenditure. The need for classroom construction should diminish from around 750-1050 per year to 430-860 per year. Classroom construction should also be rationalized and focus upon areas where there are serious safety concerns or double or triple shifting. The practice of annual textbook procurement is wasteful and should be extended to every two or three years. Since donors are heavily engaged in supporting such activities, improved donor coordination in the sector will be essential.

Health. As Chapter 6 (Volume 2) notes, the provision of health services has been particularly vulnerable to dislocations imposed by closures and roadblocks. Significant accomplishments in public health are being undermined, and a number of key indicators are starting to slip backwards. Children and those with chronic conditions are particularly at risk. Recently, the sector has been among the most vulnerable to disruptions in PA revenues and donor financing.

Unfortunately, PA expenditure policies have exacerbated these vulnerabilities. As noted above, between 1999 and 2004, expenditures on public sector wages increased by an estimated 64 percent, with a 28 percent increase between 2002 and 2004. Staffing numbers for some categories of employees more than doubled. As Table 5 indicates, these changes resulted in a reallocation of resources away from non-salary recurrent expenditure.

Table 5: Budget and Funding for Non-Salary Recurrent Expenditure in Health
(millions of dollars)

	2001	2002	2003	2004	2005
Budget Allocation	49.9	45.3	51.3	51.9	50.3
Funds Received from MoF	16.1	10.3	0	0	0
Funds from Other Sources	16.1	31.2	45.9	43.5	14.4
Financing Gap	17.7	3.8	5.4	8.4	35.9
% Financing Gap	35%	8%	11%	16%	71%

Source: Bank Staff Estimates, 2006

Until 2005, aggregate recurrent expenditure did not decrease markedly. But the source of funding shifted from PA own source revenues to funds received from other sources, heightening the vulnerability of the PA to disruptions in external aid flows. The PA’s expansive policies on salaries and contracted services effectively left little fiscal space for

critical variable expenditures such as pharmaceuticals, medical supplies and operating and maintenance budget for equipment and facilities. This is leaving many facilities with capacities that are not fully utilized.

Several other policy decisions have exacerbated the challenges confronting PA expenditures in health. On the revenue side, the PA depended on premium contributions and co-payments collected through the Government Health Insurance (GHI) system to supplement its health budget. The GHI program, established under the MOH in the 1990s, was expected to provide the basis for moving the PA's health system towards a social health insurance system that would provide a sustainable financing mechanism to cover the Palestinian population. A number of important structural reforms to the GHI system initiated in the late 1990s have been halted since 2000, and emergency measures introduced by PA to cope with the exigencies of *intifada* have further undermined its financial sustainability. At its peak in 2000, the GHI contributions covered some 51 percent of the MOH expenditures on health services, and GHI had been poised to expand its revenue base in line with the projected economic growth. With the outbreak of *intifada*, the GHI contributions declined while the number of GHI beneficiaries exempted from contributing premiums and co-payments increased as a result of the emergency measure decreed by President Arafat. Although the GHI revenues appear to have recovered in recent years (in 2004 it covered about one third of MOH's expenditures), this may largely reflect an increase in contributions from the expanded civil service staff, who are in turn receiving salaries that are heavily subsidized by donor contributions.

At the same time, the PA has expanded the volume and types of contracts with Palestinian NGO health care providers through the GHI coverage. The expansion of contracting ostensibly enabled PA to extend the GHI coverage for beneficiaries in areas where the MOH did not have facilities. It has also helped to supplement the revenues for NGOs who were suffering loss of revenues due to reductions in donor financing and private contributions. However, in the face of current fiscal crisis, the MOH has been unable fully to reimburse the NGOs for services rendered under the existing contracts, and the PA is now accumulating sizeable arrears due to these commitments. While it was the original intention of the GHI program to expand the choice of health providers to the beneficiaries through contracting of health services with NGO and private health care providers, such a step would have required substantial upgrading of GHI capacity to design, manage and monitor contracts with the external health care providers. It would also require ensuring that the benefits and coverage are affordable and actuarially sound.

Finally, PA spending on non-wage items appears to be inefficient along a number of dimensions. Expenditure for specialized treatment ballooned from \$8 million in 2002 to \$55 million in 2004, and it now accounts for about one quarter of the MOH budget. In absolute numbers, special treatment referrals nearly tripled between 2002 and 2004 from 6,483 to 20,100. Referrals for specialized treatment outside of the MOH, including referrals for services both within and outside of the WBG territories, represented 26 percent of total PA health expenditures and 44 percent of non-salary operating expenditures. Prices paid for drugs by the PA are significantly above both world market

prices and those obtained by UNRWA. (In fact, MOH procurement prices were four times the UNRWA price during the same period.) Although medical equipment is largely provided by donors, there is virtually no coordination of these donations. MOH has also not been able to estimate and allocate adequate resources for the management and maintenance of the equipment.

These short-term emergency-driven measures that have shaped PA's budget formation process over the last five years have introduced a number of structural imbalances and allocative inefficiencies that will require major adjustments to bring the system back into a more efficient alignment. First, the MOH will need to address its internal staffing structure and aim to achieve a better balance between staff and non-staff operating expenditures. Second, MOH will need to address its overextended commitments to contracted services, and determine an efficient trade-off point between outsourcing services and direct provision of services through MOH facilities.

An important aspect of budget planning will be to promote allocative efficiency that minimizes duplication and optimizes complementarity of resources between the MOH/PA services providers, UNRWA, and NGO/private sector providers. There has been a tendency in the past to plan the activities of the different constituent parts of the health system in isolation of one another. A much more sector-wide planning will be recommended to achieve a more cost-effective allocation of budget.

The MOH has the option either to shift its primary mode of health care financing through contracting and outsourcing, or through direct management of its own facilities. In either case, the MOH would need to introduce modern management and provider payment systems that better align incentives with performance and achieve a higher level of technical efficiencies. For the health services provided directly through MOH facilities, the Ministry will need to improve the timeliness and accuracy of financial data provided to line managers. For the services contracted through Special Treatment, the MOH will need to develop stringent criteria for prioritizing services that should be outsourced, including measures of cost-effectiveness, efficiency and quality of care. Contracts should include quality standards and appropriate medical audits to ensure adherence to those standards, and, prospective case-based payments rather than fee-for-service or simple price and volume contracts, in order to improve incentives for performance.

Pensions. The PA has historically operated two pension schemes: a funded system through the Gaza Pension Insurance Corporation for employees in Gaza and selected employees in the West Bank, and a pay-as-you-go system for employees of the West Bank that was closed to new entrants in 2001. Both are considered extraordinarily generous by international standards, with replacement rates in excess of 90 percent of final salaries, liberal early retirement provisions and future increases in pension benefits tied to wage levels as opposed to a cost of living index. Palestinian security service personnel had been excluded from the public sector pension system. In January 2005, however, a new Security Services Pension Law (SSPL) was enacted which provides pension coverage to all those 45 years and older in the security services. Like the Gaza system, this law mandates a contribution rate of 22.5 percent of wages (12.5 percent from government, 10 percent from employees), but provides a benefit formula even more

generous than that under the Gaza scheme. Retirees can receive 100 percent of final salary and can be eligible for retirement as early as 40 years of age. Moreover, since there are no pension assets, and nearly all those covered will be eligible for retirement upon the law's full implementation, all expenditures under the SSPL must be met from the PA's revenues as opposed to any build up of assets in a fund.

Pension reform has been high on the public policy and fiscal agenda in the West Bank and Gaza since 2003, when the PA became aware of the looming crisis. With the backing of the international donor community, the PA committed itself to a serious effort to reform its public sector pension system starting with the establishment of a broad based National Pensions Committee (NPC) under the chairmanship of the Ministry of Finance to consider pension policy and institutional reform. Based on the outcome of the NPC's discussions and recommendations, drafting of the Unified Pension Law (UPL) began in March 2004. The law was intended to launch a new two-pillar system (with both Defined Benefit and Defined Contribution components) to cover all employees, to be governed by a modern, transparent and independent pension agency. Unfortunately, the legislation was progressively weakened as it moved from the time of drafting, through the National Pension Committee, the Cabinet, the PLC Budget Committee and finally to the PLC itself. The passage of the security service pension law further derailed the reform effort by promising hugely generous pensions to a relatively small cadre of employees without regard to cost, funding, or equity.

At about the same time, considerable pressure on the PLC came from labor unions and private sector employees to pass a law providing pension coverage for the private sector. Only a small number of private schemes exist for certain professions, and Palestinians who had regular employment in Israel and contributed to social security schemes there were also entitled to pension payments although benefit payments from Israel had become increasingly undependable.²¹ A law was passed in late 2003, but has not been implemented as the Ministry of Labor determined that the law was seriously flawed in both its parametric design and institutional provisions.

Reform of the pension system is possible if the PA again makes it a priority and, in particular, addresses the shortcomings in the current version of the UPL. This would include adjusting the parameters, rolling back early retirement provisions, and limiting acquired rights. It requires appropriate changes in the legislation to ensure that the system is well governed, transparent, and that the financial assets are safeguarded for the benefit of plan participants. To speed the transition, severance payments for older employees of the security services should be considered in lieu of pensions. The UPL provision for a "Citizen's Pension" could provide a useful mechanism for providing social insurance to the elderly, but needs to be implemented in a way that is properly targeted and appropriate to the prevailing fiscal situation. Moreover, a properly designed public pension institution could be expanded over time to cover the provision of private sector pensions. Fundamental reform is not a trivial undertaking, however, especially

²¹ Unfortunately, Israeli policy has made it increasingly difficult for these workers to collect their pensions without first taking action in court.

since legislation has been so recently adopted. It should begin in earnest as soon as possible.

Social Policy and Social Protection. Social protection in WBG encompasses public pensions, social safety nets for the poorest in society and labor market and employment interventions. These are provided by PA ministries, donors, and NGOs as well as informal private assistance. Given the complex mix of providers and the limited collective resources, significant efficiency gains can be realized through a combination of greater program and institutional coordination on the provision of safety nets, better policy and program planning and improved targeting of large programs so that benefits reach the poorest and most vulnerable. Several specific recommendations emerge from the discussion in this chapter:

- *Strengthen program coordination.* The PA and donors often operate programs independently of one another with little exchange of information either at the policy or operational levels. Even within the PA, some line ministries are largely unaware of other ministries' programs with similar aims. At a minimum, regular fora for information exchange should be set up, such as monthly policy meetings, where attendance by line ministries and donors is mandatory. An example is the monthly Food Security Meeting chaired by WFP and FAO, attended by other donors and NGOs. Setting up the communication avenues could be initiated by the Ministry of Planning through line ministries.
- *Reduce potential for overlapping programs and beneficiaries.* Due in part to the lack of coordination between providers, there are many interventions purporting to reach the same or very similar populations with similar benefits. A few examples highlighted in the chapter include: (i) MOSA provides vocational training for dropouts and young adults, while MOL also provides vocational training for unemployed adults; (ii) MOSA provides cash transfers to the needy through the Social Hardship Case program, while the UNRWA provides similar benefits to the refugee population through its Social Hardship Case program and Ministry of Detainees and Ex-Detainee Affairs provides a separate transfer program for supposedly needy families of those who are detained in Israel and their families; (iii) Both UNRWA and WFP provide similar packages of in-kind food rations to similar populations, the former to poor and vulnerable registered refugees and the latter to food insecure non-refugees. The development of a strategy for social protection that would identify and clarify the roles of the PA, donors and private sector is highly desirable. This process could lead to a review of the legislative framework governing ministry mandates and new amendments to develop a more streamlined and effective social protection system.
- *Improve policy planning, budgeting, and fiscal management.* Social protection line ministries should take a more active role with regard to

policy planning and fiscal management. Currently, they see themselves only as implementers of policies developed elsewhere in the PA. There is little attention given to budget planning or linking expenditures to revenues or transfers. It is frequently difficult to obtain recent budget and expenditure information from ministries, and when available bears little relevance for actual operations. This is partly a reflection of the uncertain revenues that have plagued the PA, but is also a problem with overall fiscal management. Planning units should be developed within the key ministries, MIS systems should be upgraded to allow monitoring of program performance, and budget departments should move toward more systematic programmatic budgeting practices.

- *Develop and implement a monitoring and evaluation strategy.* Programs such as the SHC programs, the TEP, and others should be subject to routine monitoring through an updated MIS, and should be part of a strategy of external program evaluation. Only through rigorous monitoring and evaluation can programs be improved and effective long term funding decisions taken to enhance fiscal sustainability.
- *Improve safety nets targeting.* Preliminary analysis of the MOSA Social Hardship Case program found high leakages of benefits to nonpoor individuals. Targeting methods that move away from categorical targeting towards more needs-based standards, such as a proxy-means approach, can increase the proportion of benefits that go to the poor. The Social Safety Net Reform Project is developing a pilot proxy-means test which could be considered for wider application across different safety net programs.
- *Consider public workfare program component.* MOSA and the PA would benefit from considering a traditional self-targeted workfare program component, perhaps as part of TEP, to provide benefits to the able-bodied poor unemployed in a way that does not burden the staff-heavy public sector and does not require a screening mechanism to identify participants. Workfare projects can also be targeted to geographic areas with particularly high unemployment and poverty (i.e., Gaza).

Institutional Infrastructure for Reform

The policy and institutional reforms contemplated in this document are massive and far-reaching. Under the current fiscal crisis, at a time when PA salaries have not been paid in full for almost one year and there have been open clashes between Fatah and Hamas factions, it is difficult to envision many of them being implemented. However, international experience underscores that many major public sector reform efforts had their genesis in periods of acute fiscal crisis, when it became clear that the prevailing status quo was simply not sustainable. Used astutely, the depth and magnitude of the

PA's current fiscal crisis can serve as a clarion call for reforms that many within government have been seeking to advance for years.

To carry forward a reform agenda of this magnitude, an appropriate institutional infrastructure needs to be in place. At the apex is a functioning Cabinet system that ensures consultation among all ministries and departments with a stake in a given issue and imposes binding decisions upon ministers. Equally important is the careful delineation of responsibilities for the Prime Minister's Office. The PA has taken some important steps in recent years in strengthening Cabinet procedures under the leadership of the Cabinet Secretary. However, the current fate of these reforms is uncertain. Some preliminary analyses have indicated that there is considerable scope for improving institutions and procedures for policy formulation and coordination at the center for government.

Turning to the task of public sector reform, on paper the PA has established several mechanisms which, in theory, could provide a viable mechanism for driving the reform agenda forward. A Cabinet subcommittee, the Ministerial Reform Committee, exists to provide policy guidance and strategic direction for the reform effort. Unfortunately, it has no secretariat and rarely met when Fatah controlled the executive branch; its fate under Hamas is unclear. In a similar fashion, the National Reform Committee has not provided the anticipated forum through which the PLC, private sector and civil society would be able to engage and influence the reform process. In July 2005, eight principal members offered their resignation to the then Prime Minister Ahmad Qureia over what they deemed to be a "lack of political will to activate the reform process and to implement the committee's decisions."²² With proper political support, the revitalization of these institutions could provide vital impetus to a rejuvenated PA reform agenda.

In theory, technical and administrative support could be provided by the Reform Coordination Support Unit (RCSU), which has the mandate to cover all aspects of reform in the PA, including public administration, judiciary, local government, elections, etc. In practice, this represents a massive and unfeasible workload for a small technical unit with just three technical staff. Its role has been further complicated by the long-running institutional rivalry between the Prime Minister's Office and the Ministry of Planning for control of the reform agenda. The RCSU currently reports to the PMO on all components of the reform agenda apart from public administration and civil service reform, on which it reports to MOP. It should be placed under a senior political figure with enough gravitas to advance the reform agenda across ministerial boundaries, and its resources and technical capacity should be significantly expanded.

Finally, the PA should establish an Intergovernmental Fiscal Policy Commission, including but not necessarily restricted to the Ministries of Finance, Local Government, and Planning, the Palestinian Central Bureau of Statistics (PCBS), the Municipal Development Fund (MDF) and possibly the Association of Palestinian Local Authorities (APLA) and/or local government direct representation. Such a Commission could provide needed follow up to the recommendations of this report, ensuring that policy

²² Cited from *Aljazeera.Net*, July 14, 2005.

coordination is institutionalized and made a formal assignment of responsibility to each of the respective agencies. The Commission's agenda should address issues that have relevance across agencies, including but not restricted to matters of intergovernmental transfers, revenue assignment authorities, donor coordination to local governments, and addressing the problem of municipal arrears. The Commission should seek ways to better integrate local government budgetary and finance issues into national systems of reporting and monitoring, though the present level of autonomy granted to local governments should be retained and better defined within the law.

Messages for Israel

As Chapter 1 (Volume 2) underscores, an economically and financially viable Palestinian state can only exist if two basic conditions are met. The first is a radical improvement in the movement of Palestinian goods and people, including full implementation of the 2005 *Agreement on Movement and Access*. As long as the Palestinian private sector remains moribund and Palestinian workers are denied permits for jobs in Israel, the West Bank & Gaza will remain mired in unacceptably high rates of unemployment. This will, in turn, generate pressure to use the public sector to absorb excess labor that any government would find very difficult to resist.

Second, from a fiscal and administrative vantage point, it is essential that Israel resume transfers of the clearance revenue immediately. As Chapter 1 (Volume 2) notes, the decision to withhold such revenues—while consistent with Israeli law—is a violation of the 1994 Paris Protocol of Economic Relations between the Government of Israel and the Palestinian Authority. Such revenues provided \$757 million into PA coffers in 2005 (around \$63 million per month), or over 61 percent of PA revenues. Again, many governments would find it difficult to exist, let alone manage their resources effectively, in the face of fluctuations of this magnitude. For the PA to be a viable institution, it needs to receive the revenues it is entitled to in a timely and predictable manner.

Messages for Donors

Donor assistance has been of critical importance to the PA. By one estimate, the volume of foreign aid amounted to about one billion dollars annually during the past six years, rising to around \$1.3 billion in 2005. A great deal of attention has been devoted to improving donor coordination over the past five years, and some important results have been accomplished. However, few would deny that more work needs to be done. At several junctures—particularly with regard to public expenditure management reforms and in the local government, health, education and social policy sectors—the PER has noted areas where donors have inadvertently worked at cross purposes or undermined efforts to enhance efficiency or expenditure discipline.

In other areas, reform-minded Palestinian officials have expressed legitimate frustration at how broader political concerns have at times undermined important efforts to improve the quality of PA institutions and administration. Donors played a pivotal role in establishing the CTA, for example, but then stopped financing it. They supported

planning and budgeting reforms, and then pulled out. They supported the establishment of the Prime Minister's Office and then stopped. This type of "on again, off again" support is detrimental to the long-term agenda of institutional development and state building.

There are a number of areas where donors can improve the efficient and effective utilization of financial resources for the benefit of the PA and Palestinian populace. At a minimum, they should seek to "do no harm" to efforts to improve the PA's ability to manage its finances prudently. This would involve: (1) taking a comprehensive sectoral view, and not undercutting PA efforts to impose fiscal discipline upon ministries and departments by providing significant off-budget resources for non-wage expenditures; (2) moving to meet international commitments to harmonize project financial management requirements, and as far as possible make use of the CTA and the PA accounting system; (3) ensuring that PEC DAR becomes accountable to the Executive branch of government with its financial transactions being part of the CTA; and (4) participating actively and enthusiastically in various forums for donor coordination, such as efforts in late 2005 to overhaul antiquated coordination mechanisms and create four strategy groups for governance, economic policy, social development and humanitarian, and infrastructure development.

Beyond this, to truly put the PA back on the path to fiscal sustainability, the PA and donor community need to come together around a common plan for integrated assistance. The Bank's Public Financial Management Reform Trust Fund is one such example, where multiple donors came together around an agreed program that provided budget support in return for progress on governance reforms. But more needs to be done to both ensure that the proper incentive structures are in place and to build capacity for fiscal and governance reform. Future efforts along these lines would involve several components:

- The Economic Strategy Group and Governance Strategy Groups, working in close collaboration with the Office of the President, the Office of the Prime Minister, the Ministry of Finance, the Ministry of Planning, the Ministry of Interior, the General Personnel Council, the Ministry of Local Government, and the Ministry of Social Affairs form a task force dedicated to developing a sustainable fiscal policy. The Reform Coordination Support Unit within the MoP, augmented by key staff from the MoF and GPC, is strengthened to serve as the secretariat of this task force.
- The CTA is restored and accounts in the Office of the President are shut down. All donor assistance is re-routed through the CTA.
- Relatively high levels of support from Arab donors continues to flow to the PA.
- The GOI resumes the transfer of clearance revenues.

- A detailed plan for moving to a sustainable fiscal policy is worked out and agreed upon through the task force. Though it will discuss efficiency gains and necessary institutional reforms, the principal components of this plan will focus upon fiscal stabilization, including: (1) reducing the wage bill; (2) reducing net lending; and (3) streamlining and rationalizing social transfer payments.
- The donor community provides support to the PA in a fashion consistent with the task force recommendations towards a set of agreed upon milestones.

Obviously, such efforts can take place only when the broader political environment is favorable. However, technical work towards developing such a plan and generating agreement around it can proceed immediately, so that when donors are ready to re-engage they can do so around a common framework and an agreement upon a set of reforms.

ATTACHMENT 1: SUMMARY OF RECOMMENDATIONS

Macro-Fiscal Policy Recommendations

Donors:

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

Government of Israel:

- Radical improvement in Palestinian movement of goods and persons is needed, including implementation of the 2005 Agreement on Movement and Access.
- Clearance revenues should be released directly to the PA, and no arrears should be settled with private PA service providers prior to a careful inventory, verification and prioritization of outstanding arrears.

Palestinian Authority

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

- Relevant sector ministries to pursue efficiency gains outlined in individual PER chapters.

Public Financial Management Policy Recommendations

Donor Practices:

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

Scope of the Budget:

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

Nature of Budget Appropriations:

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

Budget Classification and Establishing Line Ministry Accountability for Expenditure Control:

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

Budget Documentation:

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

Budget Development Dialogue:

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

Improving Expenditure Prioritization:

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

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

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

Budget Execution and Enhancing Predictability of Funding to Line Ministries:

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

Budget Execution and Cash Management:

- MOF should sweep all bank accounts on a daily basis, with consideration being given in the longer term to consolidating all banking arrangements into one account with sub-accounts as necessary for ministry and agency operations. MOF should ensure that all ministries (MOF and line ministries) regularly carry out bank reconciliation.
- MOF should also ensure that line ministries do not issue payment orders until funds are available.
- A system of cash forecasting (involving a Cash Management Committee comprising different parts of MOF) should be developed, in order to alleviate the current short-term (day by day) approach to funds release and to provide a basis for monitoring the extent to which the budget (both revenues and expenditures) is on track.
- Provisions governing limits on borrowing should be incorporated into the Organic Budget Law. These provisions should include appropriate reporting on actual levels of borrowing to the Palestinian Legislative Council.

Managing Palestinian Authority Debt and Liabilities:

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

The Accounting System:

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

Payroll Issues:

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

Internal Audit:

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

Financial Control and Reporting:

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

External Audit:

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

Palestinian Authority Commercial Investments:

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

Civil Service Reform Policy Recommendations***Wage Bill:***

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

Civil Service Size:

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

Reform of Security Services:

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

Donor Practices:

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

Establishment Control:

- Eliminate paper-based exchanges between the GPC, MOI and the MOF related to recruitment and promotions. Strengthen efforts by the GPC to develop a computerized human resource database covering all PA employees to and develop an integrated human resource management information system (MIS) (that includes a biometric identification system) linking the databases of the GPC, MOF and MOI.
- Develop clear organizational charts for ministries, including manning charts and job descriptions, to avoid irregular promotions and appointments.
- Disallow hiring above the official agency headcount by preparing detailed job descriptions; reward agencies for staying below their payroll budget by allowing them to obtain greater resources for operating expenses.

Organizational Restructuring:

- Complete the legal database that establishes mandates for all government ministries and agencies.

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

Payroll Management:

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

Allowances:

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

Civil Service Legislation:

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

Performance Management and Recruitment:

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

Anticorruption:

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

- Equip the Office of the Commissioner established pursuant to the Law on Illicit Gains.

Strengthen Institutions Involved in Reform Coordination:

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

Policy Recommendations for Reforming Intergovernmental Fiscal Relations

Legal and Regulatory Framework

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

Policy Formulation and Coordination

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

Budget Preparation and Review

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

Central Government Oversight

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

Local Revenue Collection

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

Governance and Accountability

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

Education Policy Recommendations***Broader Strategic Objectives:***

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

Efficiency in the Use of Human and Financial Resources:

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

Providing Equitable Access to Secondary Education:

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

Improving the Quality of Education:

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

Strengthen Monitoring and Evaluation Capabilities at all Levels:

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

Managing the Education System Efficiently and with Transparency:

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

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

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

Health Policy Recommendations***Strengthen Health Policy, Planning and Coordination:***

- Develop a broad policy framework that will support an effective coordination mechanism among all the key stakeholders and make the most effective use of the limited available resources. Such a framework would also help donors to align

their assistance with the local priorities, avoid duplication and ensure a measure of stability and predictability in the flow of resources for the priority services and programs. It should also promote an efficient allocation of resources that optimizes the complementarity of services among MOH/PA, UNRWA and NGOs/private sector providers.

- The PA and the donor community should continue to support the development of institutions and organizational capacities (like the GHI system) that will be essential in the future for mobilizing, planning and managing resources in the health sector.

Improve Budget Planning and Fiscal Management:

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

Develop Strategic Purchasing Capacity:

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

Specific Programs:

- *Refocus Attention on Public Health Programs.* The emergency situation and difficulties in mobility have severely limited access to preventive care, including early screening and participation in health promoting activities. These conditions will likely increase morbidity rates due to late diagnosis and treatment of illnesses, which in turn will increase the cost of care. Refocusing attention on

- public health programs that emphasize preventive care would help to alleviate some of the long-term negative consequences of these problems.
- Develop a Comprehensive Drug Policy. In the face of constrained resources and limited access to health services, the availability of affordable, safe and effective drugs takes on a greater importance. A comprehensive drug policy should be developed that addresses the critical elements of the pharmaceutical sector, including pricing, registration, quality assurance, distribution and appropriate use.
 - Revitalize the Quality Improvement Program. In order to counter the negative effects of recent years, and prevent deterioration in the quality of care, the MOH should continue to invest in quality improvement programs that focus on both the people and the institutions, including the development of a system of accreditation for service providers, and continuing medical education programs for health care professionals.

Social Policy and Safety Nets Recommendations

General Reform Initiatives:

- *Strengthen program coordination.* The PA and donors often operate programs independently of one another with little exchange of information either at the policy or operational levels. Even within the PA, some line ministries are largely unaware of other ministries' programs with similar aims. At a minimum, regular fora for information exchange should be set up by the Ministry of Planning, such as monthly policy meetings, where attendance by line ministries and donors is mandatory.
- Reduce potential for overlapping programs and beneficiaries. Due in part to the lack of coordination between providers, there are many interventions purporting to reach the same or very similar populations with similar benefits. A few examples highlighted in the chapter include:
 - MOSA provides vocational training for dropouts and young adults, while MOL also provides vocational training for unemployed adults.
 - MOSA provides cash transfers to the needy through the Social Hardship Case program, the UNRWA provides similar benefits to the refugee population through its Social Hardship Case program and the Ministry of Detainees and Ex-Detainee Affairs provides a separate transfer program for those detained in Israel and their families.
 - Both UNRWA and WFP provide similar packages of in-kind food rations to similar populations, the former to poor and vulnerable registered refugees and the latter to food insecure non-refugees.
- *The development of a strategy for social protection that would identify and clarify the roles of the PA, donors and private sector is highly desirable.* This process could lead to a review of the legislative framework governing ministry mandates and new amendments to develop a more streamlined and effective social protection system.
- *Improve policy planning, budgeting and fiscal management.* Social protection line ministries should take a more active role with regard to policy planning and fiscal

management. Currently, they see themselves only as implementers of policies developed elsewhere in the PA. Little attention is given to budget planning or to linking expenditures to revenues or transfers. It is frequently difficult to obtain recent budget and expenditure information from ministries, and when it is available it bears little relevance to actual operations. This is partly a reflection of the uncertain revenues that have plagued the PA, but is also a problem with overall fiscal management. Planning units should be developed within the key ministries, Management Information Systems (MIS) should be upgraded to allow monitoring of program performance and budget departments should move toward more systematic programmatic budgeting practices.

- Develop and implement a monitoring and evaluation strategy. Programs such as the SHC programs, the TEP and others should be subject to routine monitoring through an updated MIS, and should be part of a strategy of external program evaluation. Only through rigorous monitoring and evaluation can programs be improved and effective long term funding decisions taken to enhance fiscal sustainability.

Program Level Initiatives:

- *Reform the pension system.* This is a top priority from a fiscal perspective. Implicit debt accumulated from the current civil service schemes are nearly twice current GDP, and even making payments to current recipients requires an ever-larger share of the budget, estimated at nearly 2 percent of GDP in 2005. Fundamental reform is not a short term undertaking. However, an initial step would be to strengthen the administrative capacity of the GPIC. It would also include analyzing and revising the Unified Pension Law to adjust the parameters of the current public system to ensure long term sustainability, revising the Unified Pension Law, strengthening the GPIC and eventually developing an independent and transparent pension institution. Similar reform is needed with regard to the 2003 Social Security Law for private sector workers.
- *Improve safety net targeting.* Preliminary analysis of the MOSA Social Hardship Case program found high leakages of benefits to non-poor individuals. Targeting methods that move away from categorical targeting to more needs-based standards, such as a proxy-means approach, can increase the proportion of benefits that go to the poor. The Social Safety Net Reform Project is developing a pilot proxy-means test which could be considered for wider application across different safety net programs.
- *Consider a public workfare program component.* MOSA and the PA would benefit from considering a traditional self-targeted workfare program component, perhaps as part of TEP, to provide benefits to the able-bodied poor unemployed in a way that does not burden the staff-heavy public sector and does not require a screening mechanism to identify participants. Workfare projects can also be targeted to geographic areas with particularly high unemployment and poverty.