



**Palestinian National Authority  
Office of the Prime Minister**

**8 April 2009**

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

**Re: LETTER OF DEVELOPMENT POLICY**

Dear Mr. Zoellick,

1. In December 2007, we published the Palestinian Reform and Development Plan (PRDP). This document laid out our vision of an independent Palestinian state and provided details on the steps we planned to take to restore good governance and the rule of law to the West Bank. We also aspire to replicate these actions in Gaza when the situation allows. In 2008, we worked to steadily implement the PRDP under extremely difficult circumstances. Despite the severe challenges, as documented by regular IMF and World Bank reviews, we have made significant progress on implementing the PRDP reforms within the West Bank. We have made major strides in improving security, reestablishing basic government services, strengthening the PA's fiscal position and increasing transparency. This progress has been possible because of the generous support of the donors, including the World Bank's Development Policy Grant. In 2009 and 2010 we will continue to implement the PRDP and look forward to continued international support.

2. We have made substantial progress on upgrading Palestinian institutions of government and creating a secure and stable internal environment and the international community has responded with their strong support. However, for the PRDP process to be ultimately successful, these steps must be accompanied by sustained and serious political dialogue, and concrete steps and commitments by all parties towards a lasting peace. Progress in this area has been slower than hoped, but we will continue to focus on strengthening the PNA's ability to deliver services and reviving the Palestinian economy while the political process continues.

## I. Background

3. When the current government was formed in June 2007, we faced a very difficult situation on several fronts including: a violent takeover of power by Hamas in Gaza, with all associated political, security, and economic ramifications, institutional degradation in our ministries resulting from the boycott of the PNA by most donor countries and by Israel, and from our internal political turmoil, large wage arrears to PNA employees and the private sector and increasing Israeli economic restrictions and barriers to movement and access.

4. In confronting these problems, our immediate objective was to regain control over the exercise of sound government policy and to put our house in order. In the economic sphere, we resolved to deal with these problems under three major policy initiatives: i) restoring the integrity of our financial management system ii) moving towards financial sustainability and reducing our dependence on external financial assistance for current expenditures, and iii) faced with rising Israeli restrictions on movement and access, initiating an economic recovery strategy, based upon small community projects, which is much less vulnerable to Israeli restrictions than the standard development approach.

5. In light of the institutional degradation it was essential to quickly restore our citizens' trust in our public finance system and to reassure the donor community about our ability to properly manage the large budget support and development financing which we needed in the wake of the degradation in our public finance system and the accumulation of arrears. Therefore the Ministry of Finance (MoF) initiated a number of measures to reform the financial system including: restructuring the MoF by establishing a budget department in the West Bank, setting up a cash and debt management department, establishing an accountant general department to execute all PNA transactions, and rolling out a financial management information system (FMIS). The FMIS made it possible to issue monthly MoF reports on budget execution and quarterly analysis of public revenue and expenditure flows on the MoF web site.

6. The PNA's financial position had deteriorated markedly: accumulation of wage and private sector arrears; a spike of PNA recruitment outside of established procedures and legality; complete breakdown of payments of electricity bills; and, a deteriorating PNA financial and administrative capacity to protect the poor and the unemployed. In addition to restoring expenditure control measures, in 2008 we acted on several fronts to stabilize the financial situation including:

- In 2007 we secured the release of clearance revenues withheld by Israel.
- In 2008 we paid more than \$360 million in wage arrears to PNA employees.
- We cancelled the illegal employment contracts which had bloated the wage bill, and in 2008 brought the wage bill down to less than 23% of GDP.
- In 2008 we took several actions to regain control over the payment of electricity bills. We reached agreement with municipalities and local governments for them to request a "certificate of payment" of electricity bills from subscribers, when applying for key government services; we expanded the use of prepaid meters and deducted payments of electricity bills from delinquent PNA employees.

7. These measures paid off, and in 2008 there was a substantial fiscal adjustment. The recurrent fiscal deficit fell from 25 % of GDP in 2007 to 20 % of GDP in 2008 and net lending fell by nearly 27%.

8. Following a steep economic decline it was essential for the PNA to initiate a quick economic recovery strategy. Since the Palestinian economy has always been driven by the private sector, and its ability to trade efficiently within Palestine and with outside markets, the traditional approach to economic recovery adopted by the PNA and international community, was to secure a relaxation of Israeli restrictions on movement and access. Indeed, this was the expectation at the Annapolis and Paris Conferences towards the end of 2007. However, as it became evident that the economic restrictions imposed by Israel were not going to be reduced soon enough, which would have meant a prolonged stagnation, we formulated an alternative economic recovery strategy. This recovery strategy had to be driven by the PNA instead of the private sector and needed to focus on stimulating domestic demand and income generation, rather than exports and production of other tradable commodities.

9. The management of this economic recovery was based on a three-pronged strategy:

- Stimulating domestic demand by regularizing the payment of salaries to PNA employees, repaying wage arrears due to them (and to the private sector), and providing the necessary resources for the social safety net, particularly in the face of an economic decline in Gaza. These objectives were to be achieved by mobilizing large external financial support, coupled with the introduction of a new FMIS, to strengthen transparency and accountability.
- Establishing a secure and predictable business environment in the West Bank by deploying PNA security forces to areas under PNA control, and reestablishing law and order and a functioning judiciary.
- Initiating a community development program that is fully integrated with the budget, to meet infrastructure needs and to alleviate the hardships of small rural communities, especially those most adversely affected by settlement activity and the erection of the wall

## II. The Reform Plan

10. Going forward the PNA will continue its focus on achieving fiscal sustainability and improving public financial management under the Medium Term Fiscal Framework as outlined in the updated Palestinian Reform and Development Plan (PRDP). The 2009 budget will be the main mechanism for achieving these goals and the 2009 budget incorporates an ambitious policy agenda derived from the PRDP and the Palestinian National Policy Agenda.

11. *Wage bill restraint.* Following a higher than expected inflation in 2008, a cost of living adjustment has been incorporated into the budget law with a maximum of 4 %. This will protect PNA public finances in the future against unsustainable wage increases, and ensure steady progress towards fiscal sustainability. Thus, the PNA wage bill will increase, relative to our 2008 wage bill projections, by 6 % in 2009, taking into account the 3000 additional net hires for public employment (2 % of the PNA work force), mostly in the areas of education and health, as specified in the PRDP. PNA employment will not exceed 153,000. As a result of wage and employment restraint, the wage bill will decline from 23% of GDP in 2008 to 22% of GDP in 2009.

12. *Shift towards development expenditures.* For the first time in several years, the 2009 budget reflects a shift in composition from recurrent expenditures to development expenditures, which are

expected to double from 4 % of GDP in 2008 (on a disbursement basis) to 8 % of GDP in 2009. Also, a more optimal balance is being established between wage and non-wage expenditures, in favor of the latter. These measures will result in improving the quality of overall public expenditures by reducing the share of public consumption and by raising capital spending.

13. *Higher expenditure in social sectors.* We have increased budget appropriations for education, health, and social affairs by 19% over 2008. Their share in the recurrent budget was raised from 36% in 2008 to 40% in 2009 and their share in GDP would increase from 13.5% to 14.8%.

14. *Social safety net reform.* The PNA has produced an outline of its Social Protection Strategy. This outline includes an action plan to reform one of the main elements of our social safety net which are cash assistance benefits. This reform will trigger the merger of the various on-going cash assistance scheme to a Palestinian National Social Safety Net Program (PNSSNP) administered by the Ministries of Finance and Social Affairs, the World Bank, the EU and UN agencies. The objective is to have a unified system of social protection that would include one transparent mechanism to select households eligible for cash assistance benefits, uniform payment criteria, and qualification procedures.

15. *Reducing "net lending" to municipalities for payment of electricity bills* by strengthening collection efforts and, in the course of the year, shifting the management of electricity distribution and bill collection to commercial distribution companies while protecting the most vulnerable groups in our society. This will be made possible with the implementation of the new Electricity Law, which will also allow the Energy Authority to set a rising block electricity tariff that will help protect the most vulnerable households. We will also continue efforts to improve utility bill collection by distributing pre-paid meters and requiring the presentation of "Certificates of Payment" by consumers who have fallen more than 90 days behind in utility payments before they may have access to important government services.

16. *Improve efficiency and transparency of the Budget Process* The 2009 budget law includes a combined recurrent and development budget for each line ministry. In continuing the shift to a greater performance focus, the budget for 2010 will include program budgets for pilot ministries that can be used as the basis for budget execution. We will also develop a new economic and administrative budget classification for use in the 2010 budget.

17. *Establish upgraded institutional and regulatory procedures to support PFM reforms* We have amended the financial regulations to provide the regulatory backing for the operation of the new FMIS by the civilian agencies, and will issue temporary instructions for the equivalent operations of the security forces. In the coming year we will roll out the new FMIS for 10 selected line ministries and implement the recommendations of the Ernst and Young report on its functionality.

18. *Strengthen PFM infrastructure and improve auditing functions* The MoF has begun to prepare annual cash plans to guide budget execution. In the coming year we will continue to strengthen the Central Treasury Account by closing non-zero balance bank accounts for line ministries connected to the FMIS. We will also pilot the use of commitment control procedures through the FMIS and extend monthly reporting to cover all domestic debt. In addition, we will increase confidence in the integrity of the financial reporting system by having the 2008 financial statements audited. We will also strengthen our auditing capability by developing a plan to build capacity of the State Audit and Administrative Control Bureau (SAACB).

19. *Municipal and local government finance reform to attain financial sustainability.* This reform will broaden local government sources of revenues and redefine local government responsibilities, under unified accounting practices. It will also establish a transfer system to assist poorer local governments. To support these objectives the Municipal Development Loan Fund (MDLF) has developed clear criteria for performance based transfers and will roll out a new municipal financial information management system across the West Bank.

20. *Establish a Comprehensive Public Procurement System* The PNA is committed to improving the public procurement system. As a first step we will pass a new procurement law and then take necessary steps to implement the new law. The law will call for the establishment of an independent Public Procurement Unit separate from a Central Tender board. We will move rapidly to make the new system effective. We will begin a national training program for public procurement and quickly initiate the development of standard bidding documents based on the new law. We aim to have at least two such documents completed within 12 months.

21. *Pension reform.* The PNA will adopt an action plan to reduce PNA short term pension liabilities and begin to implement the plan by including measures in the 2010 budget that will reduce PNA pension liabilities and put the PNA pension schemes gradually back on a path to ensure their financial sustainability.

22. The Palestinian Authority expresses its full commitment to the implementation of the 2009 budget law and the program described above along with the Palestinian Reform and Development Program from which they were derived. However, its ultimate success depends upon parallel actions by the donors and the Israelis. If the Israeli authorities do not relax restrictions and improve movement and access, the private sector will not be able to deliver the growth needed to reach the deficit targets. Likewise, if the donors do not continue to fully support the program or if Israel does not regularly transfer clearance tax revenues, the PRDP goals will not be attainable and the PNA will not be able to fully implement the 2009 budget. The PNA appreciates the help and support the World Bank has consistently provided to help us build an independent Palestinian State. Hence we request that the World Bank provide a second Development Policy Grant of \$40million to assist us as we continue to pursue the goals of fiscal sustainability and increased government transparency and accountability.

Sincerely,



Salam Fayyad  
Prime Minister