

**PROGRAM INFORMATION DOCUMENT (PID)  
APPRAISAL STAGE**

September 30, 2017  
Report No.: 120338

<b>Operation Name</b>	WEST BANK AND GAZA: FISCAL STABILITY AND BUSINESS ENVIRONMENT DEVELOPMENT POLICY GRANT
<b>Region</b>	MIDDLE EAST AND NORTH AFRICA, WEST BANK AND GAZA
<b>Sector</b>	Macroeconomics and Fiscal Management
<b>Operation ID</b>	P161252
<b>Lending Instrument</b>	Development Policy Grant
<b>Borrower</b>	PALESTINE LIBERATION ORGANIZATION (PLO) (for the benefit of the Palestinian Authority)
<b>Implementing Agency</b>	Ministry of Finance and Planning (MoFP) of the Palestinian Authority (PA)
<b>Date PID Prepared</b>	September 21, 2017
<b>Estimated Date of Appraisal</b>	October 3, 2017
<b>Estimated Date of Board Approval</b>	November 9, 2017
<b>Corporate Review Decision</b>	Following the corporate review, the decision was taken to proceed with the preparation of the operation

**I. Country and Sector Background**

1. The Palestinian territories (West Bank and Gaza) have faced long lasting political instability and violence over the last two decades, which have exacerbated macroeconomic volatility. The Palestinian territories are a small open economy with lower-middle income status with a population of 4.8 million in 2016. The Palestinian territories have experienced political instability (both regional and domestic) and a series of violent conflicts over the years. After the 2007/2008 conflict, the territories were under control of two different political parties: Fatah held control of the West Bank while effective control of Gaza was taken by Hamas. Gaza's share of total GDP is less than 30 percent, and its borders are subject to highly restrictive controls by Israel and Egypt.

2. Peace talks between the PA (Palestinian Authority) and the Gol (Government of Israel) remains stalled since the US-led initiative ("Kerry peace talks") ended unsuccessfully in 2013 and the Palestinian polity remains divided, making Gaza and the West Bank diverge further away from each other. The most recent Arab League Summit of March 2017 did not launch any major initiative. Meanwhile, donors' attention and resources are being claimed by other political developments in the region. Elections to the Palestinian Legislative Council have not been held since 2006, and local elections in May 2017 had a low voter turnout, comparable to 2012 when the last local elections were held. The two parts of the Palestinian territories have different economic conditions and regulatory environments.

3. Sluggish and unsustainable economic growth is the corrosive effect of the stalemate in the peace process, which undermines governance in the territories. The Gol's restrictions on trade, access to resources<sup>1</sup> and movement of people negatively impact the Palestinian economy. The structure of the Palestinian economy has substantially deteriorated over the last two decades; the manufacturing and agriculture sectors' share to GDP contracted by 50 percent and 75 percent, respectively during 1994-2015. On the other hand, the share of public service sector (such as education, health, and policing) in GDP expanded by around 60 percent during the same period, largely financed by donors' budget support. This drastic structural change in the economy has resulted in failure to generate sufficient private sector jobs to absorb the growing labor force (mainly youth and women) and revenues to provide provisions of services to rapidly rising population. There has been little progress in internal reconciliation. The internal divide, ongoing tight restrictions on movement, and curtailed access and trade continue to constitute the main impediments to private sector investment and growth as well as job creation.

## **II. Operation Objectives**

4. The Program Development Objectives (PDOs) of this operation is aligned with key government priorities and broader development goals. The PDO of the proposed operation constitutes the following two pillars: (i) improve transparency of fiscal transfers to local service providers; and (ii) improve the business environment. The first pillar seeks further progress on increasing fiscal stability of the electricity, water and health sectors, while reducing "net lending" – involuntary transfers from the PA to LGUs<sup>2</sup> when LGU obligations to Israel are deducted from PA revenue collected by Israel as well as accumulated debts to the PA, and containing rising sectoral expenditure. Better aligning incentives of fiscal transfers across different parties through their improved transparency and accountability will lead to improved financial viability in key sectors of the Palestinian economy, which would help the public finances become more predictable and transparent as well as sustainable. This is also critical to lay the foundation for improved private sector activity, increased confidence of potential investors, and gaining greater citizens trust compiled with improved services. On the other hand, the enhanced legal and regulatory business environment supports private sector development for job creation, which in turn allows the Palestinian territories to achieve poverty reduction and higher and more sustainable growth.

## **III. Rational for Bank Involvement**

5. This operation is envisaged as a bridge to support a transition to the objectives under the Bank's new Assistance Strategy for the West Bank and Gaza (FY18-21) and designed to support both of its objective pillars. The operation is designed to directly support the achievement of the first pillar which supports to promote an environment for dynamic and inclusive private sector growth for job creation by improving the business environment through a number of prior

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<sup>1</sup> Restrictions on access to Area C have severely limited natural resources such as electricity and water, which are key to development of the productivity sectors.

<sup>2</sup> LGUs include distribution companies (for the electricity sector), municipalities, and village councils.

actions related to streamlining and modernizing the legal framework; submitting a new Companies Law; and streamlining business licensing and registration processes. This pillar also aims at increasing access to finance for better inclusion and more formal sector job creation by supporting the legal framework for incorporation of small and medium enterprises (SMEs) and their business growth. In addition, this DPG ventures into the second pillar of the strategy, which strengthen institutions for improved citizen-centered service delivery by increasing accountability and transparency of public finances.

6. Moreover, this operation supports the PA’s strategic priorities envisaged in its national development strategy, the National Policy Agenda (NPA) (2017-2022) and provides essential financing for the PA’s 2017 budget. The DPG supports the PA’s efforts to strengthen fiscal stability by improving the transparency and accountability as well as payment discipline underlying fiscal transfers linked to utilities financing between the PA, the GoI and LGUs – where currently unpaid bills of LGUs distort revenue transfers between the GoI and the PA. The US\$30 million provided by the proposed operation for the PA’s 2017 budget will directly leverage other donor financing in the amount of roughly US\$45 million per year through the Palestinian Recovery and Development Plan (PRDP) Trust Fund. The operation also sends a strong positive signal to other donors that directly provide bilateral budgetary support to the PA.

**IV. Tentative financing**

Source:	(\$m.)
International Bank for Reconstruction and Development	30.00
Borrower/Recipient	0.00
Total	30.00

**V. Institutional and Implementation Arrangement**

7. The design of the monitoring and evaluation arrangements were built upon those developed under the earlier development policy grants. The results framework of the DPG was agreed with the authorities and developed in consultation with other development partners. As has been the practice, the results framework was developed not only to monitor progress under the DPG, but also to monitor the implementation of the Multi-Donor Trust Fund (MDTF), which is a major source for donor funding to the budget, aligned to the NPA. Since both the DPG and the PRDP TF support the implementation of selected key objectives of the PA’s strategy and aim to provide stable and predictable financial support to the PA budget, a shared results framework for both has provided additional leverage to reform implementation. The indicators used are direct measures of development objectives, the data is collected by the statistics agency and finance and line ministries, and enjoys full ownership across the government.

8. The monitoring arrangements have been institutionalized in the Palestinian Ministry of Finance and Planning (MoFP). Based on the inputs from line ministries and other government

agencies, the PA prepares quarterly reports on a regular basis to monitor the performance under both the DPG and the PRDP MDTF. The same arrangement is utilized to monitor progress against the PA's medium-term program. These reports are placed on the website of the MoFP. The monitoring arrangements developed in the context of DPGs and PRDP TF have not only been used for the purposes of those operations, but there is evidence that these arrangements have contributed to building stronger institutional arrangements for monitoring PA's broader reform efforts.

## **VI. Risks and Risk Mitigation**

9. The political and security situation in the West Bank and Gaza is very fragile. The highly volatile political situation could deteriorate, with the consequence of stalled structural reforms. Risks include the resumption of armed conflict in Gaza, which if were to happen, would most likely to push Gaza's economy back into recession, cause poverty to rise further; and lead to the return of tensions throughout the West Bank; these will result in elevated security risks that may negatively impact economic activity and poverty. If the security situation relapses, private sector confidence and investment will fall, which will lead to lower economic growth and public revenues, while unemployment rises even further. The international donor community is closely monitoring the economic activity in the West Bank and Gaza, and is supporting the PA with grants and technical assistance. The authorities' strong commitment on the continued implementation of structural reforms despite the highly difficult economic environment and fiscal pressures will provide a basis of boosting private sector confidence and supports of development partners.

10. The macroeconomic risk rating is high. Not only is the baseline Palestinian macro-fiscal outlook worrisome, but it also contains significant downside risks. As mentioned above, the possible outbreak of conflict in Gaza as well as the West Bank will affect the level of uncertainty and business confidence. On the fiscal side, should donor financing further decline, the economic outlook would, *ceteris paribus*, be substantially worse. Public debt, which reached 36.1 percent of GDP at the end of 2016, remains susceptible to the downside risks related to growth and the primary balance. Given the Palestinian territories' narrow tax base and lack of access to international financial markets, further declines in donor support and lower than expected economic growth pose additional risks to public debt sustainability. Further tightening of restrictions by Israel would have a devastating impact on the population in Gaza. This proposed DPG sends a strong signal that the World Bank supports the PA in implementing the NPA and that it needs continued donor support. Most importantly, the operation leverages around US\$45 million per year through the PRDP Trust Fund, which the Bank administers. This is particularly important since a reduction in donor aid has been identified as one of the important risks to the success of the operation.

11. The fiduciary risks are high. The PFM system encloses significant weaknesses which materialize in weak budget execution and the continued accumulation of arrears, delays in the production of the audited annual accounts mainly due to the lack of timely preparation of the financial statements by the MoFP. These deficiencies in the PFM system mainly stem from weak

commitment and decision-making process at ministerial and managerial levels, in addition to a broader context of insufficient capacity at the MoFP. In recent years, the Bank and other donors have been supporting the PA through various technical assistance to the MoFP aiming at strengthening the accountability of the PFM system. The PA recently issued a new PFM strategy (2017-2022) with the emphasis on expenditures management and control, accounting reporting and procurement. The Bank will support the implementation of the strategy through the new World Bank-financed PFM project under preparation to build on the previous TA activities with a particular aim of broadening its implementation to some line ministries such as Education, Health and Local Governments. The project will also assist the PA to improve the accuracy and timeliness in the final account preparation process which is crucial for the accountability of the PFM system.

## **VII. Poverty and Social Impacts and Environment Aspects**

### *Poverty and Social Impacts*

**12.** The overall poverty and social impact of the policy measures supported under this operation is expected to be largely positive or neutral; policy measures supported under Pillar 1, in particular those related to utility sectors are expected to have a largely positive or neutral poverty and social impact. The proposed fiscal reform aims to improve fiscal viability of utility sectors with the aim to increase investments in those sectors over the medium and long term. It is critical that these reforms translate into improving the quality and reliability of service delivery in order to have a positive impact on the poor and vulnerable. In the electricity sector, if the reforms achieve the goal of increased power supply in the West Bank they can help address critical firm-level constraints<sup>3</sup> to growth which can have a positive impact on poverty through increased employment opportunities, in addition to better meeting household service delivery demand. The fiscal reforms related to bill-collection efforts will focus on the fund transfers between LGUs and bulk service suppliers rather than on increasing payments from the end-consumers, and thereby this measure is not expected to have an adverse impact on poverty.

**13.** Reforms on the health referral system and intergovernmental fiscal transfers are unlikely to have negative poverty and social impact. The reforms that seek to improve fiscal stability of the health sector by reforming the referral system are not expected to have a negative social and poverty impact, as they seek to lower the cost of certain health services through more efficient contracting with external healthcare providers. Measures that support harmonizing standard referral procedures can also improve the equity of access to health referral services for all segments of the Palestinian population. The effort to improve the predictability and transparency of intergovernmental fiscal transfers should contribute to increased fiscal space for capital investment and allow LGUs to deliver services to citizens in an accountable manner.

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<sup>3</sup> World Enterprise Survey (2013), where close to 13 percent of firms in the Palestinian territories report electricity as their biggest obstacle. In four out five comparator countries, this figure is 5 percent or lower.

**14.** The poverty and social impact of the reforms supported under Pillar 2 is expected to be positive or neutral. The regulatory and business climate reforms supported are critical to achieve the goal of enabling private sector growth, improving employment outcomes, and increasing government revenue. The reform on establishing a collateral will benefit the Micro, Small, and Medium Enterprises (MSMEs), which are the driving force for innovations and the backbone of economic growth and job creation in the Palestinian economy by supporting financial institutions to develop diversified financing products for MSMEs. In addition, both updating the old companies law and streamlining business registration and licensing processes will support the incorporation of small businesses, their growth and thereby formal sector job creation. At the same time, these businesses will be granted to better access to finance and markets, and legal protections. Since unemployment is a key correlate of poverty, creating more formal private sector jobs through the enhanced business climate will have a positive impact on the economic welfare of the poor and vulnerable.

#### *Environment Aspects*

**15.** As per OP 8.60, the World Bank assessed whether specific measures in the PA supported by the DPG are likely to cause significant effects on its environment, forest, and other natural resources. Since the late 1990s, the Palestinian environmental legal and administrative framework has taken major steps towards protecting environmental resources and institutionalizing their sustainable management. The Palestinian Environment Law (PEL) of 1999 is a modern and comprehensive law regulating the environmental sector, covering the main issues relevant to environmental protection and law enforcement. The PEL addresses various environmental issues including- Environmental Impact Assessment (EIA) and auditing, permitting of development projects, monitoring of environmental resources and their parameters. In addition, Palestinian Environmental Assessment Policy (PEAP) by-law approved by the Palestinian Ministerial Council in 2000 supports the sustainable economic and social development of the Palestinian people. As to the PEAP, there are three documents that represent sequential stages in the project life cycle and the Environment Approval (EA) review process: Application for EA; Initial Environmental Evaluation (IEE); and the Environment Impact Assessment (EIA). The Environmental Quality Authority (EQA) established by President decree in 2002 provides guidance on the preparation of the EA reports and uses screening criteria to determine whether an IEE or an EIA is required for a project. An EIA is required for projects which are likely to have significant environmental impacts. An EA also specifies required measures to mitigate adverse environmental impacts. The EQA is responsible for ensuring that development processes are undertaken in an ordinal manner and has capacity to implement, monitor, and report on mitigating measures.

**16.** Reforms supported by this operation are unlikely to have significant negative environmental impact. Policy measures supported under the Pillar 1 will improve the fiscal sustainability of the PA's finances while they are unlikely to have any direct and indirect environmental impact. In addition, measures under the Pillar 2 support the growth in MSMEs and expansion of their businesses, which could entail environmental risks. However, the environmental regulatory framework in the Palestinian territories mentioned above would

ensure that the necessary mitigation measures are in place. Furthermore, these reforms not only promote the growth in MSMEs but also encourage them to officially register rather than operate in the informal sector. Given a significant share of the informal sector in the Palestinian economy, reducing the size of the informal sector and increasing the number of formal firms will result in reduced safety, health or environment risks, which will have a positive impact on the overall economy.

## **VIII. Contact point**

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