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ABBREVIATIONS AND ACRONYMS

APLA	Association of Palestinian Local Authorities
CGAS	Capital Grants Allocations System
EMSRRP	Emergency Municipal Services Rehabilitation Project
ESW	Economic Sectoral Work
JDECO	Jerusalem District Electricity Company
JSC	Joint Service Council
KFW	German Development Agency
LAL	Local Authorities Law
LGs	Local Governments
MDLF	Municipal Development and Lending Fund
MDP	Municipal Development Program
MFRP	Municipal Fiscal Restructuring Program
MNA	Middle East and North Africa
MoF	Ministry of Finance
MoLG	Ministry of Local Government
MoPIC	Ministry of Planning and International Cooperation
NEDCO	Northern Electric Distribution Company
NIS	New Israeli Shekels
O&M	Operation and Maintenance
PA	Palestinian Authority
PCBS	Palestinian Central Bureau of Statistics
PEA	Palestinian Energy and Natural Resources Authority
TA	Technical Assistance
UNDP	United Nations Development Program
UNRWA	United Nations Relief Works Agency
VAT	Value Added Tax
WBG	West Bank & Gaza

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EXECUTIVE SUMMARY

Objective

The main general objective of this study is to promote a deeper understanding of municipal finance in the West Bank and Gaza, including identification of the key issues that local governments currently face. The paper discusses the policy implications associated with its main findings as potential policy options for future decision making on local government reforms. As such, this study aims at facilitating the process for a future policy dialogue between the World Bank and the Palestinian Authority (PA)/Ministry of Local Government (MoLG). Furthermore, it is expected that the identification of the main issues, together with their policy implications, may assist the PA/MoLG in the selection of the key areas that could potentially benefit from the World Bank's technical assistance.

In particular, this study attempts to: (i) Clarify the actual role that municipalities play in the provision of local services; (ii) evaluate the current assignment of municipal revenue sources and determine their adequacy to cover current expenditure functions, including an analysis of whether there are unfunded mandates, and if so, identify the main contributing factors ; and (iii) determine the balance between expenditures and revenues aiming primarily to assess whether the current revenue sources cover the estimated costs of the municipal services that are being provided, and draw the corresponding conclusions on the current municipal fiscal situation. Furthermore, this ESW highlights the nature and magnitude of current fiscal imbalances across municipalities in the West Bank and Gaza.

Data Sources and Methodology

Considering the severe data limitations on the municipal sector, this study has relied mainly on three questionnaires sent out to each of the 132 municipalities. These questionnaires were specifically designed to address the main areas of interest: (i) Services being provided; (ii) actual expenditures by service; and (iii) revenue sources being used for the financing of local public goods and services. The questionnaires refer to FYs 07-08.

Other sources of information included: (i) the approved and executed municipal budgets provided by the MoLG for FY '07. The executed budgets for FY '08, unfortunately, were not available. Given this situation, the recurrent and capital expenditures by functions and the revenues by source for FY '08 were obtained from the 94 municipalities that responded both to the expenditure and revenue questionnaires; (ii) the municipal arrears for electricity and water for FY'07 provided by the Ministry of Finance (MoF); and (iii) the property tax data for FY'08 on collections and assessment for 29 municipalities was provided by the MoF. More details on the data sources and the methodology may be found in Annex 14.

Classification of Municipalities

The current MoLG classification of municipalities is based on political considerations rather than objective criteria. It is therefore impossible to use it to assess the service delivery capacity of a municipality. A description and assessment of the current classification system are offered in Annex 13. Consequently a new classification system is suggested, in terms of both population size and number of services provided, as indicators of their capacity to deliver services. The importance of the proposed classification system is that it identifies, among other things, the municipalities that in principle may be considered target groups for policies related to amalgamation and/or partnerships among municipalities to enhance delivery capacities. Also, the proposed classification contributes to policies related to the identification of the basic services that do, and the basic services that do not, constitute a priority to most municipalities.

Service Provision and Actual Expenditures

This paper examines different views regarding the actual role of local governments in service provision and the key issues they face. Among these different perceptions are the following: (i) Municipalities provide multiple local services but the largest among them are best suited to play this role; (ii) it is argued that there is a distortion in municipal service provision because those municipalities that collect revenue from electricity distribution have what is practically a subsidy from this revenue source (equivalent to a soft-budgetary constraint), in contrast to those that are non-electricity providers; (iii) also, given the current circumstances, municipal service provision in the Gaza Strip is more limited and needs a greater support than that of local governments in the West Bank; (iv) furthermore, it is claimed that part of the problem in the provision of local services is that municipalities are not held accountable for the services they are supposed to provide; (iv) in addition some of the financial problems that many of them face are due to overstaffing; and (v) finally, larger municipalities (in terms of population) offer more economies of scale than smaller municipalities and therefore amalgamation needs to be promoted. Briefly, and based on the analysis of empirical evidence, the findings of this report, on each of the above arguments, are presented below.

What services do the municipalities actually provide? Despite the large variation in population size across municipalities, all local councils have been

assigned by law the same responsibilities regarding service provision. The law mandates about 27 different local public goods and services. This means, at least in principle, that in the case of small local governments (LGs), the scope of services may be too broadly defined for them to be capable of fulfilling their mandate, whereas the larger municipalities may be, perhaps, better able to do so.

In practice, however, the empirical results indicate that most municipalities provide relatively few services. About six main local services are provided (to some extent) by most municipalities, nearly regardless of the size of their populations. These are: i) Solid waste collection, ii) street maintenance, (iii) water supply, (iv) street lighting, (v) roads maintenance, and (vi) school maintenance. The first three services are provided by at least 80% of the municipalities, while the last three are provided, in some proportion, by at least half. However, in terms of the relative importance of the actual expenditures on each of these services, the results suggest that only the first five have actually received a significant amount of yearly budgetary resources for their provision.

Do larger municipalities provide more services? Based on a classification of the 132 municipalities in terms of their population size and the number of services they provide (given the corresponding level of expenditures allocated to them), the empirical results suggest that larger municipalities actually execute expenditures in more services. These results, all together, seem to suggest that larger cities (municipalities) have a greater capacity to provide more services than do the smaller ones. For instance, the larger cities (above 100,000 inhabitants), such as Nablus, Khan Yunis and Gaza, rank in Group III, which refers to those municipalities that provide more than 12 services and up to 18. In contrast, very small towns (almost small enough to be termed villages) with under 5,000 inhabitants, such as Al Newe'emeh, Al Zahra, and Al Fokhari, rank in Group I, which refers to local governments that provide less than five (5) services.

However, the relationship between number of services provided and municipal population size is not linear, so that it cannot be generally expected that larger municipalities will provide more services. Therefore, the above results may only support the PA policy on amalgamation and other equivalent means and ways to enhance the provision of a greater number of services to a certain extent.

Do larger municipalities spend more in services? The results suggest that service provision is on the average better in the larger cities than in the smaller towns and villages. The larger municipalities generally spend more in per capita

terms on the main services, than do the smaller local councils. This is the case, for example, in electricity distribution, water supply, solid waste collection, and roads. On the other hand, expenditures on services such as street maintenance and street lighting seem with some exceptions to be rather proportional to the municipalities' population size – i.e., their per capita expenditures tend to remain fairly similar across different sizes of municipalities. In the aggregate, however, the average per capita expenditure for each of the four classes increases with population size.

Do municipalities with soft-budgetary constraints provide more services than those with hard-budgetary constraints? In 2008, based on the entire sample of 94 municipalities, the services and public works with the largest per capita expenditures included: (i) Electricity (NIS 96.80); (ii) water supply (NIS 38.36); (iii) solid waste (NIS 36.92); (iv) street maintenance (NIS 16.01); and (v) roads (NIS 11.76). However, in order to isolate potential fiscal distortions of electricity-providers, the sample was divided into two sub-samples, one for providers of electricity (which may be characterized as those municipalities having a relatively soft-budgetary constraint), and the other, for non-providers (which operate with a relatively hard-budgetary-constraint).

The empirical results of comparing these two sub-samples indicate that the main general pattern regarding municipal service provision remains practically the same. However, as expected, the per capita analysis of expenditures shows that the group of municipalities that enjoys a relatively soft-budgetary constraint spends significantly more, in per capita terms, than the group that operates with a hard-budgetary constraint (NIS13.00 versus NIS4.20). Three services have mainly benefited from this greater spending. These are: Water (NIS55.20 versus NIS21.20), roads (NIS17.90 versus NIS5.50), and streets (NIS17.70 versus 14.307). It may be inferred that the future municipal fiscal restructuring adjustment (due to the transfer of the electricity service) will most probably affect these three services.

What are the differences in service provision between Gaza and the West Bank? The empirical results confirm that the municipalities in the Gaza Strip are worse off than West Bank municipalities in terms of service provision. There are only three main services that stand out in Gaza based on the magnitude of their per capita spending. These services include: (i) Solid waste collection and disposal; (ii) water supply; and (iii) sewer systems. For most services per capita spending in Gaza municipalities is lower than in the West Bank. However, per capita spending in sewer systems is particularly high in Gaza -- in contrast to the West Bank municipalities. Services such as street maintenance and street

lighting have necessarily become less of a priority given the current municipal budgetary limitations. In general, it could be argued that there is fairly limited provision of services in the Gaza Strip, and the public services being provided mainly relate to sanitation, which in a way reflects the minimum priorities in municipal service provision when local governments have to face fairly severe budgetary constraints. The differences in expenditure structure between Gaza and the West Bank are mainly due to differences in budgetary expenditure capacities, rather than to differences in the assignment of the actual local functions.

Is there clear accountability in local service provision? It is necessary to clarify exactly what institutions are ultimately responsible for the numerous local functions established in the law. For example, it is not clear which of these functions are mandatory and which ones are optional. Also, a distinction should be made regarding whether some of these services are supposed to be provided in *concurrency* with other suppliers, including the PA, or whether some of them are the *exclusive* responsibility of the local council. This lack of clarity compromises accountability.

Are municipalities over-staffed? Some municipalities are overstaffed, while others are understaffed. The empirical results indicate that the average number of employees per thousand inhabitants for the West Bank and Gaza, as a whole, is about 2.7, which is fairly consistent with international standards. However, the actual range in number of employees across municipalities fluctuates between 0.9 and 11 employees per thousand inhabitants, which supports the argument of overstaffing. Municipalities in the Gaza Strip seem to have a greater number of employees (2.9) than municipalities in the West Bank, as compared to either 'providers' (2.7) or *non-providers* (2.4). In contrast, there are a significant number of municipalities, particularly among those with a relatively small economic base, whose operating budgets cannot even cover the cost of the average number of employees. This seems to be illustrative of the inherent constraints in the performance of small municipalities.

Are there economies of scale in the administrative costs of larger municipalities? The empirical results do not show a pattern in the number of employees in the general administration as the municipal population size increases. In fact, the results from a regression analysis indicate that there is no linear relationship between municipal population-size and number of employees (per thousand inhabitants) in municipal general administration. As such, it may be concluded that amalgamation, in and of itself, will not automatically result in

savings in administrative costs. However, potential economies of scale might still occur in the provision of the different municipal services.

Revenues

There are different arguments regarding municipal revenues, which are also examined in this study. The most important of them claim that: (i) Most municipalities have adequate revenue sources, which include user charges, local taxes and fees; it is also claimed that (ii) larger municipalities generate more per capita revenues than smaller local governments, and as such, a policy of amalgamation of local governments would be fiscally sound; furthermore, it is argued that (iii) those municipalities that do not have revenue from electricity in practice operate without subsidies, making them face a hard-budgetary constraint which makes their financial performance stronger; last, it is generally asserted that (iv) municipal revenues are fairly low in the Gaza Strip due to the current economic blockade, which compromises the coverage and quality of local services. Following is a brief summary on the empirical results found by this study, regarding the above arguments:

How do municipalities finance their services? The empirical findings¹ show that the main municipal revenue sources are comprised of: (i) User charges -- i.e., electricity (36%), water (14%), and solid waste collection (2.9%); (ii) local taxes – i.e., the property tax (4.44%) and the education tax (2.3%); and (iii) fees – i.e., building licenses (4.23%) and registration of vehicles/transport fees (3.22%). However, it should be noted that in the West Bank the property tax is levied only in 29 municipalities (out of 107), and the education tax is levied only in 46 municipalities. Clearly, there is a large horizontal fiscal inequity across municipalities regarding local taxes, since expenditure responsibilities are the same for all of them.

Do larger municipalities raise more revenue? The empirical results show that the average per capita revenue for each population class gradually increases for each group, except for the fourth one. The fourth group includes those municipalities with populations greater than fifty thousand. This drop in revenues in the highest population group appears to be due to the fact that out of the six municipalities in this class, four of them are located in the Gaza Strip, and empirical evidence, as reported in this study, has shown that per capita revenues in Gaza municipalities are significantly lower than per capita revenues in the West Bank for the same revenue sources. Briefly, the empirical results regarding

¹ The findings are based on the 94 municipalities that responded the revenue questionnaire.

revenues show that they increase with municipal size, except for those in the highest population class, apparently due to the Gaza effect.

Do municipalities with *hard-budgetary* constraints raise more local revenues than those with *soft-budgetary* constraints? The empirical results show that generally the per capita revenues for the sub-sample of municipalities with hard-budgetary constraints are significantly higher than those for municipalities with soft-budgetary constraints. For example, this is the case for the per capita revenues from solid waste collection (NIS13.09 versus NIS6.28), the property tax (NIS29.61 versus NIS0.99)², the education tax (NIS10.52 versus NIS4.54), the roofing tax, (NIS9.81 versus NIS0.83), etc. The supporting evidence is also the same for the four different fees.

Consequently, it may be argued that local revenue mobilization efforts are much greater among municipalities with hard-budgetary constraints, which make their finances more solid and stable, together with service provision.

Briefly, these results illustrate a moral hazard, and an opportunity cost, of allowing municipalities to operate with soft-budgetary constraints. This lack of financial discipline undermines the soundness of the municipal fiscal system. Furthermore, this evidence of the perverse effects in local revenue mobilization of soft-budgetary constraints (or lack of accountability) supports current efforts by the PA, and the energy sector, to correct this municipal fiscal situation.

What are the differences in revenues between Gaza and the West Bank?

The revenue assignment in the West Bank and Gaza Strip are different with respect to three local sources. One, the property tax, is collected in the West Bank by MoF on behalf of the municipalities, but collections are carried out in only 29 out of 107 municipalities; in contrast all of the municipalities in the Gaza strip are currently allowed to directly collect their own property taxes. Secondly, the education tax is only collected by the West Bank municipalities, and thirdly, electricity user charges are only collected by the 59 municipalities that distribute electricity in the West Bank.

Hence, except for revenues from electricity, the property tax, and the education tax, the revenue sources of the municipalities in the Gaza Strip and those in the West Bank are generally the same. In practice, however, the empirical results support the argument that the average per capita revenue levied by the Gaza municipalities is usually significantly lower than the revenue collected by West

² However, this as it appears is the result of the deductions made by the MoF of electricity arrears from property tax proceeds.

Bank municipalities, from the same or similar sources. For example, this is the case for the per capita revenue of the two most important user charges: water (NIS20.36 in Gaza, versus NIS74.89 in the West Bank), and solid waste collection (NIS3.99 versus NIS13.35). A similar situation characterizes the two 'local' taxes: the property tax (NIS0.29 in Gaza, but equivalent to NIS22.31 in the West Bank), and the education tax (NIS0.00 versus NIS10.87). Among fees, the above pattern generally does not change; for example in construction permits (NIS4.27, versus NIS 17.04). There is, however, one relatively marginal exception in fees, - for vehicle licensing/registration fees (NIS17.89 in Gaza, versus NIS13.92 in the West Bank).

In general, it may be argued that the differences in the structure of per capita revenues of the Gaza municipalities, in comparison to the West Bank municipalities, are more attributable to differences in ability to contribute by their residents, rather than due to the few differences in their revenue sources.

Municipal Financial Situation

There is no clarity regarding the current municipal financial situation, let alone consensus on policy direction and future steps. On the one hand there is the view that (i) most municipalities' financial situation, with the exception of those in the Gaza Strip, is rather stable; in fact, many of them close their yearly operations with budgetary operational surpluses in their current accounts. On the other hand, there is the view that (ii) most municipalities are facing a difficult financial situation, as demonstrated by significant deficits in their operating budgets. Furthermore, it is argued that (iii) part of the reason for the financial difficulties is the lack of municipal autonomy to decide both their revenues and their operating expenditures, particularly regarding municipal employees' salaries. The empirical results on the above two practically opposite views and the main municipal financial issues are summarized below.

How do expenditures and revenues for the main services compare to one another? Based on the empirical evidence of executed revenues and expenditures, comparison of the average per capita revenue with the average per capita expenditure suggests that for services such as electricity and water the current average revenue is much higher than the average expenditure. For example, in FY '08, the per capita revenue from electricity (NIS 119.43) was roughly 23% greater than the per capita expenditure (NIS 96.80). Similarly, the per capita revenue for water (NIS 47.39) was about 23.5% higher than the per capita expenditure on water for that year (NIS 38.36). However, there are

exceptions to this average pattern for both, electricity and water. There are a few municipalities in the West Bank that spend more on the service than they actually collect. Also, in Gaza many municipalities cannot cover the cost of water provision with the revenues that they are able to collect. In contrast, and not surprisingly, the average financial situation for the provision of solid-waste collection and disposal shows a very large operational deficit (-73.86%). Specifically, the per capita expenditure in refuse collection (NIS 36.92) is almost three times higher than the per capita revenue (NIS 9.65). The situation regarding refuse collection generally is more critical among the Gaza municipalities, since they have much lower per capita revenue (NIS3.99). In practice these deficits in specific services are usually financed by general revenue -- from surpluses in other user charges, or through fees, local taxes, or arrears.

In contrast to household services that in principle should be financed through user charges, there are several types of physical infrastructure (i.e., internal roads, streets, drainage of rain water, sidewalks, and public parks.) which need to be financed primarily through local taxes. These types of infrastructure are the main municipal public services currently lacking adequate financing sources. Construction Permits and Vehicle Registration Fees generally are not adequate sources of finance for the maintenance of physical infrastructure. In fact, the revenue collected from these two sources is too small, as compared to actual needs. The empirical results in West Bank and Gaza support this argument. By international standards, a typical source of financing the maintenance and rehabilitation of internal roads and streets is the property tax. In West Bank and Gaza, however, the property tax is actually levied in only about 40 percent of municipalities.

The municipalities in West Bank and Gaza urgently need adequate local fiscal revenue sources to finance a significant amount of physical infrastructure. For example, about 45% of the municipal roads in West Bank and Gaza are unpaved. In Gaza City, which is the largest urban area in West Bank and Gaza, only 30% of the streets receive regular maintenance. As mentioned above, a property tax would be the most suitable method of financing this much needed building and maintenance of physical infrastructure.

Do municipalities have financial autonomy to determine their main revenues and expenditures? Municipalities do not have the financial autonomy to determine, even within some range or limit, on the specific rates for their different revenue sources. User charges, tax rates, and fees need the approval of the PA -- either through the MoLG or the corresponding sectoral authority.

Furthermore, salaries, which represent about 80 percent of their expenditures, are set by the MoLG. This lack of autonomy in municipal financial management may be compromising, at least to some extent, financial accountability and performance in service delivery.

Is there a balance between expenditure functions and revenue sources?

Though legally all municipalities have the same expenditure functions (or, at least, are entitled to provide the same set of services), they do not have access to the same local revenue sources. For instance, the property tax is available to only 29 municipalities in the West Bank, while the education tax, which is primarily based on property tax assessments, is also limited to only certain municipalities. As such, it may be concluded that there is a '*horizontal*' fiscal imbalance across municipalities, between the services that they are, at least entitled to provide, and the actual revenue sources available to them.

Main Conclusions and Recommendations

What should be done to improve service provision? First, a distinction should be made among those services that are supposed to be financed through user charges and those that need to be financed through local taxes, or equivalent charges such as fees. Secondly, adequate user charges and tax levies (such as the property tax) would need to be implemented in all municipalities. However, in order to do this, the unit cost of service provision needs to be estimated on a systematic basis, which would also allow for the monitoring of services expenditure efficiency.

The provision of services that should be financed through user charges, such as water, solid waste collection and disposal, and electricity are not the main challenges in West Bank and Gaza. Rather, the main challenges are those services that need to be financed through taxes, such as local physical infrastructure – for example, roads, streets, public lighting, and sidewalks. It is, however recognized that the financing of water and solid waste is still difficult, especially in the Gaza Strip, given the current economic conditions. Similarly, waste water treatment generally poses a significant challenge. The goal is of course to ensure cost recovery in those services for which user chargers may be applied, within current affordability constraints.

On the other hand, the provision of services that need to be financed through local taxes, such as roads and street maintenance, is particularly difficult since a significant number of municipalities lack the most basic local taxes. Consequently, it is critical to consider the implementation of a property tax,

increasing the municipal share of the vehicle registration fee (given the actual expenditure needs in streets and roads maintenance), and, importantly, a new revenue source such as urban and rural *betterment levies*.

Furthermore, municipal finance should move away from *soft-budgetary constraints* that discourage local revenue mobilization, which is critical for sustainable financing. It is well worth supporting the efforts of LGs to strengthen their tax structure, financial performance (especially through hard-budgetary constraints as well as through performance incentives), and the local revenue administration and monitoring capacities needed to sustain and upgrade municipal services.

Last, but not least important, given the current financial/fiscal situation of most municipalities especially among electricity providers, it seems highly useful to consider the option of implementing a Municipal Fiscal Restructuring Program (MFRP). All municipalities should be eligible to benefit from MFRPs, as these comprise specific ways and means to address a broad range of municipal financial/fiscal issues. As such, the proposed MFRPs appear to be a fairly practical and important approach to consider in future discussions on municipal finance policy and the technical assistance needed for its implementation.

CHAPTER I: INTRODUCTION

1.1 Background

Several research efforts have been made in the past³ to broaden knowledge regarding the operations of the municipal sector in West Bank and Gaza. Most of these efforts have been of a *general character*, and have given only limited attention to the provision of local public services. No previous endeavor has explicitly offered a comprehensive description of the actual services provided and the sources of municipal finance. Considering that local governments face an increasing demand for public services, however, it is important to determine the actual role of municipalities, and their revenue sources for local service provision.

About 70 percent of the population of the West Bank and Gaza is urban, spread throughout 132 municipalities. Municipalities predate the establishment of the Palestinian Authority (PA) and have historically provided a variety of services such as electricity, water, solid waste management, roads, parks and recreation, slaughterhouses, markets, schools, and health clinics. Prior to FY '00, close to 90 percent of the municipalities' budgets came from local revenue collection. However, in the past five years, due to the ongoing conflict and contraction in the economy, municipal budgets have declined by an average of 30 percent. This has created a financial crisis, causing stress on the ability of the municipalities to provide these services.

Moreover, the closure of Gaza over the past year led to a near collapse of the municipal sector there; municipalities, providing key services such as water, sewage, solid waste, etc., faced a serious financial crisis. The impoverishment of the population and the near absence of private sector activities imply that not only have municipalities been unable to collect significant revenue from fees for service provision, but they have also been unable to pay their staff salaries. The ability of municipalities to provide basic services has been also severely constrained, particularly in Gaza, by the Israeli restrictions on imports of the spare parts and supplies necessary for the provision of basic services such as

³ This ESW complements the Policy Note of June 29, 2006 (The World Bank, "West Bank and Gaza: Intergovernmental Fiscal Relations and Municipal Finance Policy Note," Report No. 36519-WBG); and the West Bank and Gaza: *"Intergovernmental and Municipal Finance, Sector Study Report"*. The World Bank: Washington, D.C., November 2000, which were the first attempt to identify key policy issues on municipal finance in WB&G.

water and sanitation. This situation has been severely exacerbated by the recent invasion and destruction of institutional, economic, and social infrastructure.

1.2 Objectives

The main general objective of this study is to promote a deeper understanding of municipal finance in the West Bank and Gaza including the identification of the key issues that local governments currently face. The paper explores the policy implications associated with its main findings, in order to offer some guidance on policy options for future decision making on municipal policy reforms. As such, this study aims at facilitating the process for a future policy dialogue between the World Bank and the Palestinian Authority (PA)/Ministry of Local Government (MoLG). Furthermore, it is expected that the identification of the main issues, together with their policy implications, may assist the PA/MoLG in the selection of the key areas that could potentially benefit from the World Bank's technical assistance (T.A.) to the MoLG.

In particular, this study attempts to contribute the following:

- (i) A clear understanding of the actual role municipalities play in the provision of local economic and social services, supported by an examination of their expenditure structure;
- (ii) an analysis of the main revenue sources and the factors that might be contributing to unfunded mandates; and
- (iii) an evaluation of the current balance between expenditures and revenues aimed primarily at enabling municipalities to cover the costs of the services that they provide.

Furthermore, part of the objective is to examine the nature and magnitude of fiscal imbalances across municipalities, based on their executed operating revenue and expenditure budgets, in order to have a deeper understanding of their current fiscal/financial performance.

1.3 Scope of this Study

This study addresses the following basic questions:

- (i) What are *de facto* the major municipal *expenditure* responsibilities in both the West Bank and Gaza and how do these responsibilities compare to the law?

- (ii) What are *de facto* the main *revenue sources*⁴ for municipalities in the West Bank and Gaza, and how do they compare to other municipalities and in respect to current applicable laws?
- (iii) What are the main constraints preventing growth in municipal revenues in municipalities throughout both the West Bank and Gaza?
- (iv) What are the main constraints obstructing the improvement of municipal expenditure efficiency?

1.4 Data Sources and Methodology

One of the main challenges in carrying out this study has been the lack of data sources on municipal finance. Currently, there are no official publications put out by any Palestinian institution on the municipal revenues and expenditures or indicators on municipal fiscal/financial performance. There is not any official public information either on the municipal services being provided and their unit cost. Similarly, there is no public information on local government finances across different types of municipalities.

Considering the objectives and the key questions put forward by this study, as well as the severe data limitations on the municipal sector, this ESW has relied primarily on municipal budgetary information, supported by specific questionnaires sent out to the 132 municipalities. Data was also obtained directly from MoLG and MoF. The methodology, verification of information, data quality, and sampling are explained in Annex 14, which also describes the seven main sources of data collection for the period FY '07 and FY '08.

**TABLE 1
REPRESENTATIVENESS OF THE MUNICIPAL SAMPLE**

Municipal Demographic Structure					Sample of 94 Municipalities			
Class	Population Class	# of Mun.	% of Mun.	% of Pop.	# of Mun.	% of Mun.	Pop.	% of Pop.
I	1,000 to 5,000	27	20.5%	3.7%	20	21.3%	69,561	3.6%
II	5,001 to 10,000	57	43.2%	16.3%	40	42.6%	292,500	15.3%
III	10,001 to 25,000	27	20.5%	17.1%	19	20.2%	302,238	15.8%
IV	25,001 to 50,000	12	9.1%	16.7%	9	9.6%	329,145	17.2%
V	50,001 to 75,000	4	3.0%	9.8%	2	2.1%	130,543	6.8%
VI	75,001 to 100,000	1	0.7%	3.3%	1	1.1%	82,877	4.3%
VII	100,001 and over	4	3.0%	33.1%	3	3.2%	709,799	37.0%
	Total	132	100%	100%	94	100%	1,916,663	100%

Source: Elaborated for this report, based on number of responders by population class.

Pop. = Population

⁴ Main revenue sources refer to both own local revenue collections and central government transfers from local taxes collected on their behalf, as well as discretionary or emergency transfers and capital grants.

Table 1 above compares the relative weights of all the 132 municipalities with the corresponding relative weights of the sample, for each of the seven population classes, in order to illustrate on the representativeness of this sample.

Given the different behavioral patterns that were observed among electricity providers and non-providers, the sample of 94 municipalities was divided into two subsamples to be able to analyze each of these two groups separately. Table 2 below illustrates the breakdown of the number of municipalities in each group.

TABLE 2
NUMBER OF PROVIDERS AND NON-PROVIDERS
BY POPULATION CLASS

Distribution of the 132 Municipalities by Population Size For Electricity Providers and Non-Providers				
Pop. Class	Population	Providers	Non. Providers	Total
I	5000 or less	13	14	27
II	5001 - 10000	28	29	57
III	10001 - 50000	18	21	39
IV	more than 50000	3	6	9
Total		62	70	132
Distribution of the Sample of 94 Municipalities by Population Size For Electricity Providers and Non-Providers				
Pop. Class	Population	Providers	Non. Providers	Total
I	5000 or less	12	8	20
II	5001 - 10000	19	21	40
III	10001 - 50000	13	15	28
IV	more than 50000	2	4	6
Total		46	48	94

Source: Table 1

CHAPTER II: EXPENDITURES

2.1 Municipal Expenditure Functions According to Law

Despite the large variations in population size across municipalities, all of them have been assigned the same responsibilities regarding service provision. These current legal functions were established by the Palestinian National Authority in Article 15 of the Local Councils Law No. (1) of 1997. Article 15 refers to the functions, authorities, and powers of the local council. These mandates are grouped into 26 different areas of authority⁵. Disaggregating these areas based on the main local services, the legal functions cover 27 services that in practice cover about 28 different functions, listed in Table 3 below.

TABLE 3
MUNICIPAL SERVICES ACCORDING TO LAW

1. Town planning
2. Street construction, rehabs, paving, and roads
3. Rain water drainage system*
4. Street names and numbering
5. Sidewalks
6. Street lighting
7. Public transport stands and terminals
8. Water supply
9. Electricity supply
10. Sewer system
11. Waste water treatment
12. Public lavatories
13. Solid waste collection and disposal
14. Solid waste treatment
15. Fruit and vegetable markets
16. Public parks
17. Social assistance programs**
18. Sports facilities
19. Libraries
20. Museums and culture
21. Regulation, control and monitoring***
22. Cemeteries
23. Schools
24. Health centers
25. Slaughterhouses
26. Fire fighting

⁵ The entire text of Article 15 is included in Annex 1.

- 27. Transit management (traffic lights, signs, meters, and others)
- 28. Other (the law explicitly allows for other functions)

Source: Based on the legal functions, as established in Art. 15 of the PNA – LCL of 1997

- * These functions are not explicit in the law; however, they are understood to be part of the expenditure responsibilities of the local councils.
- ** Such as shelter for the homeless, food donations, and other local social programs.
- *** Regulation, control and monitoring of: public health standards, slaughterhouses, food safety, restaurants, hotels, and public facilities, weight and scales control, craft and industry hazards, clinic and health center standards, street vendors and stands, public transport, animal control, advertisement control, building demolition, lot fencing, etc.

2.2 Adequacy of the Assignment of Local Functions

The local government functions, as established by law, are fairly comprehensive. They include most of the services typically deemed as municipal. From a normative viewpoint, most of the current functions have inherent benefits which may be characterized as local in their own nature. As such, the decision-making process regarding the provision and financing of these services should, in principle, be the responsibility of the local governments since local responsibility would most likely enhance economic efficiency and interpersonal equity in access to local service provision.

However, there appear to be some exceptions regarding the intrinsic benefits of these local functions. It could be argued that some of their benefits spill across municipal boundaries. As such, the *benefit principle* suggests the importance of actual financing coming from central government sources in order to achieve the goals of economic efficiency in resource allocation, as well as inter-jurisdictional fiscal equity.

This is the case, for instance, for the actual benefits of schools, health centers, and social assistance programs currently being financed by the PA. These services are of national interest given the inter-jurisdictional nature of their benefits. However, as it appears from the municipal functions listed in Table 3 above, the law also allows the local governments to contribute to some of these programs, and in practice a limited number of local governments do in very small amounts – as will be illustrated below.

2.3 Municipal Expenditure Functions in Practice

This section attempts to identify not only which services municipalities actually provide, but aims at developing a classification of LGs based on service provision and population size. This classification is expected to assist the PA,

and in particular the MoLG, with policy decision making regarding local governments.

The findings regarding the services actually provided are quite important from different perspectives. Perhaps the most significant is that they may be regarded as a fairly good reflection of the actual local needs and priorities of both the municipal governments and their residents for specific local public goods and services. This is particularly relevant since the amount of local public choice given to the municipalities by law has a very wide range of options. Consequently, current choices may be a good indicator of the real needs and priorities of different municipalities as well as of the affordability of such services. A summary of the empirical results regarding the different number of services and the number of municipalities providing them is included in Table 4 below.

The detailed responses of all the 132 municipalities (107 in the West Bank and 25 in Gaza) can be summarized as follows: There is a fairly broad variation in service provision across the 132 municipalities. First, none of the municipalities actually provides all of the 27 services established by law. The municipality offering the highest number of services is Al Bireh at 24. The three services not provided by Al Bireh are social assistance programs, water supply and electricity. On the opposite end of the spectrum there are two municipalities Al Newe'emeh (Pop. 1,165) and Al Oja (Pop. 4,010), which provide only one service: water. The largest cluster of municipalities includes 17 which each provide 10 services. Every other group is smaller, though several of them provide more services.

TABLE 4
DISTRIBUTION OF THE FREQUENCY OF MUNICIPALITIES
BY NUMBER OF SERVICES PROVIDED

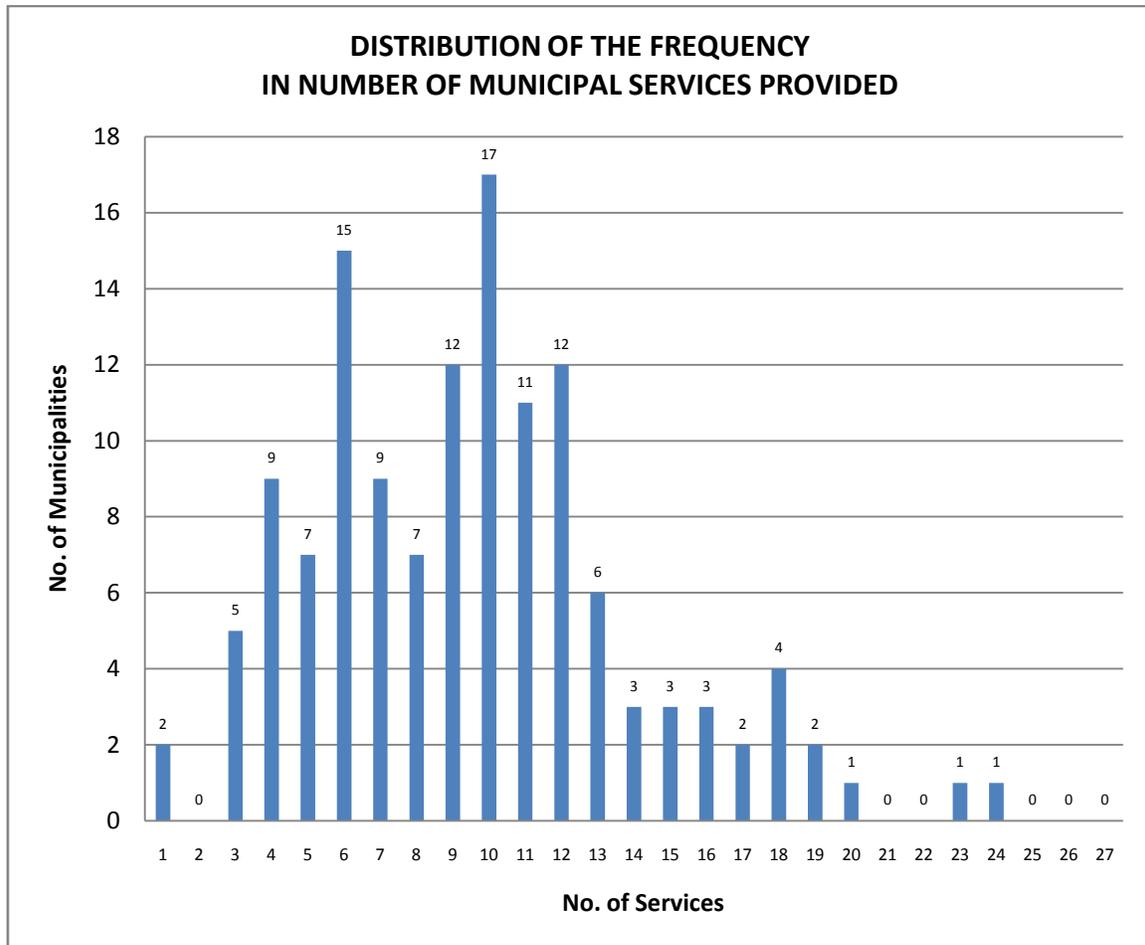
GRADUALLY INCREASING NUMBER OF SERVICES	No. of Municipalities providing such number of services (after verification)
1	2
2	0
3	5
4	9
5	7
6	15
7	9
8	7
9	12
10	17
11	11
12	12
13	6
14	3
15	3
16	3
17	2
18	4
19	2
20	1
21	0
22	0
23	1
24	1
25	0
26	0
27	0
Total No. of Municipalities	132

Source: MDLF Municipal Services Questionnaire and actual expenditures by service.

In summary, and as expected in any normal distribution, when it comes to the extremes (municipalities with either many functions or with very few) the number of municipalities at either end is small. At one end of the spectrum are the few municipalities providing a large number of services; at the other end are, those few a small number of services. In other words, most municipalities fall in between these two extreme cases. Since this result indicates that the distribution is not skewed towards one extreme or the other (see Chart 1, below) it suggests,

among other things, that a municipality that provides no fewer than six services and no more than 12 may be considered a typical Palestinian municipality. As a whole, the actual number of services provided ranges from one at the minimum to 24 at the maximum, which is rather dispersed. These results are summarized in Table 4 above and Chart 1 below. The specific set of services provided by each of the 132 municipalities may be found in Annex 2.

CHART 1



Source: Table 3

Despite the broad differences in service provision across municipalities, there appears to be a small set of services that most of the municipalities provide regardless their population size, as illustrated in Table 5 below. An examination of the pattern in service provision shows that there are three services that are provided by at least 80% of the municipalities. These services include the following: (i) Solid waste collection and disposal (provided by 121 municipalities, equivalent to 91.7%), (ii) Street maintenance, rehabilitation and construction (provided by 109 municipalities which comes out to 82.6% of them),

TABLE 5
FREQUENCY IN THE PROVISION OF SERVICES:
RANKING FROM THE HIGHEST LEVEL OF PROVISION TO THE LOWEST
Based on a 100% Response: 132 Municipalities

Municipal Services in Practice	Number of Municipalities	%
1 SOLID WASTE COLLECTION & DISPOSAL	121	91.67
2 STREET CONSTRUCTION, REHABS, PAVING & SINGS	109	82.58
3 WATER SUPPLY	106	80.30
4 STREET LIGHTING NETWORK	92	69.70
5 TOWN PLANNING/ INTERNAL ROADS	86	65.15
6 SCHOOLS	83	62.88
7 SIDEWALKS	79	59.85
8 ELECTRICITY DISTRIBUTION	62	46.97
9 CEMETERIES	61	46.21
10 PUBLIC PARKS	54	40.91
11 LIBRARIES	45	34.09
12 SEWER SYSTEM	38	28.79
13 RAIN WATER DRAINAGE SYSTEM	37	28.03
14 SPORTS & CULTURE	34	25.76
15 SOLID WASTE TREATMENT*	30	22.73
16 HEALTH CENTERS	30	22.73
17 REGULATION, CONTROL & MONITORING	29	21.97
18 STREET NAMES & NUMBERING	26	19.70
19 FRUIT & VEGETABLE MARKETS	25	18.94
20 PUBLIC TRANSPORT FACILITIES	20	15.15
21 PUBLIC LAVATORIES	18	13.64
22 FIRE FIGHTING	18	13.64
23 SOCIAL ASSISTANCE**	17	12.88
24 SLAUTERHOUSES	16	12.12
25 TRANSIT MANAGEMENT* (traffic. lights, signs, parking. meters)	14	10.61
26 WASTE WATER TREATMENT	10	7.58
27 MUSEUMS	5	3.79

Source: MDLF Municipal services questionnaire. Data verification based on FY 2008 actual expenditures by service for 94 municipalities.

and (iii) water supply (106, 80.3%). The complete list showing the empirical evidence for frequency⁶ in provision for all the 27⁷ services may be seen in Table 5, above.

⁶ Frequency in service provision was computed as the difference between the number of municipalities that actually incurred on expenditures for the provision of the particular service, and the total number of municipalities (132).

From a broader view of service provision that responds to the question of which services are provided by at least 50 percent of the municipalities, it was found that at the minimum seven local services are provided (Table 5). They include the above three (provided by 80 percent of them), together with: (i) street lighting (92, 69.7%), (ii) town planning/roads⁸ (86, 65.2%), (iii) school maintenance and construction (83, 62.9%), and (iv) sidewalks (79, 59.9%).

In contrast, the services that are the least common, (provided by only about 20% of municipalities) include the following ten of them: (i) museums (5, 3.8%), (ii) wastewater treatment (10, 7.6%), (iii) motor-vehicle transit management (14, 10.6%), (iv) slaughterhouses (16, 12.1%), (v) social assistance services (17, 12.9%), (vi) fire fighting (18, 13.6%), (vii) public lavatories (18, 13.6%), (viii) public transportation facilities (20, 15.1%), (ix) fruit and vegetable markets (25, 18.9%), and (x) street name and numbering (26, 19.7%).

Among the final 10 services, the most frequent expenditures relate to electricity distribution (62⁹, 46.9%), public parks (54, 40.9%), and libraries (45, 34.1%).

Out of these less frequently provided services at least three seem to be greatly needed by the larger cities, including traffic management, waste-water treatment plants, and fire-fighting.

The results discussed above suggest a situation that may be characterized, as being affected, among other things, by the following factors: (i) the provision of most of the services (with the exception to a large extent of those that are directly provided to households¹⁰ such as solid waste collection, water supply, and electricity) appears to be rather *discretionary*; (ii) also, based on the low frequency on expenditures for a significant number of services, the system of *accountability* for service provision seems to be relaxed or non-existent; and (iii) given the very low frequency of provision of critical services (such as those related to sanitation and environmental protection) there a case of unfunded

⁷ Though the law describes 27 services, in practice there are 28, since town planning and roads (based on the law and also in budgetary planning and reporting) are combined as one service. For the sake of transparency and accountability, as well as analysis and evaluation, these two services should be separated in the budget forms. MOLG should consider this need.

⁸ It is important to note that the current budget form requires municipalities to report expenditures on roads in the same entry as town planning, which of course compromises transparency for these two different functions. These two types of expenditures, like the rest of the functions, should be reported separately.

⁹ It is interesting to note that while only 58 municipalities (as of 2008), were in charge of electricity distribution, four additional municipalities (in total 62) in fact contributed with expenditures in electricity distribution.

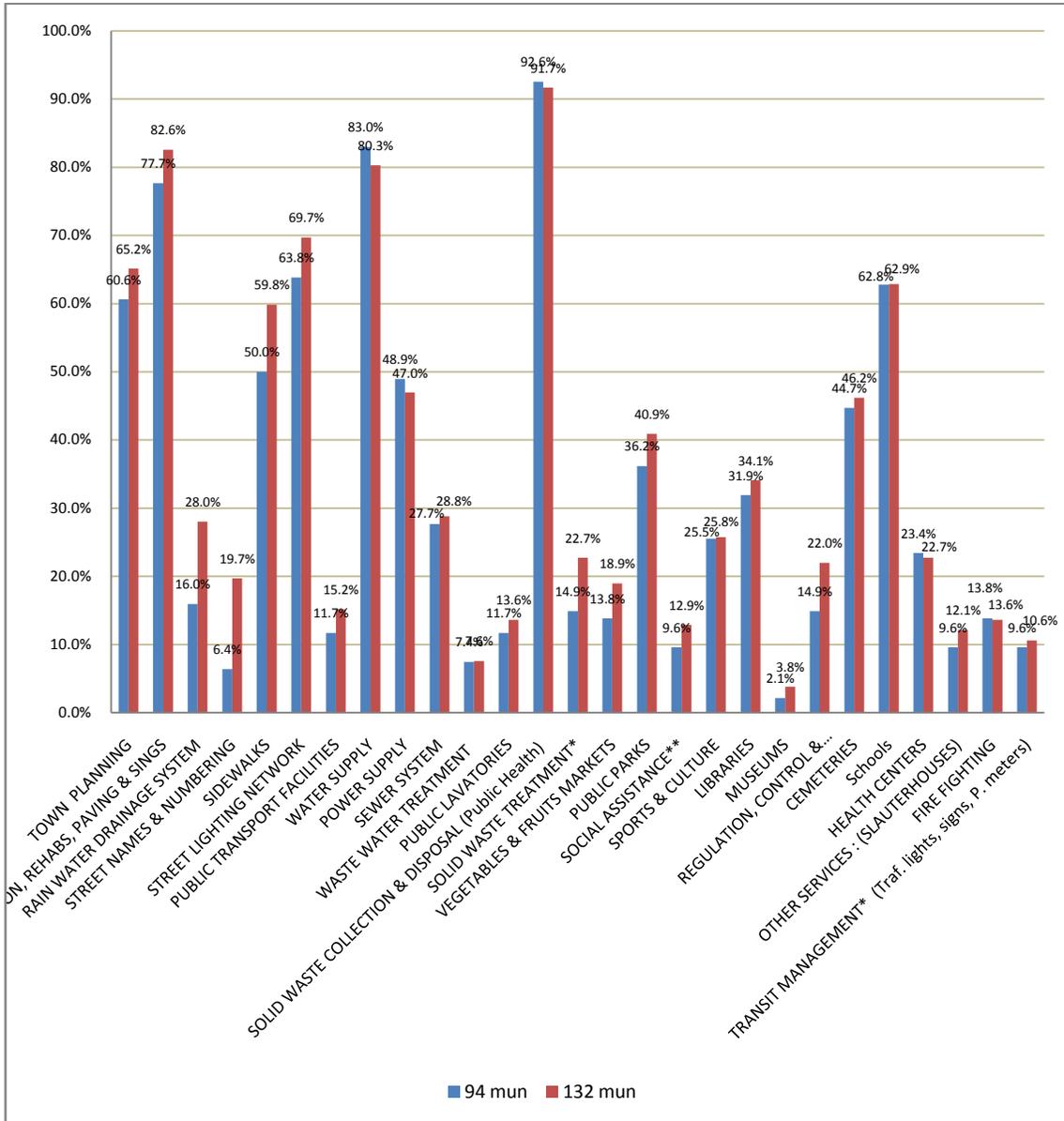
¹⁰ In some cases public utilities or JSC are in charge of the provision of the household services.

mandates also seems to exist. This finding is further examined in subsequent sections.

Chart 2 below summarizes the frequency of municipal service provision in West Bank and Gaza. This chart includes both the answers given by 94 municipalities to the service provision questionnaire as well as the frequency that results when the answers of all the 132 municipalities are included. The empirical results of this comparison indicate that the relative frequencies of municipal service provision are very much the same in both the universe of municipalities and in the sample. This result confirms the representativeness of the sample of 94 municipalities. In relative terms, as illustrated in Chart 2 below, the differences in frequencies are generally fairly small¹¹.

¹¹ There are two main exceptions to this general pattern, which are the cases of “street names and numbering” and “rain water and drainage systems”, for which the relative differences are not marginal.

CHART 2
REPRESENTATIVENESS OF THE SAMPLE
IN TERMS OF FREQUENCY OF SERVICE PROVISION
COMPARISON OF RESULTS FROM 94 AND 132 MUNICIPALITIES



Source: Questionnaires on service provision and actual expenditures by service.

2.4 Relationship Between Services Provided and Municipal Size

From empirical observation regarding actual service provision, it can be argued that there are four groups of municipalities:

- (1) The first group refers to municipalities that supply very few services. It comprises those municipalities that provide five or fewer services. Such services most commonly are focused on solid waste collection and local infrastructure, which generally includes the maintenance and rehabilitation of streets, internal/municipal roads, street lighting, and water supply. Twenty-three municipalities (17.4%) currently fall within Group I.
- (2) Group II, the largest of the four groups, comprises 82 municipalities providing at least twice as many services as Group I (up to a total of 12). These services generally include the very basic public works listed in Group I along with other common services, which usually include, among others, electricity distribution, the construction and maintenance of schools, and sidewalks. More than half (62.1%) of the municipalities in West Bank and Gaza rank in Group II.
- (3) Group III incorporates 21 municipalities (15.9%) that provide six additional local services, up to 18 in total. These additional services may be characterized as more sophisticated ones, and in some cases they may also be more costly. These services include public goods such as libraries, regulation, control and monitoring, health centers, solid waste treatment, and sewer systems.
- (4) Group IV consists of those municipalities providing the largest number of services, and includes the smallest number of municipalities. It comprises only six municipalities (4.5%). The additional services are also relatively more sophisticated and typical of larger cities. They refer to services such as social assistance programs, motor-vehicle transit management, wastewater treatment, and museums.

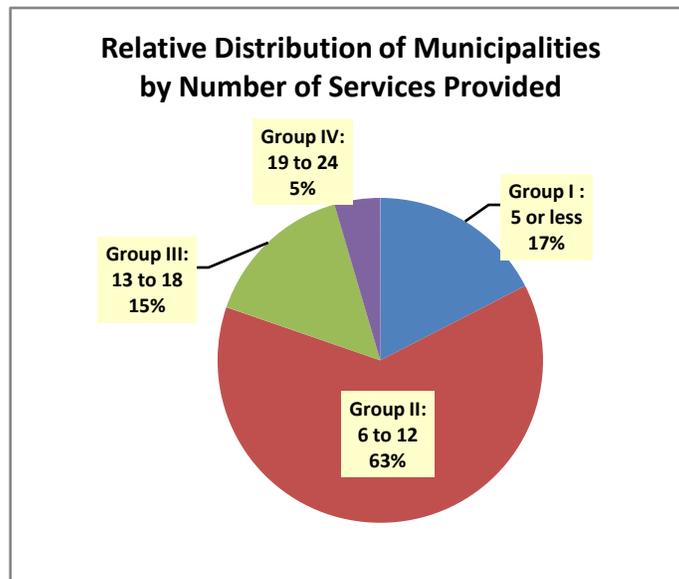
Table 6 below summarizes this classification of municipalities in terms of the number of services they provide.

TABLE 6			
CLASSIFICATION OF MUNICIPALITIES			
IN TERMS OF NUMBER OF SERVICES PROVIDED			
GROUP	NUMBER OF SERVICES	NUMBER OF MUNICIPALITIES	PERCENTS
I	5 or less	23	17.4
II	6 to 12	82	62.1
III	13 to 18	21	15.9
IV	19 to 24	6	4.5
	TOTAL	132	100%

Source: Based on the responses of the 132 municipalities to the Services Questionnaire.

About 80% of municipalities provide a minimum of six and a maximum of 18 services, as shown in Chart 3 below. The remaining 20% are located in the two extremes of the distribution, with about 17% of them supplying less than six services, and about 4% providing between 19 and 24 services.

Chart 3



The main objective of this section is to examine the relationship between the number of services provided and the size of the municipalities – the latter measured in terms of their population.

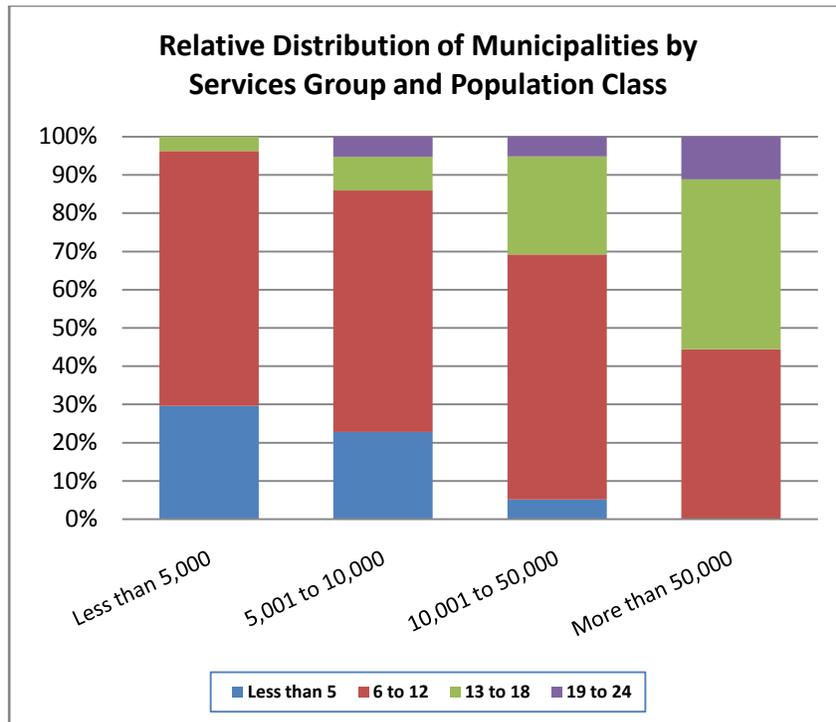
Table 7 below develops this municipal classification, taking into account these two basic variables.

The empirical results of combining number of services by groups and population class indicate that, in general, there seems to be a direct relationship between the number of available services and population size. This means that most likely, the larger the municipal population, the greater the number of services that will be provided. For instance, the larger cities (above 100,000 inhabitants), such as Nablus, Khan Yunis and Gaza, rank in Group III, which refers to those municipalities that provide between 13 and 18 services. In contrast, very small towns (practically villages) with under 5,000 inhabitants (Category A), such as Al Newe'emeh, Al Zahra, and Al Fokhari, rank under Group I which refers to local governments that provide less than five services. Briefly, population size in this analysis by groups seems to be a determinant in both the difference in the number of services actually provided, and the difference in some types of services.

However, it should be noted that there are exceptions to this general pattern. A number of relatively small municipalities (in Class II) rank in Groups III and IV, which identifies local governments that provide between 13 and 24 services. Examples of these municipalities are Shamaliyya (23), Ash Shoyukh (19), and Al Zawyeh (18). These results seem to suggest, among other things, that there is both a need for and some capacity to respond, at least to some extent, to a fairly broad range of local services, even among relatively small municipalities.

The pattern resulting from combining the service groups and the population classes is illustrated in Chart 4 below.

Chart 4



Source: Table 5 and Table 7

The empirical results illustrated in Chart 4 above show that most municipalities in West Bank and Gaza provide between 6 to 12 services, and that the relative weight of this group gradually drops as the population class becomes larger. In contrast, the relative weights of Groups III and IV, which include a greater number of services, increases with size of the population class. Simultaneously, and consistent with this general trend, the group of municipalities providing five or less services, decreases as the population increases. These results suggest that larger cities seem to have a greater capacity to provide more services than smaller towns.

However, when the analysis is carried out for all the 94 municipalities without any classification by groups (in terms of number of services), the empirical results suggest that it is rather difficult to argue that it may be expected that larger municipalities provide more services. A regression analysis indicates that there is no linear relationship between number of services provided and population size of the municipalities. The correlation coefficient is very low ($r = 0.23$), and the RSQ of the regression equation, which is a stronger measure of relationship between the two variables, is much lower ($rsq = 0.054$).

Considering that one of the policy objectives in the municipal sector is to encourage municipalities to provide more public services; then it may be the case that larger municipalities might be in a better position to do so, but size in and of itself is not enough. It seems that specific policy would need to assist in this effort. As such, sectoral policy encouraging the formation of larger municipalities through amalgamation – or other suitable means – may have stronger justification in terms of the potential economies of scale (i.e., lowering the unit cost of service provision), than in terms of the actual number of services that would likely be provided. In principle, larger municipalities, through amalgamation or equivalent means, would be more likely to benefit from economies of scale.

Table 7 below identifies the municipalities by population class and actual number of services provided. It also illustrates on the relative importance of each cluster that emerges from the combination of population classes and service groups.

TABLE 7
CLASSIFICATION OF MUNICIPALITIES
BASED ON POPULATION AND NUMBER OF SERVICES PROVIDED

POPULATION	Class	NUMBER OF SERVICES					Relative Weight
		Less than 5	6 to 12	13 to 18	19 to 24	TOTAL	
Less than 5,000	I	8	18	1	0	27	20.5%
5,000 to 10,000	II	13	36	5	3	57	43.2%
10,000 to 50,000	III	2	25	10	2	39	29.5%
More than 50,000	IV	0	4	4	1	9	6.8%
TOTAL		23	83	20	6	132	--
Relative Weight		17.4%	62.9%	15.2%	4.5%		100.0

These results identify the clusters that are better and worse off in terms of number of services provided and their relative importance given by the number of municipalities in each cluster. Therefore, these findings may assist in the identification of the clusters that could benefit more from amalgamation. Also, it

identifies the most dynamic groups in terms of service provision. These results may assist in targeting municipal development policy and technical assistance.

Table 8 below lists the specific municipalities in each population class, and in each service group. This matrix is intended to assist policy-makers in identifying the target areas where sectoral policies are most needed because either the municipalities are too small or they provide very few local services, or a combination of both. Also, Annex 2 lists both the specific services that these municipalities currently provide and those that are not being provided.

TABLE 8

CLASSIFICATION OF MUNICIPALITIES BY POPULATION AND NUMBER OF SERVICES ACTUALLY PROVIDED				
Population Categories	Number of Services by Group (G)			
	Group I 5 or less	Group II 6 to 12	Group III 13 to 18	Group IV 19 to 24
(A) 1,000 to 5,000	Al Newe'emeh (1)* Atara (3) Al Zahra (4) Al Fokhari (3) Al Oja (1) Beit Sureik (4) Beit Anan (4) Um Al Naser (5)	Al Tayybeh (6) Al Masdar (12) Zeita (10) Jayyus (9) Abwein (12) Az Zababedah (10) Kafr Al Labad (8) Baqa Al Sharqeyya (10) Kufor Tholoth (11) Kefel Hares (6) Wadi Gaza (6) Bruqin (10) Deir Ballut (12) Qarawat Bani Hassan (9) Deir Istia (9) Turmosayya (9) Wadi Al Salqa (6) Ne'lin (10)	Sabastya (14)	
(B) 5,001 to 10,000	Al Moghraqa(4) East Bani Zeid (4) Abasan Al – Jadeeda (3) Janata (3) Al Ittihad (4) Azzun (4) Jaba'a (4) Deir Debwan (5) Qatanna (3) Kufor Al Deek (5) Beit Leed (5) Beit Awwa (5)	Al Mazra'a Ash –Sharqeyya (6) Al Ubeidiyya (6) A I Khader (6) As Sawahreh Ash - Sharqiyya (10) Meithalun (10) Sinjel (8) Al Naser (11) Jammaein (11) Howwara (11) Borqin (11) Bir Nabala (7) West Bani Zeid (11) Aqqaba (6) Azzaytuna (8) Hableh (9)	Taqu'a (14) Ad Doha (13) Bedia (13) Beta(13) Arraba (13) Al Zawyeh (18)	Aseera Ash - Shamaliyya (23) Ash Shoyukh (19)

	Seelet Al - Hartheyya (5)	Za'tara (9) Seelet Ad Daher (8) Kharas (8) Silwad (6) Kufor Ra'ie (11) Beit Liqia (6) Qaffin (7) Deir Al Ghosoun (7) Beit Ula (10) Anata (7) Khaza'aa (9) Taffuh (6) Anabta (9) Bedu (11) Allar (11) Salfit (11) Birzeit (10) Qabalan (10) Bal'aa (12) Aqraba (12) Al Shokeh (12)		
(C) 10,001 to 25,000	Al Qarara (4)	Atteel (6) Tammun (6) Beit Fajjar (7) Beit Sahur (10) Al Eizariyya (7) Bani N'eim (7) Qabatya (9) Halhul (7) Tarqumia (8) Beitunia (9) Idna (9) Surif (9) Ya'bad (10) Tubas (10) Al Yamun (10) Beit Foreek (12) Se'ier (12) Beit Jala (12)	Abu Dees (16) Beit Ummar (16) Al Zawayda (15) AL Samu'e (16) Dura (14) Al Maghazi (13) Jericho (18)	Abasan Al Kabira (25)
(D) 25,001 to 50,000	Deir Al Balah (5)	AdDaheriyya (10) Yatta (6) Bani Sheila (7) Al Ram (8) Beit Hanun (12) Al Braij (10) Al Bireh (10)	Qalqilia (15) Ramallah (15) Bethlehem (18)	Jenin (20)
(E) 50,001 to 75,000		Beit Lahia (11) Rafah (6)	Tulkarem (18)	An Nseirat (19)
(F) 75,001 to 100,000		Jabalial (12)		

(G) 100,001 and over		Hebron (12)	Khan Yunis (17) Nablus (17) Gaza (13)	
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Source: Table 6 and Table 24 (Based on Annex 2: Services Questionnaire).

* The numbers in parentheses refer to the number of services being provided.

However, a more elaborated definition should be adopted to determine whether or not a municipality is providing a particular service. For instance, two municipalities could be reporting expenditures in the provision of solid waste collection, though one could be covering 10% of the population, while the other, of similar size, might be serving 90% of its residents. As such, for a more refined classification, a certain minimum coverage or standard seems advisable.

The above is particularly important, taking into account the significant differences across municipalities in terms of actual service coverage and quality, as will be addressed in section 2.10 on coverage and quality of selected municipal services.

Minimum per capita spending was not set for the municipal classifications offered here. The definition of whether or not a municipality is actually providing a service has been determined by whether or not the municipality has incurred expenditures in the provision of such a service independently of its relative magnitude.

Even though the two criteria used in the above classification (population and services) are sound and relevant, the results should be taken as indicative. Under more refined service coverage (i.e., subject to minimum standards in service provision) a significant number of municipalities may need to be reclassified. The next section examines the actual expenditures by service, which supports this view.

2.5 Expenditure Assignment and the Size of the Municipalities

The current expenditure assignment to “local councils” does not seem to recognize the wide range of variation in population size throughout the municipalities. The assignment implies that all municipalities have the same institutional capacities and the same revenue-raising potentials. Therefore, the legal expenditure assignment gives each of the 132 municipalities the same set of municipal functions and services. Furthermore, the law is ambiguous when it refers to “local councils,” which could be interpreted as including not only municipalities but also village councils (which could arguably be considered local councils as well).

As stated above, municipalities in the West Bank and Gaza are fairly small. About 84% of them have less than 25,000 inhabitants, and approximately one fourth (27%) have populations smaller than 5,000¹². Most of the municipalities fall in the range of between 5,000 and 10,000 inhabitants. Only nine municipalities (6.7%) have populations larger than 50,000. At the top of this range are four municipalities with populations greater than 100,000 (Gaza City, Nablus, Hebron and Khan Yunis). These four municipalities account for about one third of the Palestinian population. This means that in the case of small LGs, the scope of services is too broadly defined for them to be capable of fulfilling their 'mandate'¹³, whereas the larger municipalities may be more able to do so.

However, in 1997, when the Local Councils Law enacted the municipal expenditure responsibilities, these functions were apparently assigned to the 31 municipalities existing in West Bank and Gaza at that time (26 of which were located in the West Bank and five in Gaza). These municipalities were relatively large, so it could be argued that the functions assigned to them in the 1997 Law were, in principle, suitable for the 31 municipalities that existed at that time. In that year there were 103 village councils and over 400¹⁴ villages.

In the late 1900s, after the creation of the PNA, about 101 village councils legally gained the new status of municipality. The change in title gave them, among other things the following rights: (i) the rights to new revenue sources (e.g., user charges, taxes -- property and education tax -- fees, permits, licenses, etc.), and (ii) the authority to pay salaries to mayors, council members, and to hire local government staff. In addition, the 1997 law assigned municipalities (or, local councils, as denominated in the Law) about 27 expenditure functions. Before their new status as municipalities, village councils only had the responsibility to provide a very limited number of services (i.e., electricity, water, refuse collection and roads maintenance, among other things). The reform has given the former village councils functions that were originally the responsibilities of municipalities, and in some cases of the PNA. Last, and significantly, it should be noted that the 1997 reform brought the separate local governments of the West Bank and Gaza into one legal system.

¹² It should be noted that one strong recommendation that emerged from the Technical Committee for the Definition of Local Election Districts that initiated activities in FY'08?, with the support of the IFES, was that "325 districts is an excessive number and that many districts are too small for sustainable self-governance. Many of the districts only have about 1000 registered voters. Some of these districts should therefore be merged."

¹³ As discussed in section 3.6, the law is ambiguous as to which specific functions are *required* and which of them are only *optional*.

¹⁴ Ford, Fitz, "West Bank and Gaza Intergovernmental and Municipal Finance Sector Study Report", p. 5.

2.6 Accountability in the Provision of Local Services

Considering that in practice some services could be provided either by the line ministry or the local councils or both, Article 15 of the “Local Councils Law” in and of itself does not seem sufficient to determine legal accountability. For instance, the PA in practice also provides school maintenance, health care, and social assistance, among other local services. In addition, the law is ambiguous; on the one hand it states that “the local body *shall assume* the following functions,” while in the same paragraph, it also states that “the council is *entitled to assume* these responsibilities”. Therefore, in practice, the numerous legal functions seem to operate more as a ‘*legal option,*’ rather than as a ‘*legal obligation.*’ As such, there is still a need for some legal instrument to clarify which levels of government, or types of LGUs, are legally responsible for each of the numerous local public goods and services. Furthermore, there should be clarity on whether there is *concurrence, joint responsibility* or *exclusivity* in the provision of certain specific public works and services. A clear understanding of which level of government or entity is ultimately accountable for each function would help to enhance the quantity and quality of local public goods and services.

2.7 Executed Expenditures by Service

The comparisons of expenditures in this section are based on the operating budget that is allocated to service provision, which represents on the average about 78.3% of the Total Recurrent Expenditure Budget¹⁵. The remaining 22% is allocated to General Administrative Expenditures, which are not directly associated with any particular type of service.

As stated in the above sections, municipalities have been assigned about 27 different functions. However, in practice, they allocate about 80% of their total operating budget to only five of them. During FY '08 the main operating expenditures on these five main services were as follows: (i) electricity (41.3%), (ii) water (16.4%), (iii) solid waste collection (15.7%), (iv) street maintenance (6.8%), and (v) roads (5%). It should be noted that expenditures on the remaining

¹⁵ The executed Recurrent Expenditure Budgets of FY '08 for the 132 municipalities were still not available by the time this study was concluded. As such, this report had to rely only on the data on expenditure by service for 2008 that was obtained through the municipal expenditure questionnaire.

services were generally less than 1% of the municipal executed expenditures, although some expenditures may have been as high as 1-2% (Annex 3)¹⁶.

The above results indicate that, for the local councils that provide electricity distribution, this is the most costly¹⁷ of the services they provide. This high cost may be due to the intrinsic cost of energy provision, but it may also be due to the fact that energy distribution has one of the largest areas of service coverage, compared to other services. Though empirical evidence seems to support both of these arguments, it could also be argued that expenditures in electricity distribution may illustrate inefficiencies in the service cost¹⁸ structure. For instance, cost inefficiencies could be due to municipal over-staffing financed by electricity revenue.

The main policy implication of these results is that the above five services, irrespective of some distortions in their cost structures, seem to be the main local preferences. Therefore, their adequate coverage and quality should be a high priority. This in turn implies the need for: (i) adequate tariff structures and cost recovery, and (ii) adequate taxation to be able to finance both street and road maintenance (and construction). Tariff design should consider the option of built-in cross-subsidies and direct subsidies (if needed), for electricity, water, and solid waste. On the other hand, adequate taxation implies at least a properly functioning property tax, and adequate revenue from at least the vehicle registration fee.

However, not every municipality is responsible for all the services assigned in the Law. For instance, only 58¹⁹ municipalities out of 132 are responsible for electricity distribution. This is particularly noteworthy since in the

¹⁶ Annex 3 includes all the expenditures by municipality and by service for FY'07 and FY'08. It also differentiates expenditures by salaries and wages (S&W), operation and maintenance (O&M), and local public investment (i.e., capital expenditures). The expenditures for FY'07 come from the municipal executed budgets, while the data for FY'08 comes from the municipal expenditure questionnaire.

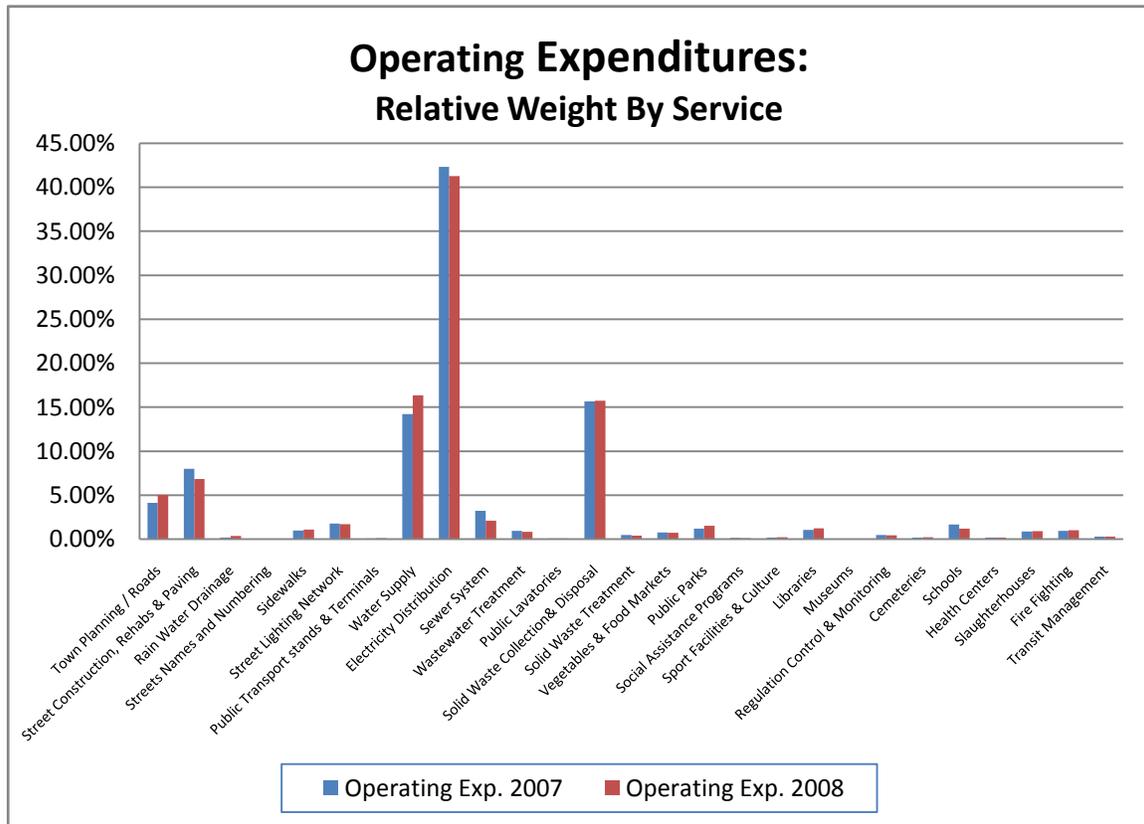
¹⁷ The term 'expenditure' in this section refers to the current cost on operation and maintenance, as well as wages and salaries, which are the main components of the total cost of service provision. This data come from executed municipal budgets, which in principle are more meaningful than the same data from approved budgets, though generally are non-audited budgets.

¹⁸ Given the apparent high cost of electricity distribution, the transfer of this service to regional companies appears to be the right sectoral policy, as an attempt (among other things) to lower the unit cost of service provision. From this perspective, competition and regulation of regional companies would support the need for cost efficiency.

¹⁹ It should be noted that in FY'07 two additional municipalities (Jayous and Kofor Tholuth) began purchasing electricity from the IEC, moving up the number of electricity distribution providers from 56 to 58. These two municipalities do not appear in the MoF database on arrears, since they were in full compliance with their payments.

consolidation of all municipal expenditures (in Chart 5 below) electricity appears to be the most important expenditure (41.27%), even though 74 municipalities do not provide this service²⁰.

CHART 5



Source: Based on the consolidated of the answers of 94 municipalities that responded the expenditure questionnaire carried out for this study (Table 9 and Annex 3).

As shown in Chart 5 above, in FY '07, the municipal expenditure structure was very similar to that of FY '08, showing that: (i) electricity distribution (42.3%), (ii) water supply (14.2%), (iii) solid waste collection (15.6%), (iv) street maintenance (7.9%), and (v) roads (4.1%) were still the expenditures with the largest shares in the operating budget. Table 9 below lists all 27 services with their corresponding relative weights.

²⁰ It is important to note that the number of municipalities that provide electricity distribution is greater than the total number of municipalities that directly buy electricity from the IEC. This is so because three municipalities (Al Yamun, Kufr Ra'i, and Selet Alshamaliyya) actually purchase their electricity from Jenin, while two municipalities (Anabta and Assera – Alshamaliyya) purchase their electricity from Nablus. The total number of municipalities that currently purchase electricity from the IEC is 53, while the total number of those that supply electricity distribution is 58. The difference with respect to the total number of municipalities, 74 municipalities, is the number of non-suppliers of the electricity service (132 – 58 = 74).

TABLE 9
RECURRENT EXPENDITURES: RELATIVE WEIGHT BY SERVICE
Based on 71% Response: 94 Municipalities

	Municipal Services	Expenditure NIS	Percent	Expenditure NIS	Percent
		2007	%	2008	%
1	Town Planning / Roads	16,306,873	4.14	22,541,187	5.01
2	Street Construction, Rehabs, Paving	31,412,285	7.98	30,694,298	6.83
3	Rain Water Drainage	662,547	0.17	1,678,081	0.37
4	Streets Names and Numbering	45,240	0.01	94,033	0.02
5	Sidewalks	3,819,989	0.97	4,834,468	1.08
6	Street Lighting Network	7,043,742	1.79	7,647,512	1.70
7	Public Transport stands & Terminals	336,956	0.09	485,953	0.11
8	Water Supply	55,986,857	14.23	73,515,287	16.35
9	Electricity Distribution	166,545,782	42.33	185,527,276	41.27
10	Sewer System	12,643,379	3.21	9,414,499	2.09
11	Wastewater Treatment	3,715,173	0.94	3,778,701	0.84
12	Public Lavatories	306,919	0.08	360,353	0.08
13	Solid Waste Collection& Disposal	61,608,679	15.66	70,758,593	15.74
14	Solid Waste Treatment	1,827,826	0.46	1,851,480	0.41
15	Fruits & Vegetables Markets	3,012,213	0.77	3,340,947	0.74
16	Public Parks	4,731,300	1.20	6,917,552	1.54
17	Social Assistance Programs	592,532	0.15	499,910	0.11
18	Sport Facilities & Culture	735,319	0.19	988,266	0.22
19	Libraries	4,151,388	1.06	5,489,177	1.22
20	Museums	14,900	0.00	17,600	0.00
21	Regulation Control & Monitoring	1,802,215	0.46	1,974,831	0.44
22	Cemeteries	736,595	0.19	992,106	0.22
23	Schools	6,503,674	1.65	5,333,454	1.19
24	Health Centers	764,234	0.19	896,040	0.20
25	Slaughterhouses	3,364,850	0.86	4,067,066	0.90
26	Fire Fighting	3,645,036	0.93	4,499,918	1.00
27	Transit Management	1,165,792	0.30	1,366,238	0.30
	TOTAL	393,482,295	100%	449,564,826	100%

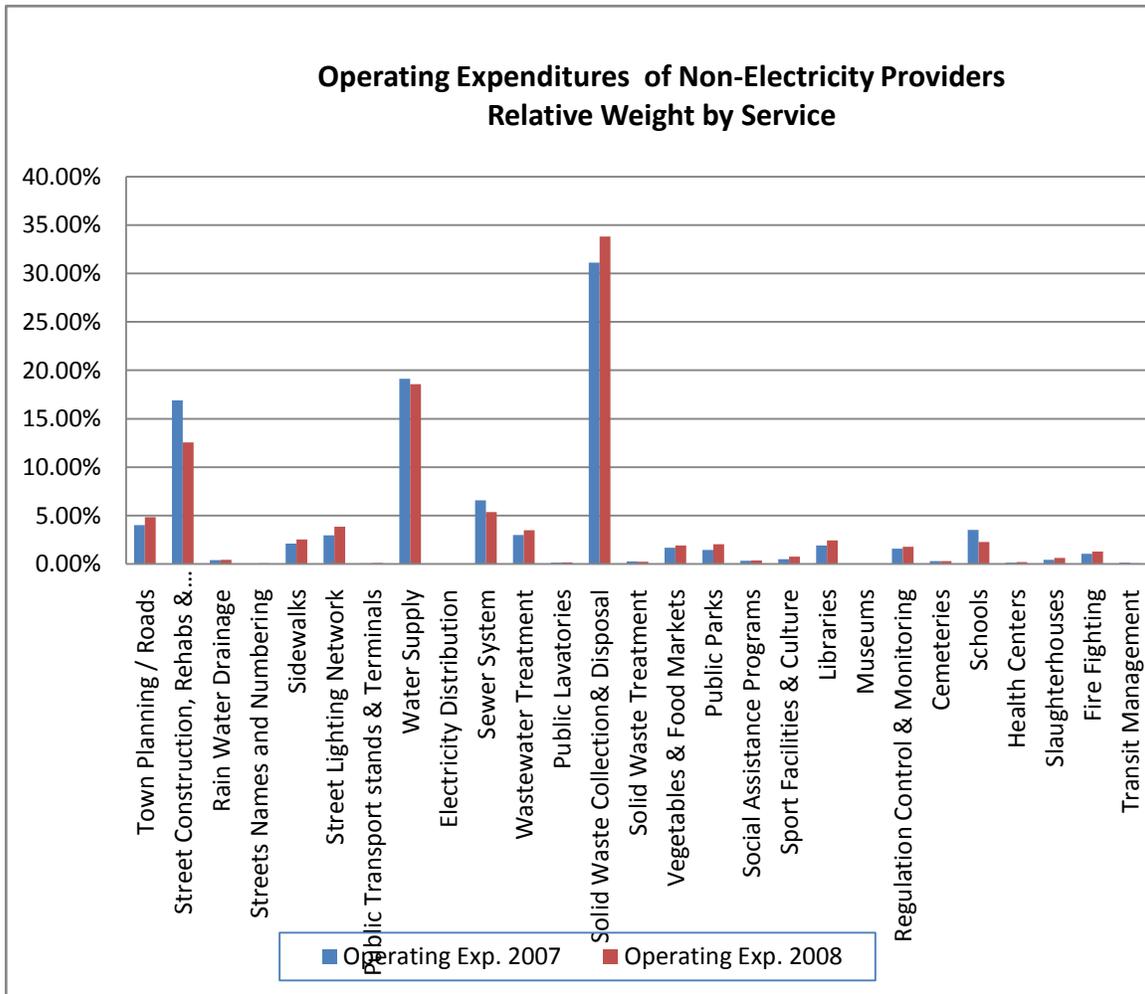
Source: Expenditure Questionnaire carried out for this study.

However, considering that about half of the municipalities (56%) do not provide electricity distribution, the sample of 94 municipalities has been divided into two sub-samples: one for electricity providers and the other for non-providers. This will show more clearly any potential differences in the expenditure structures of these two groups.

For those **municipalities not providing electricity**, the empirical results (in Chart 6 below) indicate that the most important municipal service (measured by actual expenditure), is solid waste collection and disposal -- about one third (33.82%) of the operating expenditures is spent on the provision of this service. It should be noted that this result is not that different from the consolidated results in which solid waste came up third in importance, very close in relative weight to water supply, which is second to electricity in the consolidated analysis and second (18.6%) to solid waste in this sub-sample of non-electricity providers. The other relatively most important services are street maintenance (12.5%), sewers systems (5.3%), and roads (4.8%). These results are also very similar to those obtained in the consolidated analysis, with the exception of sewer systems, which come out to be about as important as roads.

Furthermore, the results of FY '07 are very similar to those of FY '08. Solid waste (31.1%), water supply (19.1%), streets (16.9%), sewer systems (6.6%), and roads (4.0%) are the most important services among *non-providers*. The similarity in the results for these two years suggests some stability in the provision of the above services.

Chart 6



Source: Based on the answers of the municipalities that do not provide electricity distribution that responded the expenditure questionnaire carried out for this study (Table 4 and Annex 3).

The rather similar results of these two samples seem to corroborate that both the sample and the sub-samples are fairly representative of Palestinian municipalities. Furthermore, it appears that the sample and the sub-sample may be characterized as being unbiased in favor of or against any group of municipalities. This result also reflects the fact that the sub-samples of *providers* and *non-providers* include small, medium, and large municipalities. Briefly, these empirical results support the argument, stated at the beginning of this report, that the sample of 94 municipalities, (which includes municipalities in all the population classes in proportion to the total number in each class), is highly representative. Table 10, below illustrates the FY'07 and FY'08 expenditure structure for non-*providers*.

TABLE 10
MUNICIPAL OPERATING EXPENDITURES BY SERVICE
FY '07 and FY '08
(for non-providers from the sample of 94 municipalities)

	Municipal Services	Expenditure NIS	Percent	Expenditure NIS	Percent
		2007	%	2008	%
1	Town Planning / Roads	4,456,149	4.03%	5,220,615	4.83%
2	Street Construct., Rehabs & Paving	18,695,423	16.90%	13,542,620	12.54%
3	Rain Water Drainage	445,480	0.40%	461,932	0.43%
4	Streets Names and Numbering	17,840	0.02%	80,313	0.07%
5	Sidewalks	2,327,062	2.10%	2,721,891	2.52%
6	Street Lighting Network	3,297,687	2.98%	4,163,882	3.86%
7	Public Transport stands, Terminal.	82,479	0.07%	97,126	0.09%
8	Water Supply	21,178,433	19.14%	20,070,982	18.58%
9	Electricity Distribution	0	0.00%	0	0.00%
10	Sewer System	7,289,977	6.59%	5,782,507	5.35%
11	Wastewater Treatment	3,331,123	3.01%	3,765,581	3.49%
12	Public Lavatories	163,335	0.15%	171,346	0.16%
13	Solid Waste Collection& Disposal	34,456,259	31.14%	36,528,650	33.82%
14	Solid Waste Treatment	294,832	0.27%	249,258	0.23%
15	Fruits & Vegetables Markets	1,878,114	1.70%	2,053,731	1.90%
16	Public Parks	1,601,083	1.45%	2,213,715	2.05%
17	Social Assistance Programs	392,387	0.35%	406,856	0.38%
18	Sport Facilities & Culture	557,181	0.50%	823,139	0.76%
19	Libraries	2,139,901	1.93%	2,632,594	2.44%
20	Museums	0	0.00%	0	0.00%
21	Regulation Control & Monitoring	1,755,613	1.59%	1,924,243	1.78%
22	Cemeteries	337,560	0.31%	334,771	0.31%
23	Schools	3,902,009	3.53%	2,432,434	2.25%
24	Health Centers	178,586	0.16%	211,014	0.20%
25	Slaughterhouses	502,255	0.45%	682,415	0.63%
26	Fire Fighting	1,189,550	1.08%	1,369,966	1.27%
27	Transit Management	180,618	0.16%	56,430	0.05%
	TOTAL	110,650,936	100%	107,998,011	100%

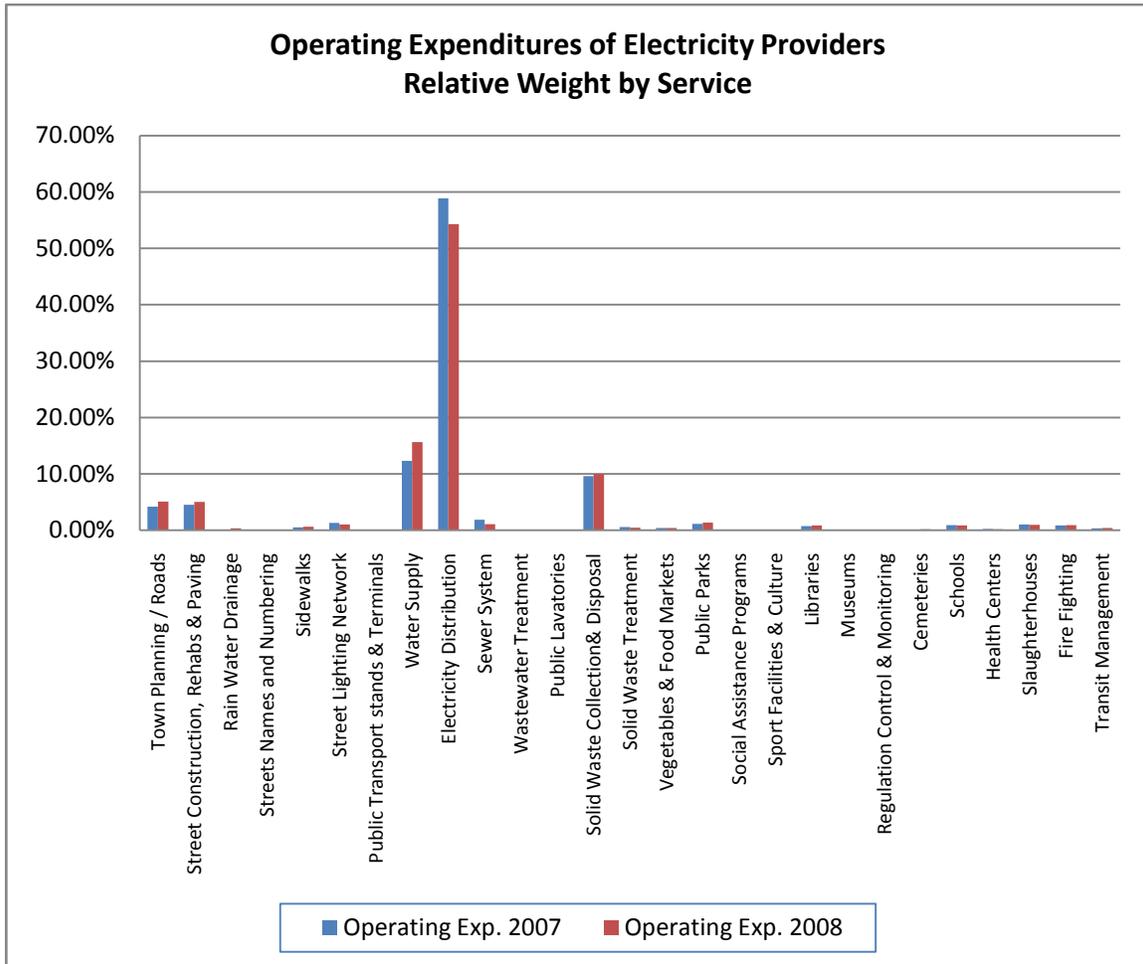
Source: Expenditure questionnaire carried out for this study (Answers from non-providers of electricity as reported in Annex 3).

The highlights of a comparison of the expenditure structures of electricity *providers* with that of *non-providers* for FY'07 and FY'08 may be summarized as follows:

- The patterns of expenditures for basic services (solid waste collection, water provision, street building and repairs) are similar. However, providers spend significantly more in per capita terms on water, roads, and public parks than *non-providers*.
- For *providers*, electricity distribution accounts for more than half of the operating budget allocated to services in FY'07 and FY'08 (54.3% and 58% respectively). For *non-providers* solid waste disposal and collection is the highest expenditure at over 30% of the budget.
- The expenditure structure of both *providers* and *non-providers* indicates that, apart from the five or six basic services, municipalities incur fairly small or even negligible expenditures on other services -- as will be seen in the analysis of per capita spending. It appears that some of the revenue diverted in the form of electricity arrears contributes to the financing of greater expenditures in the maintenance of the water supply networks and the road network.

Chart 7 below illustrates the pattern of FY'07 and FY'08 expenditure structure for *providers*.

Chart 7



Source: Table 10.

The relative weights of operating expenditures in each of the 27 services for *providers* in FY '07 and FY '08 may be seen in Table 11 below.

TABLE 11
MUNICIPAL OPERATING EXPENDITURES BY SERVICE
FY '07 and FY '08
(for providers from the sample of 94 municipalities)

	Municipal Services	Expenditure NIS	Percent	Expenditure NIS	Percent
		2007	%	2008	%
1	Town Planning / Roads	11,850,724	4.19%	17,320,572	5.07%
2	Street Construct, Rehabs & Paving	12,716,862	4.50%	17,151,678	5.02%
3	Rain Water Drainage	217,067	0.08%	1,216,149	0.36%
4	Streets Names and Numbering	27,400	0.01%	13,720	0.00%
5	Sidewalks	1,492,927	0.53%	2,112,577	0.62%
6	Street Lighting Network	3,746,055	1.32%	3,483,630	1.02%
7	Public Transport stands & Terminals	254,477	0.09%	388,827	0.11%
8	Water Supply	34,808,424	12.31%	53,444,305	15.65%
9	Electricity Distribution	166,545,782	58.89%	185,527,276	54.32%
10	Sewer System	5,353,402	1.89%	3,631,992	1.06%
11	Wastewater Treatment	384,050	0.14%	13,120	0.00%
12	Public Lavatories	143,584	0.05%	189,007	0.06%
13	Solid Waste Collection& Disposal	27,152,420	9.60%	34,229,943	10.02%
14	Solid Waste Treatment	1,532,994	0.54%	1,602,222	0.47%
15	Vegetables & Food Markets	1,134,099	0.40%	1,287,216	0.38%
16	Public Parks	3,130,217	1.11%	4,703,837	1.38%
17	Social Assistance Programs	200,145	0.07%	93,054	0.03%
18	Sport Facilities & Culture	178,138	0.06%	165,127	0.05%
19	Libraries	2,011,487	0.71%	2,856,583	0.84%
20	Museums	14,900	0.01%	17,600	0.01%
21	Regulation Control & Monitoring	46,602	0.02%	50,588	0.01%
22	Cemeteries	399,035	0.14%	657,335	0.19%
23	Schools	2,601,665	0.92%	2,901,020	0.85%
24	Health Centers	585,648	0.21%	685,026	0.20%
25	Slaughterhouses	2,862,595	1.01%	3,384,651	0.99%
26	Fire Fighting	2,455,486	0.87%	3,129,952	0.92%
27	Transit Management	985,174	0.35%	1,309,808	0.38%
	TOTAL	282,831,359	100%	341,566,815	100%

Source: Municipal executed budgets for 2007 and expenditure questionnaire for 2008.

Based on the municipal Recurrent Expenditure Budgets for FY '07 (which are the most recent executed budgets available), the share of expenditure for each of the main services in the Recurrent Expenditure Budget was calculated for those municipalities that provide each particular service. The results indicate

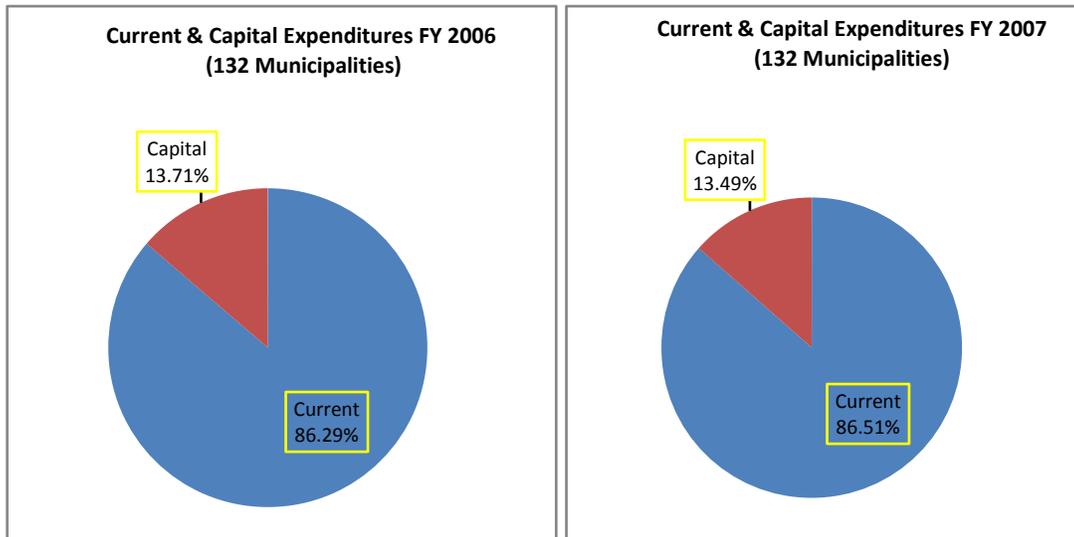
that the relative importance of the main services remains the same. Electricity is substantially the largest average expenditure (30.78%), while water (17.36%) and solid waste (17.18) are very close in their relative importance to one another as was already identified in the sample of 94 municipalities. Similarly to the results in the sample as a whole, street and roads expenditures (7.82%) come next in relative importance. These findings are summarized in Table 12 below.

TABLE 12						
OPERATING EXPENDITURES FOR SELECTED SERVICES						
AS A PERCENT OF THE MUNICIPAL RECURRENT BUDGET						
FY 2007						
SERVICE	Number of Providers	Sample size	Service Oper. Exp. NIS Millions	Municipal Recurrent Exp. Budget NIS Millions	Average across LGs' Shares %	Median Share on Recurrent Budget %
1. Electricity	58	42	143.5	344.3	30.78%	15.13%
2. Water	106	76	55.8	495.2	17.36%	10.53%
3. Solid Waste	121	86	61.5	541.6	17.18%	13.79%
4. Streets & Roads	109	71	31.4	462.0	7.82%	6.08%
Source: Municipal Executed Budgets for FY '07						

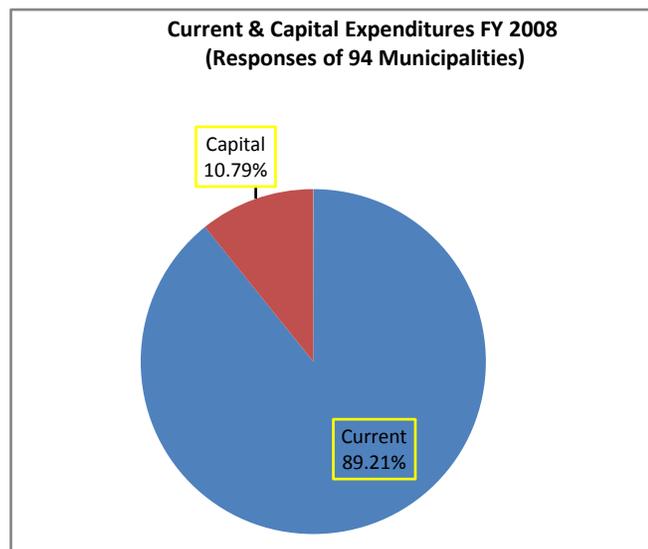
In addition to the analysis with respect to the entire recurrent budget, the analysis also compared the average and median expenditures in order to determine whether the conclusions would be any different. For the median municipality, electricity still is the most important expenditure (15.13% -- in Table 12). Last, the relative importance of streets and roads is also the same using either the median or the averages. These results suggest that using the averages for analytical purposes does not give a distorted or biased result of the relative importance of the services in the municipal expenditure structure.

Last, it should be noted that actual municipal operating expenditures in functions such as social assistance programs and health care (as a proportion of total expenditures in services) are fairly insignificant -- their relative weights in FY '08 were less than 1% of the operating budget (0.11% and 0.20%, respectively). Typically, the programs related to social assistance include food for the poor and shelters for the homeless. These types of social assistance and health care programs were carried out in 12.9% and 22.7% of the municipalities, respectively. The specific expenditures for the corresponding municipalities are detailed in Annex 3. Most social assistance programs (in 34.8% of the municipalities) and health centers (in 62.9% of them) are funded by the central government, though other providers may include municipalities, non-

**CHART 8
MUNICIPAL BUDGETS
SHARE OF OPERATING AND CAPITAL EXPENDITURES**



Source: Table 13

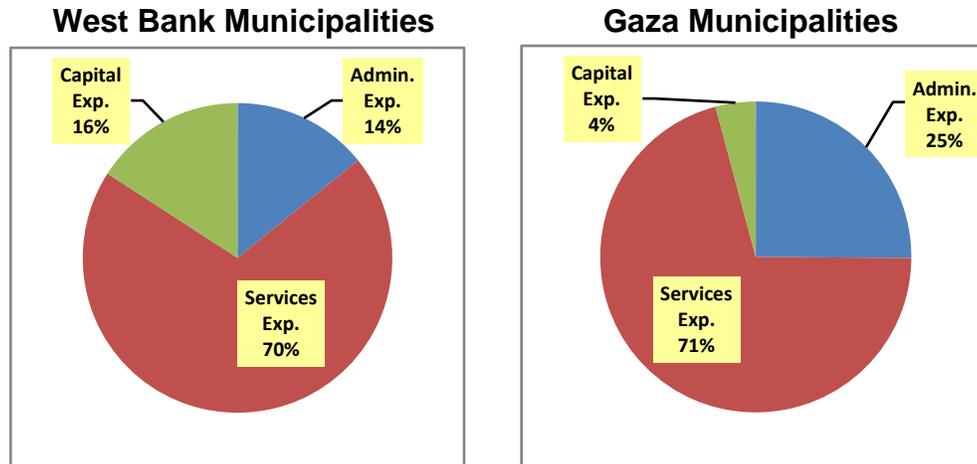


Source: Table 13

The findings also suggest that the Israeli economic blockade may have adversely affected the level of local public investment in the Gaza Strip. The consolidation of the municipal capital budgets as a proportion of the total consolidated budget is only 4% in the Gaza Strip, in contrast to 16 % in the West Bank. (See Chart 9 below). It must be highlighted that as part of the economic blockade, particularly in the Gaza Strip, municipalities generally cannot import, among other things, cement, machinery, and equipment, including cement mixers, spare parts, and construction materials, which are critical for investments

in public works. There have, however, been some exceptional cases in which the Israeli authorities have allowed certain materials and construction equipment to enter the Gaza Strip.

Chart 9
Distribution of Expenditures in West Bank and Gaza
And Potential Effects of the Economic Blockade



Source: 2007 municipal executed budgets.

With respect to recurrent expenditures, while both the West Bank and Gaza allocate about 70% of their budgets to finance the provision of municipal services, the proportion of administrative expenditures (which is mainly salaries) is almost twice as high in Gaza (25%) as in the West Bank (14%). This also seems to support the argument that due to the high rates of unemployment, particularly in the Gaza Strip (about 40%), some municipal administrations have felt compelled to contribute to the alleviation of this critical social and economic situation.

The higher proportion of administrative expenditures in Gaza (25%) as compared to the West Bank (14%) also suggests that it could be due to municipalities trying to maintain their work force while reducing expenditures in services. This is a result of the severe crises in their revenue budgets due to the overall effects on the local economy of the Israeli blockade. It could also simply be a result of a larger number of employees, and/or higher salaries, or a combination of all these factors.

The analysis of empirical evidence for Gaza and the West Bank (in Table 14 below) supports the argument that a larger number of employees in the Gaza

Strip (and only to some extent higher salaries) contributes to this result. In fact, while the national average of employees (per thousand inhabitants) is about 2.7, in the Gaza Strip the average²¹ is 2.9. Also, it should be noted that comparing Gaza municipalities (*non-providers*) with the West Bank (for *non-providers*), the average²² number of employees in Gaza (2.9) still comes out higher than in the West Bank (2.4).

Furthermore, in terms of salaries (as reported in their executed budgets), the average municipal salary in the Gaza Strip is higher than the average for *non-providers* in the West Bank. The yearly average salary for Gaza is about NIS 27,700, while the average for non-provider in the West Bank is about NIS 23,782.

In general, analysis of the results across municipalities for both number of employees and average salaries indicates that there is much greater variability in number of employees than in average salaries. Therefore, it could be argued that the total cost of salaries and wages per municipality depends more on the actual number of employees than on their salary levels.

It should be noted that the Gaza Strip includes some of the largest urban areas in the West Bank and Gaza as a whole, which could explain their higher staffing levels. However, the RSQ of the regression equation between per capita staff and municipal population size indicates that there is no linear relationship between municipal size and employees per capita.

Furthermore, examining the main components of the Current Expenditure Budget, the empirical results indicate that salaries and wages (S&W) as a proportion of average municipal budget are greater among the sampled municipalities in the Gaza Strip (46.33%) than in the West Bank (35.20%). These findings are illustrated in Table 14 below. The total relative weight of the expenditure budget allocated to salaries and wages is obtained by adding the S&W in general administration to the S&W in services.

²¹ The calculation includes all 25 municipalities in the Gaza Strip.

²² The calculation is based on a sample of 50 West Bank municipalities that do not provide electricity.

TABLE 14						
WEST BANK AND GAZA STRIP						
S&W AS A PERCENT OF THE CURRENT EXPENDITURE BUDGET						
FY 2007						
	CURRENT EXPENDITURE BUDGET				CAPITAL BUDGET	TOTAL BUDGET
	General Administration		Services			
	14%		70%		16%	100%
	S&W	O&M	S&W	O&M		
WEST BANK	10.50%	3.50%	24.70%	45.30%		
	General Administration		Services			
	25%		71%		4%	100%
	S&W	O&M	S&W	O&M		
GAZA STRIP	21.25%	3.75%	25.08%	45.91%		

Source: Based on the sample of 94 municipalities.

As noted above, considering the high rates of unemployment (both in the West Bank and the Gaza Strip), some mayors have opted for hiring extra staff as a social protection measure. Consequently, some services in these municipalities, such as electricity distribution, water supply, and solid waste collection, may be overstaffed. However, as already argued, the responsibility of a safety net program cannot be a municipal expenditure function. Overstaffing has also proven to be unsustainable. A significant number of municipalities do not even have enough resources to pay the salaries of normal levels of staffing, and the arrears on salaries, in some cases, are significant. These factors characterize the situation of most of the municipalities in the Gaza Strip.

As discussed above, the empirical results indicate that the average for the West Bank and Gaza is about 2.7 staff per 1000 inhabitants. In FY'07 it fluctuated between one and 11 staff per thousand inhabitants, which suggests that there is some potential for downsizing in those cases where there is clear evidence of overstaffing. The municipalities with the largest number of employees per capita are Jericho (11:18)²³ and Ramallah (7:15) in the West Bank, while in the Gaza Strip they are Al Zahra (6.3:4) and Al Masdar (5.4:12).

²³ The first figure within each parenthesis refers to the number of employees, while the second is the number of services provided. The complete list of the number of services for each of the 132 municipalities may be seen in the proposed classification by population and number of services in Table 8.

Some municipalities, such as Ramallah, provide a large number of services, while others, such as Al Zahra, do not. Table 15 below summarizes the main findings regarding the absolute and relative numbers of employees, as well as the average and median salaries for the Gaza Strip and the West Bank, differentiating between *providers* and *non-providers*. Annex 6 details the total number of employees for each municipality.

TABLE 15
NUMBER OF EMPLOYEES PER THOUSAND INHABITANTS
AND AVERAGE AND MEDIAN SALARY
FY '07

	Sample Size	Employees per 1,000	Median Salary	Average Salary
Gaza Strip	13	2.9	22,729	27,704
West Bank <i>Providers</i>	44	2.7	22,877	23,743
West Bank <i>Non-providers</i>	50	2.4	22,725	23,782
WB&G	107	2.7	22,760	24,242

Source: Executed Municipal Budgets and summary in, Annex 6

Some mayors of indebted municipalities (i.e., those with the largest electricity arrears) have recognized overstaffing as a constraint to their financial performance. For instance, the Mayor of Jenin recognized this situation and his administration has taken specific actions to downsize the municipal staff.

On the other hand, smaller municipalities claim that salary levels, which were recently established by MoLG, are above their fiscal capacity. Empirical evidence supports this argument. First, the cost of the average *payroll* was estimated based on the municipal population, the average number of employees per 1000 inhabitants, and the national average salary. Subsequently, this estimated cost of *payroll* was compared with the actual municipal recurrent revenue budget. The findings show that in some cases the estimated cost of an average payroll comes out to be greater than the municipality's recurrent revenue budget, which makes the cost of the average payroll unaffordable. These results are illustrated in Table 16 below.

TABLE 16

ESTIMATED SALARIES AS A PERCENT OF THE REVENUE BUDGET					
SELECTED CASES FOR THE WEST BANK AND GAZA					
MUNICIPALITY	Population	Estimated* number of employees	Estimated Cost of Payroll**	Total Recurrent Rev. Budget	% of Payroll on Rev. Budget
WEST BANK:					
Abwein	3,436	9.3	224,898	213,803	105%
Sinjel	5,561	15.0	363,986	334,715	109%
Janata	5,881	15.9	384,931	197,739	195%
GAZA STRIP:					
Wadi Gaza	3,444	9.3	225,422	194,837	116%
Wadi Al Salqa	3,444	9.3	225,422	151,893	148%
Al Shokeh	8,094	21.9	529,780	261,614	203%
Khaza'aa	9,665	26.1	632,607	429,556	147%
Source: Municipal Executed Budgets for FY 2007					
* Based on the national average of 2.7 employees per one thousand inhabitants.					
** Based on an estimated average salary of NIS 24,242 for WB&G					

This overall situation has made it difficult for these municipalities to allocate significant amounts of their own financial resources for public works.

Given these constraints to the capital budget, most of the municipal development budgets are primarily financed by the PA (MoF and MoLG) and the community of donors through different kinds of grants-in-aid.

2.9 Per Capita Expenditures by Service

The average per capita spending in municipal services is about nine Shekels (NIS 8.69). Most services, however, fall substantially below the national average, while only a few of them rank above (Table 12). In FY'08 the services and public works with the largest per capita expenditures included electricity (NIS 96.80), water supply (NIS 38.36), solid waste (NIS 36.92), street maintenance (NIS 16.01), and roads (NIS 11.76). As expected, most of the main local services may be characterized as revenue-generating, since they substantially contribute to their own financing, and in some cases may generate net revenue, thus creating the ability to finance other local expenditures. These results are consistent with the analysis in absolute terms (in Table 9 above) of their relative importance within the municipal expenditure structure. A complete list of all per capita spending by service is included in Table 17 below.

In contrast, the services that have the lowest per capita expenditure, (i.e., less than one Shekel per capita per year), and are not revenue generating include, museums (NIS 0.01), street names and numbering (NIS 0.05), public lavatories (NIS 0.19), public transport stands and bus terminals (NIS 0.25), social assistance programs (NIS 0.26), health centers (NIS 0.47), sports facilities and culture (NIS 0.52), cemeteries (NIS 0.52), transit management (NIS 0.71), rain water drainage (NIS 0.88), and solid waste treatment (NIS 0.97).

However, it should be noted that the PA provides social assistance in 35% of municipalities, while the private sector and NGOs do so in 11%. Only 17% of municipalities use a limited amount of their own funds for social assistance. In healthcare, the PA provides facilities in 63% of the municipalities while the private/NGO sectors provide services in 17%. Only 35% of municipalities use a very limited amount of their own funds for healthcare provision. Consideration should be given to the goal of inter-jurisdictional equity in service provision, which is only attainable, at least in principle, when functions of national interest, such as education, health, and social assistance, are the responsibility of a central authority.

TABLE 17					
Per Capita Operating Expenditures by Service					
Based on 71% Response: 94 Municipalities					
	Municipal Services	Expenditure	Operating	Expenditure	Operating
		NIS	Per Capita	NIS	Per Capita
		2007	NIS	2008	NIS
1	Town Planning / Roads	16,306,873	8.51	22,541,187	11.76
2	Street Construction, Rehabs & Paving	31,412,285	16.39	30,694,298	16.01
3	Rain Water Drainage	662,547	0.35	1,678,081	0.88
4	Streets Names and Numbering	45,240	0.02	94,033	0.05
5	Sidewalks	3,819,989	1.99	4,834,468	2.52
6	Street Lighting Network	7,043,742	3.68	7,647,512	3.99
7	Public Transport stands & Terminals	336,956	0.18	485,953	0.25
8	Water Supply	55,986,857	29.21	73,515,287	38.36
9	Electricity Distribution	166,545,782	86.89	185,527,276	96.80
10	Sewer System	12,643,379	6.60	9,414,499	4.91
11	Wastewater Treatment	3,715,173	1.94	3,778,701	1.97
12	Public Lavatories	306,919	0.16	360,353	0.19
13	Solid Waste Collection& Disposal	61,608,679	32.14	70,758,593	36.92
14	Solid Waste Treatment	1,827,826	0.95	1,851,480	0.97
15	Vegetables & Food Markets	3,012,213	1.57	3,340,947	1.74
16	Public Parks	4,731,300	2.47	6,917,552	3.61
17	Social Assistance Programs	592,532	0.31	499,910	0.26
18	Sport Facilities & Culture	735,319	0.38	988,266	0.52
19	Libraries	4,151,388	2.17	5,489,177	2.86
20	Museums	14,900	0.01	17,600	0.01
21	Regulation Control & Monitoring	1,802,215	0.94	1,974,831	1.03
22	Cemeteries	736,595	0.38	992,106	0.52
23	Schools	6,503,674	3.39	5,333,454	2.78
24	Health Centers	764,234	0.40	896,040	0.47
25	Slaughterhouses	3,364,850	1.76	4,067,066	2.12
26	Fire Fighting	3,645,036	1.90	4,499,918	2.35
27	Transit Management	1,165,792	0.61	1,366,238	0.71
	TOTAL	393,482,295	Avg. =7.60	449,564,826	Avg.=8.69

Source: Municipal executed budgets for 2007 and Expenditure Questionnaire for 2008.

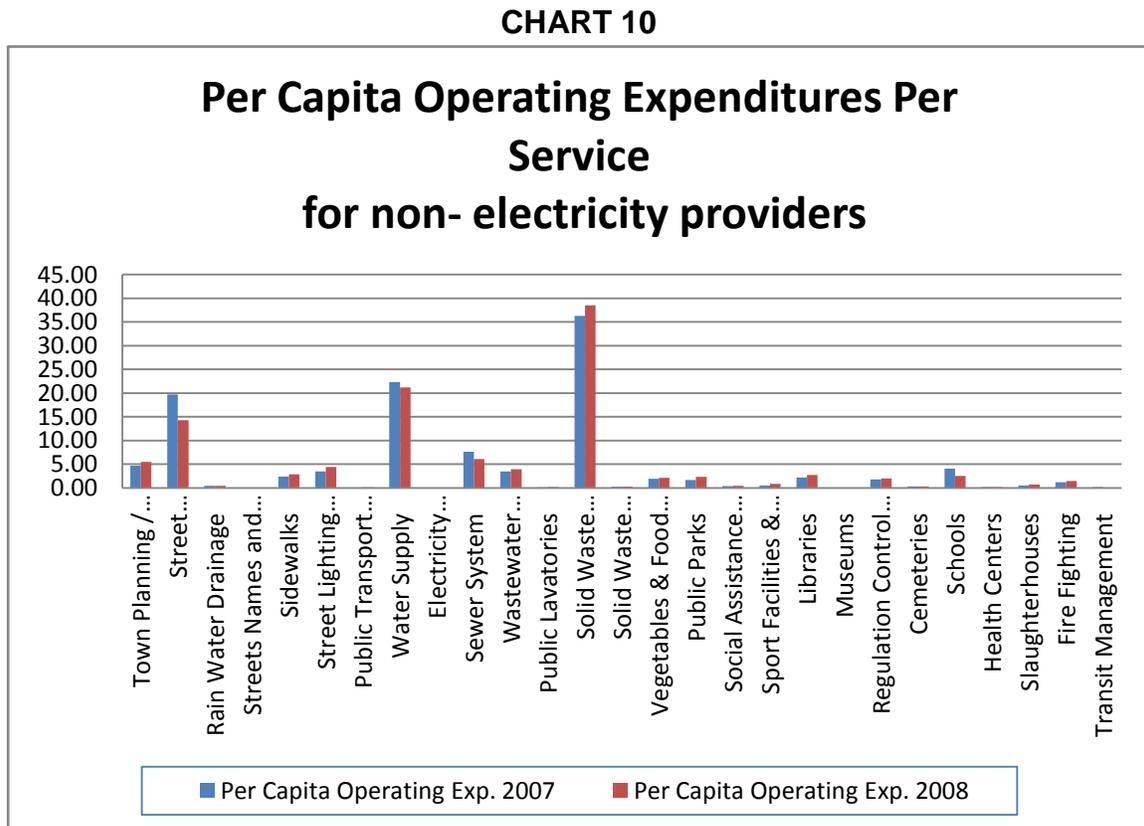
When analyzing per capita expenditures for *providers* and *non-providers* separately (as was done for the analysis of absolute spending) in order to identify potential differences in their expenditure structures, the findings are as follows:

The per capita results for *non-providers* show, as expected, the same pattern of importance in service provision, as was previously reported in the analysis of absolute values. The purpose here is to determine the significance of

the per capita amounts allocated to the provision of basic services. These results will be compared in the next chapter with their corresponding per capita revenues. The FY'08 per capita expenditures for the most relevant services are the following: (i) solid waste collection and disposal (NIS 38.50), (ii) water (NIS 21.16), (iii) streets (NIS 14.27), (iv) sewer systems (NIS 6.09), and (v) roads (NIS 5.50). The results for 2007 show the same order of importance in terms of yearly expenditure allocations, with very similar per capita amounts.

Comparing the results of *non-providers* (in Table 18 below) with respect to the findings gathered from all 94 municipalities (in Table 17 above), it may be concluded that *non-providers* are spending significantly less on services such as water, streets, and roads.

Chart 10 below illustrates the pattern on per capita spending by service for *non-providers*.



Source: Table 18.

Table 18 below includes the results on per capita spending by services for *non-providers*.

TABLE 18
Per Capita Operating Expenditures by Service
FY '07 and FY '08
(for *non-providers* from the sample of 94 municipalities)

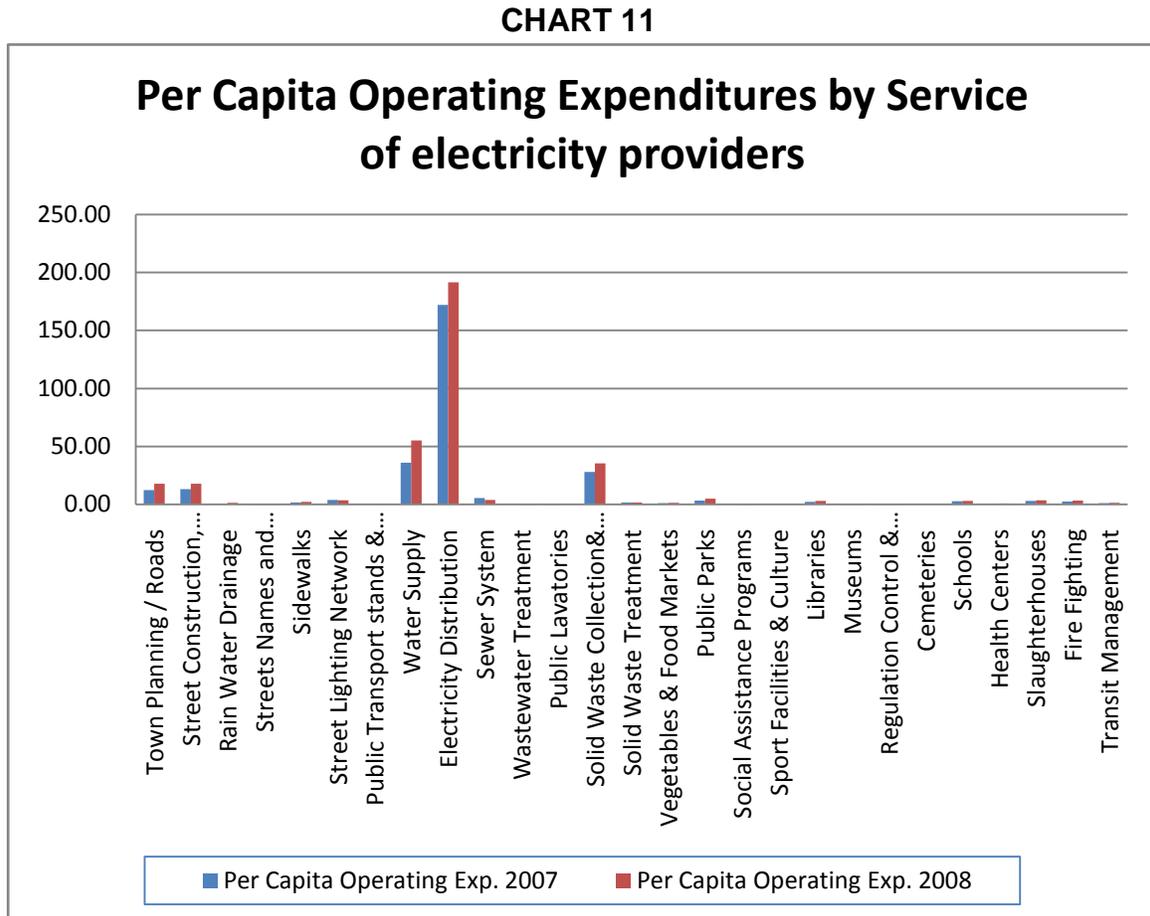
	Municipal Services	Expenditure NIS	Operating Per Capita	Expenditure NIS	Operating Per Capita
		2007	NIS	2008	NIS
1	Town Planning / Roads	4,456,149	4.70	5,220,615	5.50
2	Street Construc., Rehabs & Paving	18,695,423	19.71	13,542,620	14.27
3	Rain Water Drainage	445,480	0.47	461,932	0.49
4	Street Names and Numbering	17,840	0.02	80,313	0.08
5	Sidewalks	2,327,062	2.45	2,721,891	2.87
6	Street Lighting Networks	3,297,687	3.48	4,163,882	4.39
7	Transport Stands & Terminals	82,479	0.09	97,126	0.10
8	Water Supply	21,178,433	22.32	20,070,982	21.16
9	Electricity Distribution	0	0.00	0	0.00
10	Sewer Systems	7,289,977	7.68	5,782,507	6.09
11	Wastewater Treatment	3,331,123	3.51	3,765,581	3.97
12	Public Lavatories	163,335	0.17	171,346	0.18
13	Solid Waste Collection & Disposal	34,456,259	36.32	36,528,650	38.50
14	Solid Waste Treatment	294,832	0.31	249,258	0.26
15	Fruits & Vegetables Markets	1,878,114	1.98	2,053,731	2.16
16	Public Parks	1,601,083	1.69	2,213,715	2.33
17	Social Assistance Programs	392,387	0.41	406,856	0.43
18	Sports Facilities & Culture	557,181	0.59	823,139	0.87
19	Libraries	2,139,901	2.26	2,632,594	2.77
20	Museums	0	0.00	0	0.00
21	Regulation Control & Monitoring	1,755,613	1.85	1,924,243	2.03
22	Cemeteries	337,560	0.36	334,771	0.35
23	Schools	3,902,009	4.11	2,432,434	2.56
24	Health Centers	178,586	0.19	211,014	0.22
25	Slaughterhouses	502,255	0.53	682,415	0.72
26	Firefighting	1,189,550	1.25	1,369,966	1.44
27	Transit Management	180,618	0.19	56,430	0.06
	TOTAL	110,650,936	Avg. = 4.32	107,998,011	Avg. = 4.22

Source: Expenditure Questionnaire carried out by MDLF for this study.

The per capita results for *providers* of electricity show the same pattern of importance in service provision. The yearly per capita amounts allocated to the provision of the basic services are the following: (i) electricity (NIS 191.68), (ii)

water (NIS 55.22), (iii) solid waste collection and disposal (NIS 35.36), (iv) roads (NIS 17.89), and (v) streets (NIS 17.72).

Chart 11 below illustrates the pattern on per capita spending by service for providers.



Source: Table 19

The level of yearly per capita expenditures for the remaining services is small. For some, the yearly allocations are negligible. Most are below one shekel per year; at best they are as high as three shekels per capita per year. For instance, a typical Palestinian municipality with a population of about 8,000 inhabitants has a per capita expenditure of NIS 1 per year is equivalent to 8,000 shekels (about US\$2 thousand dollars). A municipality of this size spends about NIS 1,533,440 (US\$383,360 dollars) in energy distribution, NIS 282,880 (US\$70,720) in solid waste collection, and NIS 141,760 (US\$35,440) in both road maintenance and street maintenance, respectively. Clearly, an allocation of about NIS 1 per capita (US\$ 2,000) or less per year to a municipal service is a

negligible amount. Given this small scale, it cannot be argued that these services constitute a municipal priority. This result is important for public policy in regards to the current assignment of expenditure responsibilities as it highlights the 5 services that municipalities are willing to pay for. Table 19 below includes the results on per capita spending by service for *providers*.

TABLE 19
Per Capita Operating Expenditures by Service
FY '07 and FY '08
(for 46 electricity providers in the sample of 94 municipalities)

	Municipal Services	Expenditure NIS	Operating Per Capita	Expenditure NIS	Operating Per Capita
		2007	NIS	2008	NIS
1	Town Planning / Roads	11,850,724	12.24	17,320,572	17.89
2	Street Construc., Rehabs & Paving	12,716,862	13.14	17,151,678	17.72
3	Rain Water Drainage	217,067	0.22	1,216,149	1.26
4	Street Names and Numbering	27,400	0.03	13,720	0.01
5	Sidewalks	1,492,927	1.54	2,112,577	2.18
6	Street Lighting Networks	3,746,055	3.87	3,483,630	3.60
7	Transport Stands & Terminals	254,477	0.26	388,827	0.40
8	Water Supply	34,808,424	35.96	53,444,305	55.22
9	Electricity Distribution	166,545,782	172.07	185,527,276	191.68
10	Sewer System	5,353,402	5.53	3,631,992	3.75
11	Wastewater Treatment	384,050	0.40	13,120	0.01
12	Public Lavatories	143,584	0.15	189,007	0.20
13	Solid Waste Collection & Disposal	27,152,420	28.05	34,229,943	35.36
14	Solid Waste Treatment	1,532,994	1.58	1,602,222	1.66
15	Vegetables & Food Markets	1,134,099	1.17	1,287,216	1.33
16	Public Parks	3,130,217	3.23	4,703,837	4.86
17	Social Assistance Programs	200,145	0.21	93,054	0.10
18	Sports Facilities & Culture	178,138	0.18	165,127	0.17
19	Libraries	2,011,487	2.08	2,856,583	2.95
20	Museums	14,900	0.02	17,600	0.02
21	Regulation Control & Monitoring	46,602	0.05	50,588	0.05
22	Cemeteries	399,035	0.41	657,335	0.68
23	Schools	2,601,665	2.69	2,901,020	3.00
24	Health Centers	585,648	0.61	685,026	0.71
25	Slaughterhouses	2,862,595	2.96	3,384,651	3.50
26	Firefighting	2,455,486	2.54	3,129,952	3.23
27	Transit Management	985,174	1.02	1,309,808	1.35
TOTALS and Averages: '07 & '08		282,831,359	10.82	341,566,815	13.07

Source: Expenditure questionnaire carried out by MDLF for this study.

Below is an analysis of per capita expenditures based on the populations of various municipalities to help determine the potential effects of municipal size on service provision.

TABLE 20
PER CAPITA EXPENDITURES IN MAIN SERVICES
BY SIZE OF MUNICIPALITY
 (Based on a sample 94 municipalities)
 FY '08

MAIN MUNICIPAL SERVICES		PER CAPITA EXPENDITURES BY POPULATION CLASSES			
		Less than 5,000	5,000 to 10,000	10,001 to 50,000	More than 50,000
		NIS	NIS	NIS	NIS
1	Electricity	51.81	71.78	73.21	124.24
2	Water	29.18	31.55	20.52	53.40
3	Solid Waste	18.36	22.63	30.66	47.12
4	Streets	20.30	16.97	16.85	14.82
5	Roads	8.48	10.28	6.99	15.74
6	Sidewalks	9.17	1.82	4.83	0.67
7	Public Parks	3.89	1.07	1.92	5.55
8	Street Lighting	4.81	6.13	5.94	1.91
9	Sewer Systems	1.30	1.09	5.21	6.19

Source: Municipal expenditure questionnaire

The per capita results suggest that service provision is better in larger cities than in smaller ones (as illustrated in Table 20 above). Larger municipalities generally spend more in per capita terms in the main services than the smaller local councils. This is the case in regards to electricity distribution, water supply, solid waste collection and disposal, and roads. On the other hand, expenditures on services such as street maintenance and street lighting, with some exceptions, are proportional to the municipalities' population size. Another plausible explanation is that higher per capita expenditures in larger cities might be more costly due to overstaffing and other factors. However, empirical evidence (as illustrated in Annex 6) suggests that overstaffing is not concentrated in the largest cities; on the contrary, it varies independently of population size. In fact, the regression equation between number of per capita employees and municipal population size (as discussed in Section 2.8) shows no linear relationship between staffing and the size of the municipality.

These empirical findings also indicate that the smallest municipalities are unable to provide adequate levels of services; therefore, the policy of encouraging amalgamation among the smallest municipalities seems appropriate. This policy is also consistent with the intrinsic ability of larger jurisdictions to potentially benefit more from economies of scale in service provision.

Furthermore, it is usually argued that larger municipalities are better because of economies in general administration. Therefore, municipal amalgamation will automatically capture the potential cost savings (economies of scale), not only in the unit cost of service provision, but also in the overall administration cost. This study has empirically examined this argument based on executed budgetary data²⁴ of the *indirect* cost²⁵ of municipal administration in 130 municipalities. The statistical results from a cross-section analysis of whether there is a relationship between the *per capita cost of general administration* and the *population size of a municipality* indicate that there is no linear relationship between these two variables.²⁶

General administration expenditures, and especially expenditure efficiency, are to a large extent discretionary, and administration cost could also be related to socio-economic factors different from population size. Furthermore, the above result seems to be consistent with the broad deviations from the national average of per capita staffing across municipalities. Thus, it can be argued that amalgamation, in and of itself, will not necessarily result in savings in municipal general administration, as supported by executed budgetary data.

However, considering the small size of Palestinian municipalities, their services could be more cost efficient if they could benefit from some type of association with neighboring jurisdictions. By entering into partnerships or associations, smaller municipalities could, in principle, reach some economies of scale that would be otherwise impossible. If so, this would give these municipalities a greater ability to offer better coverage in services such as road rehabilitation, street maintenance, solid waste collection, and public lighting, among several other public works and services.

In fact, and not surprisingly, the empirical results show that most of the Joint Service Councils (JSCs) have been created to collaborate²⁷ in provision in services such as solid waste collection (28), solid waste treatment (18), street maintenance (12), and water supply (6), among others (as reported by every

²⁴ Given that the executed budgets for FY'08 had not been released by the end of the second quarter of 2009, this study had to use the most recent available budgetary data, which was that for FY'07.

²⁵ The main costs include salaries and wages of staff as well as administrative expenses, overhead, and operational expenditures of the general administration.

²⁶ The value of the RSQ of the regression equation is 9.8E-08. Separate regressions for these two variables were run for electricity *providers*, electricity *non-providers*, and for the Gaza Strip, and no indication of a linear relationship was found.

²⁷ An assessment of the determinants of JSC performance is important given the actual and potential role that they can play, considering both the fractioning of West Bank and Gaza into so many small LGUs, and the political difficulties of amalgamation.

municipality for each of these service in Annex 2). However, in practice, and for reasons that need to be determined in a separate study, many of the JSCs are not functioning properly, and a significant number of them seem suffer from the same problems of cost recovery as do municipalities.

Last, this section analyzes the differences in municipal per capita expenditures by services in the West Bank and the Gaza Strip. However, considering that the municipalities in Gaza do not distribute electricity, the relevant comparison carried out below is made with respect to municipalities in the West Bank that do not provide electricity either. In addition, taking into account that most of the municipalities in the Gaza Strip are in charge of water provision, the most meaningful comparison, as illustrated below, is with respect to municipalities in the West Bank that are water providers as well. These sub-samples include 28 LGs in the West Bank and 10 municipalities in the Gaza Strip with these same two characteristics (i.e., non-providers of electricity and providers of water); consequently the comparison is highly relevant to identify any differences and/or similarities in the current spending patterns between the West Bank and in the Gaza Strip.

The results of the comparison of these two sub-samples are as follows: The empirical findings indicate that the municipalities in the Gaza Strip are worse off in service provision. There are three main services that stand out because of the magnitude of their per capita expenditures, for both the West Bank and the Gaza municipalities. These three main services are solid waste collection and disposal, water supply, and street maintenance. In each of these three services per capita expenditures in Gaza are significantly lower than in the West Bank, as summarized in Table 21 and Chart 12 below. Sewer systems, however, are quite important in Gaza, (typical of more urbanized areas), in contrast to the West Bank municipalities. In general, the limited provision of services in the Gaza Strip, which are mainly related to sanitation, reflects the most pressing priorities given the fairly severe municipal budgetary constraints -- as will be shown in the revenue chapter.

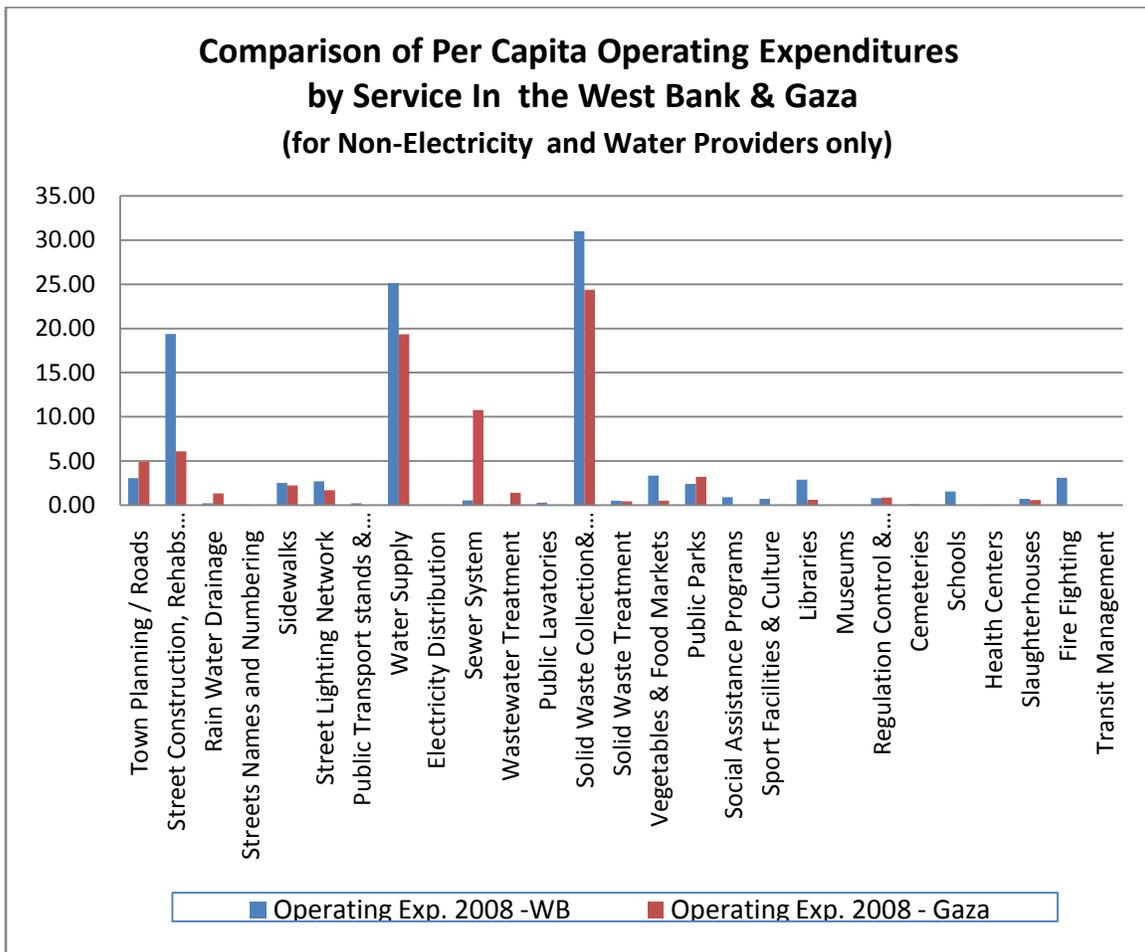
TABLE 21
COMPARISON OF PERCAPITA EXPENDITURES BY SERVICE
FOR THE WEST BANK AND THE GAZA STRIP
FY '08

MUNICIPAL SERVICES		PER CAPITA EXPENDITURES		
		West Bank: (28) Water Suppliers and Non-electricity Prov. ²⁸	West Bank: (46) Electricity Providers	Gaza Strip: (10) Water Suppliers and Non-electricity
		NIS	NIS	NIS
1	Electricity	0.00	191.68	0.00
2	Water	25.15	55.22	19.32
3	Solid Waste	31.01	35.36	24.36
4	Streets	19.38	17.72	6.08
5	Roads	3.06	17.89	4.91
6	Sidewalks	2.55	2.18	2.24
7	Public Parks	2.42	4.86	3.22
8	Street lighting	2.70	3.60	1.69
9	Sewer System	0.57	3.75	10.77

Source: Municipal expenditure questionnaire and corresponding sub-samples in parenthesis.

²⁸ This sample of 28 observations deliberately examines expenditures in the West Bank only among non-electricity providers and water providers, versus a sample of 10 municipalities in Gaza.

CHART 12



Source: Sample of 28 municipalities of water providers in WB and 10 in Gaza Strip.

In order to gain a greater understanding of current needs for services, the actual coverage and quality of these services is examined in the next section.

2.10 Coverage and Quality of Selected Municipal Services

Considering that the subject of quality and coverage of the services warrants a separate study, this section only offers a brief view of the current situation for some of the most important municipal services.

Empirical findings indicate that substantial improvements are needed in the coverage and quality of basic municipal services. For instance, in water supply, about one fourth (26.6%) of the existing water supply network is in urgent need of maintenance. In municipal roads, less than half (48.6%) of the total network is paved. In solid waste collection, municipalities have less than half (46.5%) of the equipment actually needed. Furthermore, the municipalities have

only about 82% of the classrooms that are required. Annex 5 offers a complete list of these needs²⁹ for each of the 132 municipalities.

Water Supply: Several municipalities were visited as part of this study, and the results (in Table 22) confirm that the situation varies significantly from one municipality to another. For instance, all households in Rafah are connected to the water supply service, but it is only available for 3.5 hours each day. In contrast, in Khan Younis the service is available for 18 hours, but only 75% of all households are actually covered.

In general, for the five municipalities that were visited the main issue regarding water supply is the conflict between hours of operation and actual household connections to this service. None of the municipalities visited in the Gaza Strip have water service available 24 hours a day. Also, the problem of rationing water is aggravated by the urgent need of adequate maintenance to the network, which would eliminate water losses.

Water supply, as reported in the expenditure section, is one of the priority services for most municipalities. In FY '08, recurrent expenditures on this service for the two groups of municipalities (*providers* and *non-providers*) were similar -- equivalent to 15.6% and 18.6% of their operating budgets, respectively.

²⁹ The needs are based on the baseline survey carried out during the preparation of the EMSRP project, as well as on specific questionnaires handed out to the six municipalities visited by the World Bank mission in March of 2009.

TABLE 22
QUALITY OF WATER SUPPLY
Selected Cases

Municipality	A: Total Number of Households	B: Number of Households Covered	C: Ratio: (B/A)	D: Is water drinkable	E: Hours per day	F: Consumption Per Capita
	No.	No.	%	Yes / No	Hr/day	Ltr./p.c./day
Atara	495	480	96%	Yes	NA	NA
Gaza	80000	76000	95%	80% only	8 to 10	80 to 100
Jabalia	22000	21780	99%	Yes	8	100
Khan Younis	32000	24000	75%	Yes	18	85
Rafah	13803	13803	100%	Yes	3.5	55

Source: Municipalities visited by the mission and questionnaire on services quality

Solid Waste Collection: The situation in this service also varies significantly across the LGs visited in both the Gaza Strip and the West Bank. For example (in Table 23), while the refuse collection service covers all households in Albireh and Gaza City, only 69% and 75% of them are covered in Khan Younis and Rafah. The main issue in this service in most of the municipalities visited is related more to coverage than to frequency in service provision. This result is consistent with the argument that there is a significant shortage in both spare parts³⁰ and in the equipment needed to provide this service.

Since shortage of staff and workers could be another reason to explain low service coverage this possibility was also briefly examined. As it appears, the level of per capita staffing in Khan Younis (3.28) and Rafah (5.07) is higher than both the average (2.7) and median (2.36) for the West Bank and Gaza (WB&G). Rafah, in particular, has one of the highest levels of staffing in WB&G. As such, empirical evidence suggests that understaffing is not the reason for low service coverage.

Table 23 below summarizes the findings on the coverage and quality indicators that were applied to these cases in WB&G. Other indicators for the 132 municipalities can be seen in Annex 5.

³⁰ It should be highlighted that in practically every municipality visited in the Gaza Strip, the issue of lack of spare parts and, hence, of operating equipment, was one of the most crucial problems facing local governments. Among other limitations is the need of adequate land-fills.

TABLE 23
QUALITY OF SOLID WASTE COLLECTION
Selected Cases

Municipality	A: Total Number of Households	B: Number of Households Covered	C: Ratio: (B/A)	D: Collection Number of days per week	E: Quantity of solid waste collected
	No.	No.	%	day/week	Ton/week
Albireh	13742	13742	100%	6	NA
Birzeit	1005	957	95%	5	NA
Atara	495	421	85%	3	NA
Gaza City	80000	80000	100%	7	3850
Jabalia	22000	21500	97.70%	7	800
Khan Younis	32000	22000	69%	6	500
Rafah	13803	10345	75%	6	28

Source: Municipalities visited by the mission and service quality questionnaire.

Street Maintenance: The distribution of this service illustrates the broad variance in service provision from one municipality to another. These differences may be due to financial and administrative capacities, which are generally associated with the size of the municipality and other factors. For instance, in Gaza City, the largest city in West Bank and the Gaza Strip, about 30% of the transportation network receives regular maintenance; in contrast, in Atara, one of the smallest jurisdictions, no regular maintenance is available. Meanwhile, in Birzeit, which benefits from highly qualified human resources, only about half of the transportation network is regularly maintained (see Table 24). As will be further discussed in the revenue chapter, it seems that the main cause of the low levels of street (and road) maintenance is financial. As was shown in the expenditure chapter, streets and roads are priorities in local infrastructure, but they are still limited by current municipal revenue sources for these types of expenditures. In per capita terms, as will be analyzed below, *providers*³¹ spent the equivalent of NIS17.72 in contrast with NIS14.27 for *non-providers*.

³¹ In this study the terms *provider* and *non-provider* refer to municipalities that provide or do not provide the electricity distribution service.

TABLE 24

**QUALITY OF ROAD TRANSPORT NETWORKS
Selected Cases**

Municipality	A: Total Number of Kmts (paved & unpaved)	B: Number of Kmts maintained from the municipal budget or other sources	C: Ratio: (B/A)
	Km	Km	%
Albireh	142	28	19.7
Birzeit	82	40	49
Atara	10	0	0
Gaza City	573	172	30
Jabalia	60	5	8
Khan Younis	360	11	3
Rafah	300	1.1	3.6

Source: Municipalities visited by the mission and service quality questionnaire.

Schools: The results (in Table 25) illustrate the typical case of some municipalities' ability to maintain all the schools in their jurisdictions (like Albireh and Birzeit); some maintain one third of them (such as Atara), and some, such as those in the Gaza Strip, have no responsibility in terms of school maintenance (such as Jabalia and Khan Younis). Most schools in the Gaza Strip are maintained by the UN (UNRWA) and the PA. These results emphasize the importance of setting national standards and appropriate financial mechanisms to ensure equal opportunities across municipalities. A local tax, such as the education tax, depends on the local economic base, which is directly correlated to population. Furthermore, the education tax is not available in most of the municipalities because it is supposed to be based on property tax assessments, which has very limited coverage in the West Bank.

About 83 municipalities (62.9%) report some form of recurrent expenditures, which primarily include schools maintenance. These municipalities are, in practice, assisting with operating expenditures in the education sector, which may also include renting places for education and paying for items such as desks, blackboards, books, and supplies. Part of the proceeds of the education tax also covers school construction.

Some of the issues with schools are inadequate sources of school financing, particularly considering the current shortages of classrooms, the problems associated with overcrowded schools, and other concerns.

TABLE 25
QUALITY OF SCHOOLS MAINTENACE
Selected Cases

Municipality	A: Total Number of Schools	B: Number of Schools Maintained from the municipal budget or other local sources	C: Ratio: (B/A)
	No.	No.	%
Albireh	11	11	100%
Birzeit	3	3	100%
Atara	3	1	33%
Jabalia	33	0	0%
Khan Younis	86	0	0%

Source: Municipalities visited by the mission and service quality questionnaire.

Street Lighting: The variance in coverage is fairly broad. There is virtually no pattern (see Table 26). Service coverage ranges from 100% (in Atara, a fairly small municipality) to 7% in Khan Younis, which is one of the largest municipalities in the West Bank and Gaza. In general, street lighting, as already identified in the expenditure section, is not a top priority in municipal service provision. For example, in FY '08, the operational expenditures in this service among municipalities that are *providers* and *non-providers* are both on the low side (i.e., 1% and 3.8%) of the services operating budget. In per capita terms, *providers* spend slightly more than *non-providers* (NIS4.39 and NIS3.60, respectively).

TABLE 26
QUALITY OF STREET LIGHTING
Selected Cases

Municipality	A: Total Number of Kmts:	B: Number of Kmts Maintained from the municipal budget or other sources	C: Ratio: (B/A)
	Km.	Km.	%
Albireh	4	1.2	30
Birzeit	19	5.2	27
Atara	7	7	100
Gaza City	245	122	50
Jabalia	40	10	25
Khan Younis	870	64	7.3

Source: Municipalities visited by the mission and service quality questionnaire.

Sewer Systems: Not all municipalities have sewer systems. Smaller municipalities, such as Birzeit and Atara generally rely more on septic and cesspits tanks, while larger municipalities, such as Gaza City, Jabalia, and Rafah, use more sewer systems. The financial needs in this sector are substantial. The Gaza Strip municipalities already allocate the highest per capita spending to this service and the coverage is still fairly low. However, it should be noted that in some large cities, like Khan Yunis, septic and cesspit tanks are used by more than half (65.5%) of all households (Table 27).

TABLE 27
QUALITY OF SEWER SYSTEMS
Selected Cases

Municipality	A: Total Number of Households	B: Households Connected to sewerage networks	C: Ratio: (B/A)	D: Number of Households Connected to cesspits or septic tanks	Ratio: (D/A) %
	No.	No.	%	No.	No.
Albireh	13742	12505	91%	NA	NA
Birzeit	1005	0	0	1005	100%
Atara	495	0	0	495	100%
Gaza	80000	72000	90%	8000	10%
Jabalia	22000	20000	91%	2000	9%
Khan Younis	32000	11000	34%	21000	65.50%
Rafah	13803	10850	79%	2953	21.40%

Source: Selected municipalities visited for this study and service quality questionnaire.

The above results support the argument that municipalities still need a significant amount of financial resources to close the gaps in physical infrastructure and to improve overall living conditions.

2.11 Expenditure Efficiency: Constraints and Opportunities

Several factors are currently affecting **expenditure efficiency** in a significant number of municipalities. Among them are the following: (i) the size of at least 20% of the municipalities is too small to allow for any economies of scale, particularly among the 27 LGs with populations between 1,000 and 5,000; (ii) a significant number of municipalities operate with the equivalent of a *soft budgetary constraint*, as is the case among the 58 municipalities that distribute electricity, many of which incur significant arrears (i.e., 'net lending'); (iii) the current accounting and budgeting systems of most municipalities do not provide them with the unit cost of service provision for the services they provide. This makes it practically impossible to determine whether expenditure efficiency is going up or down; and (iv) some municipal authorities argue that their budgets cannot cover the salaries of their staff. This seems to be the case particularly among some of the 27 LGs in the lowest population class. These LGs used to be village councils due to their small sizes and limited budgets. In fact, some of their tasks and duties used to be performed by community volunteers.

On the other hand, there are several **opportunities** that could potentially contribute to lower the unit cost, reduce local revenue administration costs, and enhance municipal service provision. Among these, the following may be worth considering: (i) amalgamation of small municipalities may allow them to save in administration and operation costs; it appears that some concrete efforts have already started in this direction; (ii) the mechanism of Joint Service Councils (JSC) has been in place for some time and apparently the results of this experience are mixed; however, given that the concept is in principle fundamentally sound, its application may warrant a revision; (iii) alternatively, other forms of partnerships across municipalities that might allow them to benefit from some economies of scale are worth considering; (iv) public-private partnerships may be an option among the largest municipalities, as private sector involvement may offer greater incentives to participate in local service provision; and finally (v) regional utilities or special districts for the provision of specialized services are and have been an option for the delivery of local services.

Furthermore, the strengthening of LGs' financial performance (especially through enforcing *hard-budgetary constraints*) and the development of the institutional capacities needed to manage unit cost budgeting and cost

accounting would be expected to enhance expenditure efficiency and service delivery.

Last, consideration should be given to the proposed Municipal Fiscal Restructuring Programs (MFRPs) to facilitate the transition process of those municipalities that need to move away from *soft-budgetary-constraints* and towards greater local fiscal discipline.

2.12 Conclusions

Local government functions, as established by law, are fairly comprehensive. They include most of the services typically deemed to be the responsibility of the municipality. The text of the law specifies 27 different functions, but is ambiguous as to which of these are required and which are optional. This compromises accountability in the provision of some services.

Based on the classification of municipalities by population size and number of services provided, most LGs fall in the group of those that provide between six and 12 services, although most of the operating budget of the sector as a whole, is allocated to only five or six services. These include electricity, water, solid waste collection, streets, roads, and street lighting.

However, not every municipality provides these six main services. Electricity is the largest expenditure (and revenue source) in the municipal sector, but only 58 municipalities are in fact in charge of electricity distribution. Though the pattern in service provision among *providers* and *non-providers* is in relative terms very similar, electricity *providers* (which may be characterized as operating under a *soft budgetary constraint*), tend to spend more in per capita terms on the most common services (such as water, streets and roads), than do *non-providers*. Furthermore, the results indicate that larger cities spend substantially more in per capita terms on services than do the smaller LGs. This suggests that service provision might be generally better in the larger cities than in smaller towns and villages.

These results indicate that larger cities (municipalities) may have a greater capacity to provide more services than do smaller ones. This finding supports the PA policy on amalgamation and any other equivalent means and ways to benefit from potential economies of scale in service provision.

Furthermore, the brief overview on quality and coverage of services indicates significant gaps in service provision. This finding confirms the argument

that most municipalities need to mobilize more local financial resources to be able to close current gaps and improve living conditions.

Empirical evidence confirms the hypothesis that municipalities in the Gaza Strip are worse off in the quality of local services than the LGs in the West Bank. The per capita expenditures in the provision of the most common services are significantly lower than they are in the West Bank. Also the results suggest that Gaza Strip municipalities allocate a much lower proportion of their municipal budget to capital expenditures/public works (i.e., 4% in the Gaza Strip versus 16% in the West Bank).

On the other hand, municipalities in the Gaza Strip tend to spend more of their recurrent budget in general administration than do the municipalities in the West Bank (25% in Gaza versus 14% in the West Bank). The proportion of salaries and wages (S&W) is greater among municipalities in the Gaza Strip, than in the West Bank (85% versus 75%). The average level of staffing is higher for municipalities in the Gaza Strip than among *non-electricity providers* in West Bank (2.9 employees per one thousand inhabitants for Gaza versus 2.4 for the West Bank).

CHAPTER III: REVENUES

This section examines the revenue sources currently available to municipalities for the financing of the services that they are, by law, *entitled to assume*.³² The first section describes such revenue sources and their legal basis while the second part reports on which of these revenue sources are most important in actual practice. Considering that the different revenues have been established through different laws, only the PA can reform or change them.

3.1 Assignment of Revenue Sources

The main municipal revenue sources are comprised of fees, taxes, user charges (i.e., utility revenues), transfers from the PNA, and municipal fines. Most revenue sources in the West Bank have originated and still operate under old Jordanian Laws, while in the Gaza Strip the legal basis of municipal revenues relies on Egyptian laws. The main features of these revenue sources are described below.

Fees: The main fees include: (i) crafts and industry fees, (ii) profession and industry fees, (iii) transportation fees and fines, (iv) construction permit fees, (v) public market fees, and (vi) signboard fees. Under current practice, water and electricity revenue are classified as fees which, for the purposes of this study, are examined under the section on user charges. In some cases, fees are similar to taxes (e.g. crafts, profession and industry), and in others, fees are similar to the purchase of a right (e.g. construction permits, signboards, and food markets³³).

(i) Craft and Industry Fees: Since 1953, under the Jordanian law³⁴ on Crafts and Industry, local councils have been authorized to collect these fees within their jurisdictions and have full autonomy on the budgetary allocation of this revenue. The fees were initially established in the Law and the approval of the PA Legislature is required before a new fee can enter into effect. During this current time period, the Law on Craft and Industry Fees may only be reformed by the MoLG (i.e., the executive), given the interruption in the normal operations of the PA's legislature. In practice, since LGs do not have full autonomy to change fees, this may be a legal constraint on the municipal governments to increase their revenues. A

³² It should be noted that the "Local Councils Law" is ambiguous; on the one hand it states that "the local body *shall assume* the following functions, while in the same paragraph, it establishes that "the local council is *entitled to assume* these responsibilities". In practice, however most of the functions seem to operate more as a '*legal option*' than as a '*legal responsibility*'.

³³ Strictly, revenue from food markets should be classified as rents (or user charges) from municipal property, rather than as fees.

³⁴ Jordanian Law on Crafts and Professions No.16, 1953.

summary of the different institutions with some specific authority over the most important municipal revenue sources is offered in Table 28 below.

(ii) Profession and Industry Fees: Jordanian Law³⁵ originally established these types of fees in 1966. They are fairly small and are numerous, since they vary by nature of the business, occupation, size of the industry, and location. A proposed reform is currently under preparation by MoF that will combine the profession and industry fees with the crafts and industry fee, since there is an overlap in these two laws. This reform will also transfer the collection of the profession and industry fees to those small local councils from which MoF still collects them.

Municipalities have full autonomy over the allocation of this revenue, although, as in the case of the crafts fees, MoLG approval is required for final rate setting before LGs may apply the proposed fee in their local councils. The fees in this Law may only be reformed by the MoLG. In practice, therefore, LGs face legal constraints to increase the revenue from this source without Central Government (CG) approval.

(iii) Transportation Fees and Fines: Article 25 of the Local Council Law (LCL) No. 1 (1997), and in accordance with the transport law, authorizes LGUs to receive from the MoF no less than 50% of both the transportation fees (i.e., licensing/registration vehicles fee) and the traffic tickets collected by the CG within their jurisdictions. As such, this source operates as form of revenue-sharing system between the CG and the LGs.

The collection of vehicle license fees is carried by the Ministry of Transport (MoT), while fines are collected by the police. These two entities transfer the proceeds to the MoF, which keeps 50% of them as PA revenue, and transfers the other half (in *net* 45%) to the local councils – after a deduction of 5% as management fee.

³⁵ Jordanian Law on Professions and Industries No. 89, 1966.

TABLE 28

INSTITUTIONS WITH AUTHORITY OVER MUNICIPAL REVENUE SOURCES						
	REVENUE SOURCE:	Establish Revenue Source***	Propose Rate Setting	Rate Approval	Revenue Collection	Revenue Allocation
	TAXES:					
1	Property Tax	PA/MoLG	PA	MoF	MoF	LG/MoF
2	Education Tax	PA/MoLG	PA	MoF	LG	LG
3	Roofing Tax/Villages	PA	LG	MoF	LG	LG
	USER CHARGES:					
1	Electricity	PA	LG	PEA	LG	LG
2	Water Supply	PA	LG	PWA	LG	LG
3	Refuse Collection	PA	LG	MoLG	LG	LG
4	Sewer System	PA	LG	PWA	LG	LG
5	Slaughterhouses	PA	LG	MoLG	LG	LG
6	Public Markets	PA	LG	LC	LG	LG
	FEES:					
1	Building License*	PA	LG	MoLG	LG	LG
2	Transport Fee**	PA	PA	MoLG/CoM	MoT/P	MoLG/CoM/LG
3	Public Property Fees	PA	LG	MoLG	LG	LG
4	Prof. & Ind. Fee	PA	LG	MoLG	LG/MoF	LG
5	Craft & Ind. Fee	PA	LG	MoLG	LG	LG
6	Signboard fees	PA	LG	MoLG	LG	LG

Key: PA: Palestinian Authority; LG: Local Government; MoLG: Ministry of Local Government; MoT: Ministry of Transport; P: Police; CoM: Council of Ministers, MoF: Ministry of Finance; LC: Local Council. PWA: Palestinian Water Authority; PEA: Palestinian Energy Authority. * Also referred to as Construction Permit. ** This refers to the Vehicle Registration Fee. *** Though several of these revenue sources were originally established by Jordanian and Egyptian laws, it is the prerogative of the PA to maintain, reform, or abolish them.

Any additional distribution³⁶ from MoF's 50% is decided by the Cabinet based on MoLG recommendations. Municipalities have no control over any additional revenue from this source. According to the law, MoF needs to take into account five criteria to decide on these allocations. The five criteria are: (i) Population, (ii) proportion of its contribution to the fund, (iii) the significance of the LG as a center, (iv) responsibilities outside those dictated by law, and (v) needs as identified by a development plan approved by the Ministry.

It should be noted that there is an initiative in MoLG and MoF to reform the transportation fee by transferring 90% of the proceeds and withholding only 10% as a management fee.

(iv) Construction Permit Fees: The current³⁷ system is based on the Jordanian Law on Organizing Cities, Towns, and Buildings (1966), which gives LGUs the authority to collect this type of fee. Decisions on issuing building permits depend almost entirely on zoning on a town plan. Therefore, to be able to collect building permits a municipality must have an approved town plan. The municipality is then obliged to provide a permit when a proposal is in accord with the town plan, and to deny one when it is not. In the absence of a municipal town plan, generally the district offices of MoLG, in coordination with the MoF office, are in charge of handling requests for building permits.

Municipalities, however, do not have the authority to set building permit fees. LGs may only propose such fees; ultimately it is the legal authority of MoLG to approve them. Consequently, this is another revenue source in which municipalities have to face a legal constraint that limits their financial autonomy.

(v) Public Market Fees: These fees are based on Article 15 of the Local Councils Law No. 1 (1997). Based on this law, local governments may establish and operate public markets and collect fees through ordinances. However, LGs in this particular case also need the approval of MoLG. These fees (or more accurately user charges or rents) are collected from the lessors³⁸ of commercial space located in the municipal fruit and vegetable markets. As such, LGs do not have the financial autonomy to

³⁶ Article 26 of the LCL.

³⁷ MoLG Regulation on Unified Construction Permit Fees, 1996

³⁸ Jordanian Law on Lessors and Lessees No. 62, 1953.

ensure that fees are set at a level that covers the operation and maintenance costs of the public markets. This paper will examine some of the effects on the balance between revenue and cost for this particular service that might be attributed to this lack of financial autonomy, among other factors.

- (vi) **Signboard Fees:** This fee has also been based on the functions established in Art. 15 of the Local Councils Law No. 1 (1997), which authorizes LGs to regulate advertisements and commercial boards.

Similar to all the fees described above, modification of the signboard fee requires the approval of the MoLG. Jordanian Law, which was amended by new regulations based on local Council Law No. 1 of 1997 (article 2 and article 15a, sets a cap of JD 25 per square meter (equivalent to 132 shekels). The revenue from this fee is usually significant only in the larger municipalities that are characterized by greater economic activity.

Briefly, local revenue mobilization that originates from fees may be constrained because approval authority is centralized at the MoLG rather than being decided by the local councils. Local authorities usually have a better understanding than does the MoLG of their unique socio-economic circumstances and the actual possibilities of mobilizing local revenue.

Furthermore, centralization of the municipal revenue authority may limit the ability of some jurisdictions to match the preferences of local residents (as supported by their willingness to pay) with the corresponding supply of public goods and services. If this is the case, the actual centralization of the revenue system would compromise economic efficiency.

Previous studies have argued *“one should question whether these minimal fees are anything more than “nuisance taxes”, since often the revenue raised with such minor taxes and fees [as will be confirm by the empirical evidence in this chapter] do not justify the administrative and compliance costs imposed on local residents.”*³⁹

User Charges: As noted above, these mainly include charges to subscribers of electricity, water, and solid waste collection among other local services. It is important to differentiate these charges from municipal fees, since subscribers purchase services that directly benefit their household unit (while the

³⁹ UNDP/PAPP. Support to Local Government Reform Project. Stage One: Diagnostic Report. p. 99.

payment of most typical municipal fees generally do not involve the purchase of goods or a household service.).

Adequate user charges, or tariffs, are expected to cover the cost of providing the service in order to insure its financial sustainability. As already pointed out in the expenditure chapter, however, substantial improvements could still be made in estimating the unit cost of municipal services. The various institutions with authority to establish user charges, propose the rates, approve such charges, do the billing and collection and decide on the allocation of corresponding revenue are summarized in Table 28 above.

- (i) **Electricity:** In the West Bank, the charges for electricity distribution are collected by the 58 municipalities that currently provide this service. In the Gaza Strip, GEDCO distributes 60% of electricity and the Gaza Power Plant supplies the remaining 40%. Therefore, electricity charges do not constitute a municipal revenue source in the Gaza municipalities.

LGs providing this service are legally required to request the approval of the tariffs by the Electrical Sector Regulatory Council. This Council considers the applications and makes recommendations to the Palestinian Energy and National Resources Authority (PEA), which issues the approval⁴⁰. Municipalities have complete autonomy in the collection of the electricity bills and the allocation of the electricity revenue. Based on the findings of studies⁴¹ on the causes of electricity arrears, it is not so much the tariff that operates as a constraint in local revenue mobilization, but rather the inefficiency of collection of the retail sales invoices. This is further aggravated by the *diversion* of a substantial proportion of electricity revenue for the financing of other municipal expenditures, while making only partial or no payments to the IEC. As such most municipalities providing electricity, in practice, benefit from the equivalent of a *soft budgetary constraint* – i.e. the equivalent of central government *indirect* subsidies.

- (ii) **Water:** Charges for water supply in the West Bank and Gaza are collected by 106 municipalities that currently provide some form of service either on their own or simultaneously with other providers operating in different communities. Water tariffs must be approved by the Local Council and the

⁴⁰ Local Councils Law No. 1, 1997, Article 15 B.

⁴¹ Garzon, Hernando. *Municipal Development Fund: Main Causes of Municipal Electricity Arrears and Expected Fiscal Impact of Transferring the Electricity Service*. Ramallah, West Bank and Gaza. January 28, 2009.

Palestinian Water Authority (PWA).⁴² However, similar to the electricity sector, revenue mobilization constraints to cover O&M costs do not generally emerge from the tariff structure but mainly from revenue collection inefficiencies. These constraints are the result of *free-riders* in the system and a weak enforcement system, among other crucial factors such as high unemployment rates and very low income levels. The municipalities (and the utilities) “*cope by not paying for the bulk water supplied by either Mekorot or PWA*”⁴³. However, with respect to municipal wells, the financial sustainability of the service cannot be passed on to other institutions; it has to be faced directly by the municipality. This reduces the possibility of using this revenue source as a *soft budgetary constraint*, in addition to the fact that revenue from water is equivalent to only about 38% of the revenue from electricity.

- (iii) **Refuse Collection:** In both the West Bank and Gaza, charges for refuse pick up are collected by about 120 municipalities that provide this service. Four municipalities have reported that they do not provide this service, nor does any other entity. For the remaining 8 municipalities, this service constitutes a revenue source for the JSC that are in charge of refuse collection. Tariffs for solid waste collection also require the approval of the MoLG. The financial situation of solid waste removal seems to be the most critical of all the services that are supposed to be financed through user charges, as will be illustrated in Chapter IV. This may be due to the fact that enforcement of payment is relatively more difficult than it is for electricity and water since, at least in principle, these services could be interrupted. On the other hand, the frequency and quality of this service may seem less critical to the municipal administration than the budgetary allocations for electricity and water. These factors may compromise the performance of this service, which is weakened even further due to an apparent lack of accountability in service provision. Table 28 above includes the inter-institutional arrangements for other services that are expected to be financed through user charges.

Taxes: Only some municipalities in the West Bank and Gaza benefit from three local taxes, all of which are property-related. These are the property tax, the housing/room tax, and the education tax. A summary of these three legal tax sources follows:

⁴² Local Councils Law No. 1, 1997, Article 15 B.

⁴³ The World Bank, “Assessment of Restrictions on Palestinian Water Sector Development”. Middle East and North Africa Region, Sustainable Development Sector Note April 2009. P. 20.

- (i) **Property Tax:** In the West Bank⁴⁴ this tax is collected by the MoF, while in the Gaza Strip⁴⁵ it is directly levied by each of the 25 municipalities. However, it is important to note that MoF does not levy the property tax in every municipality in the West Bank but only about one fourth of them (i.e., specifically, as of the end of FY '08, it collected it in 29 out of the 107 municipalities.).

The property *tax base* is the annual rental value of property, which constitutes the *net* rental value of land and buildings. The *tax rate* in the West Bank is 17%, while in Gaza it ranges between 10% and 15%. These rates are applied on 80% of the annual rental value. In the West Bank, MoF returns 90% of the collections to the municipalities based on the origin of the tax proceeds (after deducting 10% as a management fee).

It should also be noted that for those municipalities that distribute electricity and are in arrears, the MoF deducts part of those arrears from the property tax collections that the Ministry is supposed to transfer to them. This is done because the MoF has to pay on behalf of the municipalities for such arrears, through deductions in the VAT that the Government of Israel transfers to the PA. Most municipalities do not question this procedure since their arrears are much greater than the revenue that they would have received from property tax collections.

- (ii) **The Housing Tax:** This tax is a fixed amount levied on each housing unit based on the number of rooms. It is also called the roofing or room tax. The levy is fairly small and is based on old legislation that applies mainly to village councils in both the West Bank and the Gaza Strip. Some village councils that were raised to the status of municipality have kept this revenue source. Currently there are 33 municipalities that still levy this village tax. In the rural areas of the West Bank, only irrigated land is supposed to be taxed.
- (iii) **Education Tax:** This tax is levied by only about 42% of the municipalities in the West Bank, and local governments in the Gaza Strip do not collect it. Its *tax base* is also the *net* rental value of property, and its *tax rate* is 7% to be applied on the *net* rental value as assessed by the MoF. Though the MoF collects the property tax in only 29 municipalities, 46 LGs actually levy the education tax. This suggests the need of some LGs to

⁴⁴ In the West Bank the property tax is based on the Jordanian Land and Building Tax Law No. 11 of 1954 and subsequent amendments to this law in 1967.

⁴⁵ In the Gaza Strip, local governments apply Egyptian law.

mobilize local resources, their capacity to collect it, and the apparent willingness of communities to contribute to the financing of expenditures on schools.

It should be noted that the municipalities in the West Bank collecting the education tax are supposed to deposit this revenue in a separate bank account, and may only use it for the financing of both capital expenditures in building schools and recurrent expenditures primarily in school maintenance. In some cases, however, these municipalities assist the Ministry of Education with operating expenditures, such as renting buildings to use as schools and paying for items such as desks, blackboards, books, and school supplies. Furthermore, part of this revenue may also be allocated to cover recurrent expenditures for the maintenance of public libraries. Capital expenditures in education, which are the most important allocations of these funds, generally include school construction, rehabilitations, and new classrooms. School operating expenditures related to staffing and teachers' salaries are the responsibility of the Ministry of Education.

Central Government Transfers: These refer to budgetary revenue from the Central Government (CG) to the municipalities, in the form of small, generally one-time discretionary grants-in-aid, for specific purposes.

Grants-in-aid are resources in cash that some municipalities may receive through the MoLG in case of emergencies, or for other specific operating expenditures. The decision to make an emergency transfer is the responsibility of the Council of Ministers based on MoLG recommendations.

It must be noted that this section refers to CG budgetary fiscal transfers in cash only; it does not include CG transfers in kind. These, in principle, are not supposed to be reported in the operating budget since they only cover cash flow. For example, financial aid for capital expenditures channeled through the MDLF in-kind is generally not reflected in the municipal budget. MDLF *transfers* operate as an extra-budgetary account for the benefit of the municipalities. This Fund directly pays suppliers for specific municipal public works, goods, and services. MDLF *transfers* to the municipal operating budget in the case of emergency situations, such as those provided to municipalities in Gaza, are also *transfers* in kind⁴⁶. It should be noted that the PA currently does not use *matching grants* to induce LGs to invest in the provision of certain services that might be considered of national interest.

⁴⁶ The revenue questionnaire attempted to measure the magnitude of revenue in kind; particularly that which supports the capital budget functions.

3.2 Brief Assessment of the Main Revenue Sources

Local Taxes: The fact that the **property tax** is not levied in all jurisdictions is perhaps the most unusual feature of tax policy/practice in the West Bank and Gaza. The need for additional financial resources for infrastructure finance is evident, however, and consequently the 78 municipalities where this tax is not being collected could benefit substantially from this untapped fiscal source.

In contrast to the property tax, the **room tax** is in principle and in practice a *regressive* tax, because the number of rooms in a housing unit is not a measure related to the market value of a property, or its rental value, or the corresponding ability to pay of the taxpayer. Clearly, a fixed levy represents a greater percent for the household with a lower income. Consequently, this is not a form of taxation that should be encouraged.

The **education tax** is also atypical. Generally, the education function, including schools, works best as a national responsibility. As has been stated above under municipal services, even if this tax were only meant for school maintenance and/or rehabilitation, these functions are not deemed to be local responsibilities. This is particularly true because not every municipality necessarily has the required fiscal *capacity* to support these functions within certain minimum standards.

Fees: Several concerns arise from some of the current fees. The most pressing relate to the fact that there are numerous fee structures that yield very low revenues while imposing substantial administrative costs, rendering many of them uneconomical. Also, some of these fees have become redundant due to overlaps.

User Charges: Municipalities do not have full autonomy in setting their user charges. However, user charges are generally at a level that could potentially recover the cost of service provision provided revenue collection is efficient. This usually is the case in electricity water and solid waste removal.

However, it should be noted that, particularly in the case of electricity, the actual cost of providing this service has been artificially reduced by those municipalities that have failed to comply with the full payments of wholesale electricity purchases to the IEC. This situation (referred to as *net lending*) has created significant distortions in both the revenue and expenditure structures in a large number of municipalities, compromising sound fiscal management.

This lack of fiscal discipline and accountability in municipal finance will be gradually reduced by sectoral policy, especially through the transfer of the municipal electricity service to regional utilities. The associated negative fiscal impact of this reform on municipal finance will of course need to be addressed as part of a municipal fiscal restructuring program. Both the MoF and the MoLG have recognized this situation and are considering specific actions.

Loans and Credits: Local councils are authorized⁴⁷ to borrow funds from any party upon the approval of the MoLG. However, in the event that such a process requires the guarantee of the executive authority, the Cabinet is supposed to be consulted and its approval obtained to carry out such a process. Briefly, this process requires the following actions: (i) the guarantee of the executive authority, (ii) a consultation with the cabinet and (iii) executive approval in order to allow the local councils to carry out the necessary processes to obtain loans and credits

In FY'08, only one⁴⁸ municipality (Jabalia) borrowed from a commercial bank. The equivalent to a guarantee (i.e., a letter of approval) from the executive authority (MoLG) was obtained by Jabalia in order to obtain this loan for the financing of operating expenditures.

Also, only two municipalities (Dura and Halhul) borrowed from commercial banks for the financing of small public works. The specific criteria that MoLG uses to approve or reject an application are not specified by law, and in practice are not clearly known.

3.3 Revenue Sources in Practice

Based on the consolidated results for the sample of 94 municipalities, the empirical findings⁴⁹ show that user charges for electricity and water supply are the main recurrent municipal revenues. Revenue from electricity is the highest, with about 36% of total municipal proceeds coming from this source, while only about 14.27% of revenues originate from water sales. The solid waste collection and disposal fee (2.9%) is the smallest user charge currently being collected.

The next most important revenue source is the property tax (4.44%)⁵⁰, while the education tax (2.3%) is the smallest tax source. Other non-tax sources,

⁴⁷ As established in Article 21 of the Local Councils Law, No.1, 1997.

⁴⁸ This result is based on the information on revenue sources provided by the sample of 94 municipalities.

⁴⁹ The findings are based on the 94 municipalities that responded the revenue questionnaire.

⁵⁰ It must be noted that the property tax revenue reported in the municipal budgets refers to the *net* transfers from the MoF, after deductions of electricity and water arrears. Currently 10 municipalities in which the PT is being collected by MoF are electricity providers. Therefore, this

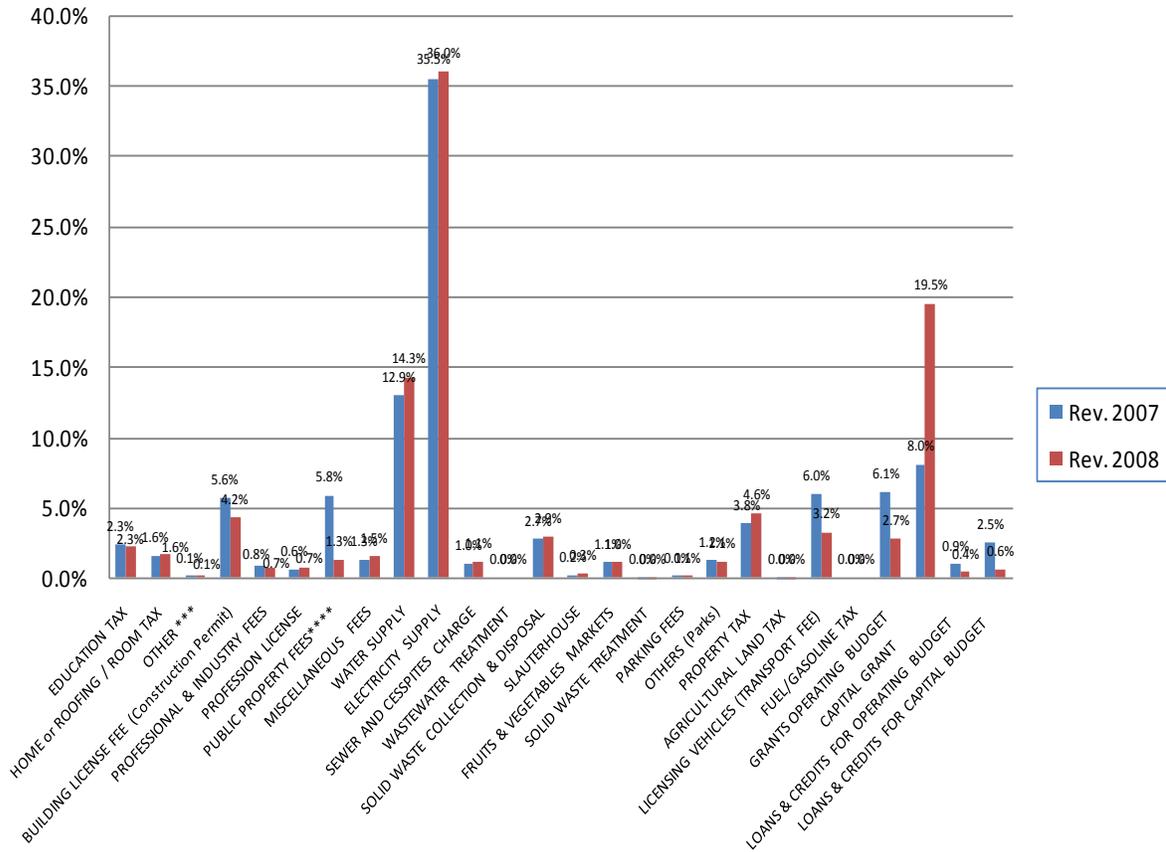
in order of importance, include construction permits (i.e., building license fees -- 4.23%), and the CG transfers of revenue sharing in the registration of vehicles (i.e., the transport fee – 3.22%). While the relative weights of these operating sources are fairly low, the relative weights of the rest of the *recurrent* revenue sources are practically insignificant; they fall in the range of 1% or less of the total revenues, as illustrated in Table 29.

Per capita revenues will be examined in the next section. It should be noted that the above comparisons are made with respect to the consolidated revenues reported in the questionnaires for all the sampled municipalities. These overall comparisons are only meant as indicators of the relative magnitudes of the different revenue sources in the municipal sector as a whole. Chart 13 below illustrates the relative weights of these different revenue sources.

budgetary figure underestimates the relative importance of the PT. Considering this situation, the relevance of this tax is analyzed based on actual tax collections that were obtained from the MoF for this study.

Chart 13

Municipal Revenues : Relative Weight by Source



Source: Table 29

Table 29 below provides the absolute and relative weights for each revenue sources for FY '07 and FY '08.

TABLE 29
MUNICIPAL REVENUE SOURCES: Relative Weights
Number of Responders: 94 Municipalities (71.2%)

Bud. Code	Revenue Sources	Rev. 2007 (NIS)	Rev. 2008 (NIS)	% Rev. 2007	%Rev. 2008
1	EDUCATION TAX	11,304,256	14,375,756	2.30	2.26
2	HOME or ROOFING / ROOM TAX	7,746,209	10,117,284	1.58	1.59
3	OTHER	385,266	508,500	0.08	0.08
4	BUILDING LICENSE FEE (Const. Per.)	27,654,131	26,922,033	5.63	4.23
5	PROFESSIONAL & INDUSTRY FEES	3,932,771	4,631,085	0.80	0.73
6	PROFESSION LICENSE	2,845,645	4,294,044	0.58	0.67
7	PUBLIC PROPERTY FEES	28,688,210	8,200,245	5.84	1.29
8	MISCELLANEOUS FEES	6,252,360	9,517,047	1.27	1.49
9	WATER SUPPLY	63,480,088	90,833,576	12.91	14.27
10	ELECTRICITY SUPPLY	174,509,509	228,915,056	35.50	35.95
11	SEWER AND CESSPITES CHARGE	4,975,701	7,029,405	1.01	1.10
13	SOLID WASTE COLLECTION & DISP.	13,357,099	18,497,597	2.72	2.91
14	SLAUTERHOUSE	801,207	1,691,176	0.16	0.27
15	FRUITS & VEGETABLES MARKETS	5,357,434	6,604,459	1.09	1.04
16	SOLID WASTE TREATMENT	4,330	400	0.00	0.00
17	PARKING FEES	404,684	467,423	0.08	0.07
18	OTHERS (Parks)	5,807,193	7,014,885	1.18	1.10
19	PROPERTY TAX (C.G):	18,383,505	28,293,087	3.74	4.44
20	AGRICULTURAL LAND TAX (Mun.)	29,706	47,421	0.01	0.01
21	LICENSING VEHICLES (TRANSP. FEE)	29,325,485	20,534,555	5.97	3.22
23A	GRANTS OPERATING BUDGET (C.G)	9,490,448	1,810,778	1.93	0.28
23B	MDLF	4,819,953	7,995,518	0.98	1.26
23C	Donors	12,098,771	2,242,358	2.46	0.35
23D	PS & community donation	3,452,745	5,365,785	0.70	0.84
Sub	GRANTS OPER. BUDGET (A+B+C+D)	29,861,917	17,414,439	6.07	2.73
	CURRENT REVENUE SOURCES	435,106,706	505,909,473	88.52	79.45
24A	CAPITAL GRANT (C.G)	995,246	4,012,758	0.20	0.63
24B	MDLF	2,616,334	14,360,756	0.53	2.26
24C	Donors	34,345,389	98,719,336	6.99	15.50
24D	PS & community donation	1,491,022	7,030,579	0.30	1.10
	CAPITAL REVENUE SOURCES/GRANTS	39,447,991	124,123,429	8.02	19.49
Sub	LOANS & CREDITS FOR OP. BUDGET	4,518,423	2,301,005	0.92	0.36
Sub	LOANS & CREDITS FOR CAP. BUDGET	12,223,744	3,660,530	2.49	0.57
	TOTAL REVENUE SOURCES	491,625,564	636,749,175	100%	100%

Source: Municipal Revenue Questionnaire: Responses of 94 municipalities -- Annex 4.

Considering that not all the municipalities in West Bank and Gaza have access to the same revenue sources, it is also important to determine their

relative importance among those municipalities that actually have access to each revenue source.

Though the results of this disaggregated analysis indicate the same relative importance of the main revenue sources, it is worth highlighting the following findings: (i) Electricity revenue represents more than half (63.5%) of the municipal current revenue budget for the average provider. The median share is slightly higher (66.5%) than the average; (ii) revenue from water is equivalent to about one fifth of the revenue budget (while the median is 15%), and (iii) the relative weight of construction permits (4.1%), the fourth main revenue source, comes out to be fairly close to its relative weight (4.2%) in the sector as a whole. Table 30 below summarizes these findings.

TABLE 30						
CURRENT REVENUE FOR SELECTED SOURCES						
AS A PERCENT OF THE RECURRENT REVENUE BUDGET						
FY 2007						
MUNICIPAL REVENUE SOURCE	Number of LGs collecting	Sample size	Municipal Source Current Revenue	Municipal Recurrent Revenue Budget	Average Revenue across LGs' Shares	Median Share on Recurrent Revenue Budget
			NIS Millions	NIS Millions	%	%
1. Electricity	58	40	174.5	408.4	63.50%	66.50%
2. Water	106	74	63.5	604.0	21.60%	15.20%
3. Solid Waste	121	81	13.4	393.3	5.70%	4.30%
4. Construction Permits	109	92	27.7	682.3	5.90%	2.90%
5. Property Tax	29	29	64.7	618.0	16.47%	12.23%
6. Education Tax	46	37	11.3	551.0	2.69%	1.64%

Source: Municipal Executed Revenue Budgets for FY '07, and MoF PT Collections.

In interviews held in the West Bank with mayors of small, medium-sized, and large municipalities, both mayors and their technical staff stated that the amount of **potential property tax revenue** that is not being collected by the MoF is significant. It was further stated that the lack of local authority over the administration of the property tax imposes a significant opportunity cost to those 78 municipalities in which the PT is not being collected.

Empirical evidence strongly supports these arguments. Property tax revenue in the 29 municipalities in the West Bank where it is being collected by MoF is significant. In FY'08, for instance, in Albireh (with a population of about 40,000) the percent share of the property tax was almost half of their current revenue budget (49.36%), while in a fairly small town such as Turmosayya (with a population of about 4,000) the PT share in the municipality's current budget was 31.6%. Also, in a medium-sized municipality, such as Bethala (population: 16,700), the relative weight was more than one third (38.7%) of their current revenue budget.

However, there are also examples in relatively large municipalities where the property tax seems to be fairly limited or underutilized, such as in Qalqilia (4.5%), Hebron (10.3%), and Nablus (3.5%). These three municipalities fall below both the average (16.4%) and the median (12.2%) share for the 29 municipalities. Clearly, empirical evidence supports the case for expanding the implementation of the property tax to the rest of the Local Governments.

However, consideration needs to be given to several limiting factors. Perhaps the most pressing constraint that seems to be blocking the implementation of the property tax in the remaining 78 West Bank municipalities is the legal need to have a Master Plan (or a Town Plan) in place. However, these plans need to be first approved by MoLG before the MoF is legally able to proceed with the assessment of lands and buildings. MoF can legally only assess lands that have been incorporated into the Town Plan. Once the plan is approved and actually adopted, then the MoF may proceed with the identification and review of all the relevant property registers of lands and buildings. However, current property registers appear to be either incomplete and/or outdated, which also constitutes a constraint.

Other factors are, of course, the institutional capacity that needs to be in place to administer the data bases related to this tax, as well as the funding to update municipal cadastres, and the required IT equipment, software, plotters, mapping, and office equipment. Current cadastres need to be updated not only in the legal documentation regarding ownership, but also in the current physical description and property dimensions (including lands and buildings), as well as the corresponding fiscal/tax assessments on the rental values of such properties.

Other limiting factors on the actual coverage of the tax base (and taxpayers), especially in some of the larger cities, include the fact that the property tax cannot be applied in Israeli settlements, refugee camps, or land in area C.

Table 31 below illustrates on the actual relevance of the property tax collection in the 29 municipalities in which MoF levies this tax.

TABLE 31

THE RELEVANCE OF THE PROPERTY TAX						
No	Municipality	Recurrent Budget '07	Property Tax Collection 2008	Population	Percent Share in Recurrent Budget	PT Collection Per Capita NIS
1	Ramallah	28,346,914	10,909,734	25,467	38.49	428.39
2	Albireh	22,696,083	11,203,752	39,538	49.36	283.37
3	Nablus	265,493,863	9,477,327	134,116	3.57	70.67
4	Hebron	84,978,564	8,757,937	116,003	10.31	75.50
5	Betlahem	11,375,308	4,143,972	29,927	36.43	138.47
6	Jenin	22,307,574	4,295,574	35,760	19.26	120.12
7	Tolkarem	49,730,838	2,863,404	53,896	5.76	53.13
8	Jericho	15,276,945	1,868,315	20,416	12.23	91.51
9	Qalqilia	39,790,228	1,814,358	44,709	4.56	40.58
10	Dora	9,038,178	1,138,124	21,554	12.59	52.80
11	Betjala	3,860,214	1,496,726	16,689	38.77	89.68
12	Betonyeh	7,003,562	1,758,703	13,274	25.11	132.49
13	Betsahor	3,241,918	1,036,875	15,388	31.98	67.38
14	Kabatyeh	6,961,854	280,028	19,694	4.02	14.22
15	Yaabad	4,979,976	96,199	14,429	1.93	6.67
16	Arrabeh	2,257,240	92,885	9,990	4.11	9.30
17	Tobass	4,023,434	295,490	16,087	7.34	18.37
18	Anabta	4,478,925	205,076	7,315	4.58	28.03
19	Der ghsoon	2,271,800	80,614	9,456	3.55	8.53
20	Salfeet	8,786,310	398,743	9,756	4.54	40.87
21	Der Debwan	1,294,422	287,454	6,928	22.21	41.49
22	Bir zeat	3,054,383	525,871	6,624	17.22	79.39
23	Selwad	974,495	285,417	7,253	29.29	39.35
24	Almazraa	599,612	136,976	5,173	22.84	26.48
25	Tormos aya	671,658	212,433	4,448	31.63	47.76
26	Aldoha	1,055,605	120,535	7,089	11.42	17.00
27	Al Eiazaryyeh	3,907,757	170,667	17,398	4.37	9.81
28	Halhol	3,131,964	550,207	21,803	17.57	25.24
29	Yatta	6,434,542	164,376	42,853	2.55	3.84
Total		618,024,166	64,667,772	773,033	10.46	83.65
Source: Property Tax collections from MoF.				Average =	16.47	71.05

Based on the property tax national median of 41.49 Shekels per capita, it is estimated that the yearly revenue lost by the 78 West Bank municipalities in

which the property tax is not being collected ⁵¹ may be about 29.1 million shekels, or the equivalent of about \$7.3 million dollars, annually.

Municipal financial managers also believe that there is a need for a more *transparent* property tax management information system (PT-MIS) that should offer, among other things, current information on property tax assessments, tax liabilities, billing, actual collections, and tax arrears. It appears that most of this information is at present unknown by the municipalities. Furthermore, it is claimed that this PT-MIS should also make *transparent* the amount that the MoF currently withholds to cover the 10% collection fee.

Considering, among others factors, the forthcoming *negative net fiscal impact* on municipal revenues, it is essential to equip municipalities with adequate local revenue sources. Based on the current situation of the revenue structure, and the availability (or the lack) of strong local tax sources, a fairly difficult fiscal situation is foreseen for numerous municipalities. Therefore, it is important to develop and strengthen the municipal property tax, among other local sources.

Furthermore, considering that the electricity service will be transferred from 58 municipalities to regional utilities, the above findings highlight the importance of **a municipal fiscal restructuring program (MFRP)** that would assist the relevant municipalities in making adjustments for this transition. The proposed MFRP would identify those municipalities that will face the most critical financial/fiscal adjustments, and would provide them with technical assistance on how to gradually restructure both expenditure obligations and local revenue collection. These adjustments would be guided, among other things, by national indicators⁵² on fiscal and financial performance in order to bring their budgetary situation from a current fiscal deficit to more balanced operations within a specified timeframe.

Also, based on the fact that almost two thirds (63.12%) of the operating revenue budget comes from electricity, when estimated only for electricity *providers*, then, it may be inferred that the transfer of this service will probably

⁵¹ The population of the 78 municipalities (107-29) is 701,771, times NIS 41.49, yields NIS 29.1 million.

⁵² Performance indicators would be considered in order to guide and monitor the strengthening of both expenditure efficiency (in areas such as staffing, salaries, services unit cost, etc.), and revenue collection efficiency (in areas such as user charges of main municipal services in order to ensure cost recovery and tax enforcement -- whenever it is relevant, etc.).

have a large net fiscal impact on municipal finance. In fact, a recent study⁵³ estimated that the *net*⁵⁴ fiscal impact of transferring the electricity service to regional utilities will cause an average drop in municipal revenues for electricity *providers* of about 39.6%, which is a very large impact. At least 41 municipalities (out of 58) will lose revenue, while eight of them will benefit from the transfer of this service – i.e., those that spend more than they collect.

In addition, considering that only 43.9% of the municipalities (58 out of 132) provide electricity, the sample of 94 municipalities was divided into *providers* and *non-providers* in order to examine potential revenue differences between these two groups. *Providers* constitute a sub-sample of 46 municipalities, while *non-providers* are represented by a sub-sample of 48 LGs.

The revenue structure for **municipalities providing electricity** indicates that their recurrent revenue comes from three main sources: (i) electricity revenue, (ii) water revenue, and (iii) building license fees. Since revenue from electricity and water should in principle be limited to covering the cost of providing these services, most of these municipalities would have only one main source of non-tax revenue (building licenses) to assist in the financing of local public infrastructure and other services not suitable to user charges. It should be noted that the average contributions of the property tax and the education tax are equivalent to about 16.47% and 2.69% of the average recurrent budget for this group, which constitutes a significant proportion particularly in the case of the property tax. As will be discussed later in this chapter, the empirical results also show that *non-providers* make a greater local tax effort than *providers*. As such, most of the LGs could significantly benefit if these two taxes were made available to all of them for the financing of municipal infrastructure.

It should be noted that in principle the property tax should yield at least twice as much revenue as the education tax, since its tax rate is more than twice as large (17% versus 7%). However, in practice, the municipalities in the group of *providers* collect more from the education tax than from the property tax, though this seems to be due to the fact that the MoF deducts property tax proceeds from any arrears that the electricity, or water providers may have. As such, the property tax *revenue* reported in the municipal budgets only refers to the *net* revenue transferred by the MoF rather than the actual revenue collected. The

⁵³ Garzon, Hernando. *Municipal Development Fund: Main Causes of Municipal Electricity Arrears and Expected Fiscal Impact of Transferring the Electricity Service*. Ramallah, West Bank and Gaza. January 28, 2009.

⁵⁴ The *net* fiscal impact on their revenue budget is defined as the difference between what the municipalities spend on electricity provision *and* what they receive from electricity revenue collection.

main features of the actual revenue structure for providers are illustrated in Table 32 below.

TABLE 32

REVENUE SOURCES: RELATIVE WEIGHT for FYs 07 and 08					
(for electricity providers out of a 94 municipal sample)					
Bud. Code	Revenue Sources	Rev 2007 (NIS)	Rev 2008 (NIS)	% Rev. 2007	%Rev. 2008
1	EDUCATION TAX	3,589,076	4,397,439	1.17%	1.21%
2	HOME or ROOFING / ROOM TAX	615,550	806,043	0.20%	0.22%
3	OTHER	174,078	185,817	0.06%	0.05%
4	BUILDING LICENSE FEE (C.P.)	9,243,404	8,548,950	3.02%	2.36%
5	PROFESSIONAL & INDUSTRY FEES	1,537,399	1,739,445	0.50%	0.48%
6	PROFESSION LICENSE	732,982	1,035,117	0.24%	0.29%
7	PUBLIC PROPERTY FEES	13,991,730	4,121,619	4.57%	1.14%
8	MISCELLANEOUS FEES	3,909,116	5,580,480	1.28%	1.54%
9	WATER SUPPLY	34,958,242	46,223,179	11.42%	12.75%
10	ELECTRICITY SUPPLY	174,509,509	228,915,056	57.02%	63.12%
11	SEWER AND CESSPITES CHARGE	1,321,437	1,705,382	0.43%	0.47%
13	SOLID WASTE COLLECT. & D.	4,510,501	6,080,836	1.47%	1.68%
14	SLAUTERHOUSE	515,505	1,185,547	0.17%	0.33%
15	FRUITS & VEGETABLES MARKETS	1,457,333	1,681,039	0.48%	0.46%
17	PARKING FEES	227,415	273,138	0.07%	0.08%
18	OTHERS (Parks)	3,519,329	4,557,832	1.15%	1.26%
	PROPERTY TAX	304,837	958,242	0.10%	0.26%
21	LICENSING VEHICLES/TRNS. FEE	5,560,318	6,576,370	1.82%	1.81%
23A	GRANTS OPERATING BUDGET	5,092,603	768,949	1.66%	0.21%
23B	MDLF	859,603	2,108,981	0.28%	0.58%
23C	Donors	10,048,684	282,887	3.28%	0.08%
23D	PS & community donation	776,335	712,031	0.25%	0.20%
Sub.	GRANTS OPER BUDGET A+B+C+D	16,777,225	3,872,848	5.48%	1.07%
	CURRENT REVENUE SOURCES	277,150,149	327,486,137	89.64%	90.32%
24A	CAPITAL GRANT (Central Govt.)	0	2,740,781	0.00%	0.76%
24B	MDLF	1,863,076	8,901,629	0.61%	2.45%
24C	Donors	18,410,210	15,515,558	6.02%	4.28%
24D	Priv. Sec. & community donation	785,939	3,223,942	0.26%	0.89%
	CAPITAL REVENUE SOURCES/GRANTS	21,059,225	30,381,910	6.88%	8.38%
Sub.	LOANS, CREDITS OPER. BUDGET	3,460,641	1,189,520	1.13%	0.33%
Sub.	LOANS & CRED. CAPITAL BUDGET	4,047,175	2,614,555	1.32%	0.72%
	TOTAL REVENUE SOURCES	305,717,190	361,672,122	100.00%	100.00%

Source: Municipal Revenue Questionnaire: Responses from 94 municipalities in Annex 4.

On the other hand, the empirical results on the **municipal revenue structure for non-providers** may be summarized as follows: First, the revenue

structures of *non-providers* are significantly different from those of electricity *providers*. In general, their main recurrent revenue source is water supply. Secondly, and interestingly enough, *non-providers*, as it appears, tend to depend more on three local taxes on property: (i) the property tax, (ii) the roofing tax, and (iii) the education tax. This may be partly the case because this group cannot incur in electricity arrears (i.e. *net-lending*), and therefore the MoF does not have to deduct any arrears from the property tax transfer. The third revenue source, similar to *providers*, is building licenses fees, and the fourth important source is the municipal revenue sharing in the vehicle registration fee, which is a transfer from the MoF also free of any deductions *in lieu of* electricity arrears. This revenue structure for *non-providers* is illustrated in Table 33 below. A more in-depth examination of these two revenue structures will be carried out in per capita terms in Section 3.5.

TABLE 33

REVENUE STRUCTURE: RELEATIVE WEIGHTS for FYs 2007 and 2008

non-electricity providers out of 94 municipal sample

Bud. Code	Revenue Sources	Rev 2007 (NIS)	Rev 2008 (NIS)	% Rev. 2007	%Rev. 2008
1	EDUCATION TAX	7,715,180	9,978,317	4.16%	3.64%
2	HOME or ROOFING / ROOM TAX	7,130,659	9,311,241	3.84%	3.40%
3	OTHER	211,188	322,683	0.11%	0.12%
4	BUILDING LICENSE FEE (Cons. Per.)	18,410,727	18,373,083	9.92%	6.70%
5	PROFESSIONAL & INDUSTRY FEES	2,395,372	2,891,640	1.29%	1.05%
6	PROFESSION LICENSE	2,112,663	3,258,927	1.14%	1.19%
7	PUBLIC PROPERTY FEES	14,696,480	4,078,626	7.92%	1.49%
8	MISCELLANEOUS FEES	2,343,244	3,936,567	1.26%	1.44%
9	WATER SUPPLY	28,521,846	44,610,397	15.37%	16.27%
10	ELECTRICITY SUPPLY	0	0	0.00%	0.00%
11	SEWER AND CESSPITES CHARGE	3,654,264	5,324,023	1.97%	1.94%
12	WASTEWATER TREATMENT	0	0	0.00%	0.00%
13	SOLID WASTE COLLECTION & D.	8,846,598	12,416,761	4.77%	4.53%
14	SLAUTERHOUSE	285,702	505,629	0.15%	0.18%
15	FRUITS & VEGETABLES MARKETS	3,900,101	4,923,420	2.10%	1.80%
16	SOLID WASTE TREATMENT	4,330	400	0.00%	0.00%
17	PARKING FEES	177,269	194,285	0.10%	0.07%
18	OTHERS (Parks)	2,287,864	2,457,053	1.23%	0.90%
19	PROPERTY TAX	18,407,368	28,089,583	9.92%	10.25%
21	LICENSING VEHICLES/TRANS. FEE	23,765,167	13,958,185	12.80%	5.09%
22	FUEL/GASOLINE TAX	0	0	0.00%	0.00%
23A	GRANTS OPER. BUDGET (C.G)	4,397,845	1,041,829	2.37%	0.38%
23B	MDLF	3,960,350	5,886,537	2.13%	2.15%
23C	Donors	2,050,087	1,959,471	1.10%	0.71%
23D	Priv. Sec. & community donation	2,676,410	4,653,754	1.44%	1.70%
Sub	GRANTS OPERATING BUDGET	13,084,692	13,541,591	7.05%	4.94%
	SUB-TOTAL: CURRENT REVENUE	157,950,714	178,172,411	85.10%	65.00%
24A	CAPITAL GRANT (C.G)	995,246	1,271,977	0.54%	0.46%
24B	MDLF	753,258	5,459,127	0.41%	1.99%
24C	Donors	15,935,179	83,203,778	8.59%	30.35%
24D	PS & community donation	705,083	3,806,637	0.38%	1.39%
	SUB-TOTAL: CAPITAL REVENUE/GRANTS	18,388,766	93,741,519	9.91%	34.20%
Sub.	LOANS & CRED. OPER. BUDGET	1,057,782	1,111,485	0.57%	0.41%
Sub.	LOANS & CRED. CAP. BUDGET	8,176,569	1,045,975	4.41%	0.38%
	TOTAL REVENUE	185,597,582	274,106,827	100.00%	100.00%

Source: Municipal Revenue Questionnaire: Responses from 94 municipalities in Annex 4.

3.4 Current and Capital Revenue Budgets⁵⁵

In FY'08 the municipal revenue structure, as a whole⁵⁶ was made up of about 80% recurrent revenues and 20% capital proceeds. It is important to note the substantial increase in capital revenues from an 8% low in FY'07 to the significantly higher 19.49% in FY'08. Capital revenue more than doubled due to a substantial increase in the contributions of donors in FY'08, as illustrated in Table 34 below. Furthermore, it should be noted that in FY'08 the *direct* capital contributions of donors to the municipalities was equivalent to 15.5% of their total revenue budgets, while *indirect* allocations through the MDLF were only equivalent to about 2.3% of their total budgets.

3.5 Per Capita Revenues by Source

One of the purposes of estimating per capita revenues is to examine actual revenue effort across municipalities as well as potential revenue improvements, particularly regarding various taxes and fees. User charges should, in principle, reflect the cost of service provision and, for economic efficiency reasons (including potential economic distortions), should not be used to subsidize the provision of other services.

Empirical results show that most per capita revenues across different sources are relatively low with respect to their purchasing power. This is the case of some fees and user charges. These revenues are generally below 40 Shekels per capita per year, which is equivalent to about US\$10. For example, the per capita revenues from construction permits (NIS 14.05, US\$3.51), and the vehicle registration fee (NIS 10.71, US\$2.67) all fall below the US\$10 per capita. Table 34 below includes the main per capita revenues collected by source.

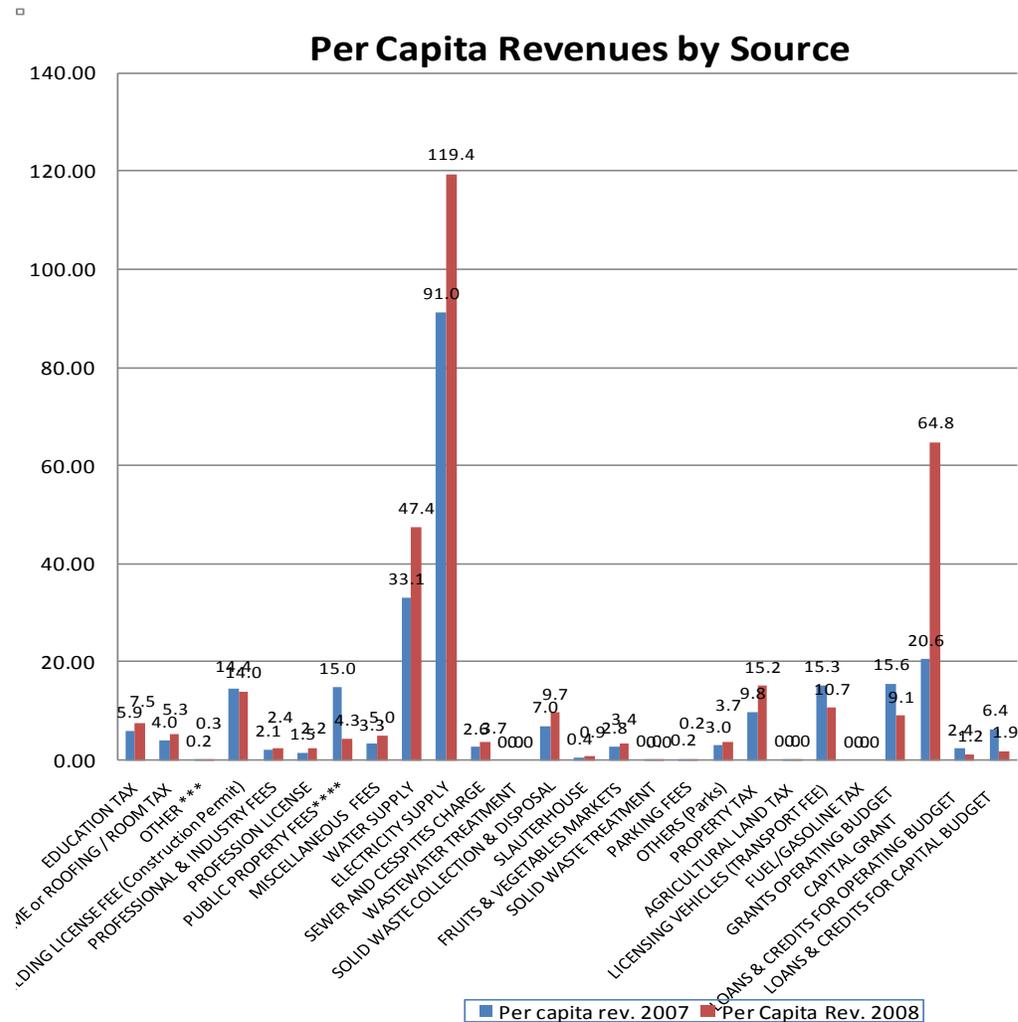
In contrast, the per capita revenue from electricity (NIS 119.43, or US\$29.85), and water (NIS 47.39, or US\$11.85), are the two highest municipal revenue sources in the West Bank and Gaza. Solid waste collection (NIS 9.65,

⁵⁵ In the West Bank and Gaza, municipal current budgets are generally split into two budgets called the Operations Budget and the 'Enterprise' Budget. The Operations Budget refers to the general administration (revenues and expenditures), while the Enterprise Budget relates only to revenues and expenditures directly associated with municipal services. On the other hand, the Capital Budget, which is called the Development Budget, refers to revenues and expenditures only for the expansion and provision of public goods/works and services. In the West Bank and Gaza the Capital Revenue Budget is strongly supported by grants from the Donor Community.

⁵⁶ International experience shows that generally the proportions between the current and capital budgets vary with the municipalities' population size. In small towns the greater proportion is the current budget while the smaller is the capital budget. In contrast, in relatively large cities the reverse seems to be the case: Capital Budgets are the largest proportion, while the Current Budget is the smallest share. Clearly West Bank and Gaza's average budget structure seems to resemble more the case of small communities.

US\$2.41) is the third most important user charge, but the current revenue from this source, on average, does not make up for the cost of providing this service. Last, other revenue sources are quite low that their respective payments could be considered negligible. This is the case for the education tax (NIS 7.50, US \$1.87), the industry fee (NIS 2.42, US\$0.60), and the professional license (NIS 2.24, US\$0.56). Chart 14 below offers a comparison of the different revenue sources.

Chart 14



Source: Table 34.

Table 34: PER CAPITA REVENUES BY SOURCE

Based on Responses of 94 municipalities (71.2%)

No.	Revenue Source	Rev 2007 (NIS)	Rev 2008 (NIS)	Per capita 2007	Per capita 2008
1	EDUCATION TAX	11,304,256	14,375,756	5.90	7.50
2	HOME or ROOFING / ROOM TAX	7,746,209	10,117,284	4.04	5.28
3	OTHER ***	385,266	508,500	0.20	0.27
4	BUILDING LICENSE FEE/Constr. P.	27,654,131	26,922,033	14.43	14.05
5	PROFESSIONAL & INDUSTRY FEES	3,932,771	4,631,085	2.05	2.42
6	PROFESSION LICENSE	2,845,645	4,294,044	1.48	2.24
7	PUBLIC PROPERTY FEES****	28,688,210	8,200,245	14.97	4.28
8	MISCELLANEOUS FEES	6,252,360	9,517,047	3.26	4.97
9	WATER SUPPLY	63,480,088	90,833,576	33.12	47.39
10	ELECTRICITY SUPPLY	174,509,509	228,915,056	91.05	119.43
11	SEWER AND CESSPITES CHARGE	4,975,701	7,029,405	2.60	3.67
13	SOLID WASTE COLLECTION & DISP.	13,357,099	18,497,597	6.97	9.65
14	SLAUTERHOUSE	801,207	1,691,176	0.42	0.88
15	FRUITS & VEGETABLES MARKETS	5,357,434	6,604,459	2.80	3.45
16	SOLID WASTE TREATMENT	4,330	400	0.00	0.00
17	PARKING FEES	404,684	467,423	0.21	0.24
18	OTHERS (Parks)	5,807,193	7,014,885	3.03	3.66
19	PROPERTY TAX	18,383,505	28,293,087	9.59	14.76
21	LICENSING VEHICLES/Transp. Fee	29,325,485	20,534,555	15.30	10.71
22	FUEL/GASOLINE TAX	0	0	0.00	0.00
23A	GRANTS OPERATING BUDGET	9,490,448	1,810,778	4.95	0.94
23B	MDLF	4,819,953	7,995,518	2.51	4.17
23C	Donors	12,098,771	2,242,358	6.31	1.17
23	PS & community donation	3,452,745	5,365,785	1.80	2.80
	GRANTS OPERATING BUDGET	29,861,917	17,414,439	15.58	9.09
24A	CAPITAL GRANT	995,246	4,012,758	0.52	2.09
24B	MDLF	2,616,334	14,360,756	1.37	7.49
24C	Donors	34,345,389	98,719,336	17.92	51.51
24	Priv. Sect. & community donations	1,491,022	7,030,579	0.78	3.67
	CAPITAL GRANT	39,447,991	124,123,429	20.58	64.76
25	LOANS & CREDITS OPER. BUDGET	4,518,423	2,301,005	2.36	1.20
26	LOANS & CREDITS CAPITAL. BUDGET	12,223,744	3,660,530	6.38	1.91
	Total Revenue Sources	491,625,564	636,749,175	9.87	12.78
	Revenues Net of Capital Grants	452,177,573	512,625,746	9.07	10.29

Source: Municipal Revenue Questionnaire: Responses from 94 Municipalities April 09

Comparing the per capita revenues of the two sub-samples of municipalities that correspond to *providers* and *non-providers* (i.e., with *soft and hard budget constraints*), the empirical findings may be summarized as follows:

First, the per capita revenues for the sub-sample of municipalities that do not provide electricity are significantly higher than those (for the same main revenue sources) for the electricity providers. The only exception is water for which the per capita revenues, in both sub-samples, are practically the same (NIS47) as illustrated in Table 35 below.

Secondly, it could be argued that the revenue structure of *non-providers* is more diverse than that of providers. Each of the per capita revenues, by main sources, is quite different. For example, the average municipal per capita revenue for solid waste collection is NIS6.28 for the sample of *providers*, while it is NIS13.09 for the sample of *non-providers*. The difference in the property tax is even larger; while the per capita revenue for providers is less than one shekel (NIS0.99), for *non-providers* it is NIS29.61. However, as noted above, this might be due to the deduction of arrears from property tax proceeds. Also, it must be noted that the per capita education tax, which is administered directly by the municipalities, is higher for the sample of *non-providers* (NIS10.52) than for *providers* (NIS 4.54).

Thirdly, it may be argued that local revenue mobilization efforts appear to be much greater among municipalities that do not provide electricity than among those that do provide this service. The most likely explanation of this result is as follows: While electricity *providers*, in practice, have been able to avoid paying everything they owed to the IEC, allowing them to stretch their operating budgets, *non-providers* of electricity, have not had that financial flexibility (or lack of financial discipline), and have therefore been forced to use their own revenue sources more effectively -- including user charges, local taxes, and fees. The only way *non-providers* can stretch their budgets is by increasing their own revenue collections at the risk of not having enough cash to pay for their operating expenditures such as salaries.

These results illustrate the *moral hazard* of allowing municipalities to operate with *soft-budgetary constraints* which undermine the soundness of the municipal/local fiscal system.

TABLE 35			
COMPARISON OF PER CAPITA REVENUES ACROSS MUNICIPALITIES			
FOR PROVIDERS AND NON-PROVIDERS OF ELECTRICITY			
	<i>Providers</i>	<i>Non-Providers</i>	
MAIN REVNUUE SOURCES	Per Capita REVENUE	Per Capita REVENUE	Percent higher for non-providers
	FY '08	FY '08	FY '08
	NIS	NIS	%
USER CHARGES:			
1. Electricity Distribution	236.51	0.00	0.00
2. Water Supply	47.76	47.02	0.00
3. Solid Waste Colletion	6.28	13.09	108.43
TAXES:			
4. Property Tax	0.99	29.61	2890.91
5. Roofing Tax	0.83	9.81	1081.92
6. Education Tax	4.54	10.52	131.71
FEES:			
7. Construction Permit	8.83	19.37	119.36
8. Vehicle Registration	6.79	14.71	116.64
9. Professional & Indutry Fees	1.80	3.05	69.44
10. Profession license	1.07	3.43	220.56

Source: Tables on per capita figures for electricity providers and non providers

Furthermore, in order to examine the potential effect of municipal size on the revenues of the local councils, the sample of 94 municipalities has been subdivided into four population classes. The effect on per capita revenue across different municipal sizes has been examined and the results are summarized in Table 36 below.

TABLE 36
COMPARISON OF PERCAPITA REVENUES
BY SOURCE AND MUNICIPAL SIZE
(Sample of 94 municipalities)
FY 08

MUNICIPAL REVENUES		PER CAPITA REVENUES BY POPULATION CLASSES			
		I Less than 5,000	II 5,000 to 10,000	III 10,001 to 50,000	IV More than 50,000
		NIS	NIS	NIS	NIS
1	Electricity	142.40	146.95	90.73	128.62
2	Water	55.70	42.88	43.32	50.98
3	Solid Waste	11.83	15.60	12.77	5.47
4	Licensing Vehicles	17.84	11.46	12.88	8.46
5	Property Tax	2.42	4.03	33.82	6.88
6	Education Tax	1.57	2.63	12.76	5.90
7	Roofing Tax	0.67	3.11	14.07	0.30
8	Construction Permit	6.70	9.31	26.13	7.84
9	Profession & Industry	1.85	2.02	3.89	1.57
10	Public Markets	1.12	0.01	3.20	4.88

Source: Based on the data obtained from the municipal revenue questionnaire.

The empirical results show that the average per capita revenue gradually increases for each population class, except for the fourth one. The fourth group includes those municipalities with populations greater than 50,000. This drop in revenues in the highest population group appears to be due to the fact that out of the six municipalities in this class, four of them are located in the Gaza Strip. Empirical evidence, as reported in this study, has shown that per capita revenues in Gaza municipalities are significantly lower than per capita revenues in the West Bank for the same revenue sources. Briefly, the empirical results on revenues show that they increase⁵⁷ with municipal size, except for those in the highest population class, apparently due to the Gaza effect. Examples of gradually increasing per capita revenues for the first three population classes include revenue sources such as the property tax, the education tax, the roofing tax, the construction permit fee, and the profession and industry fee. Consequently, it may be inferred that the largest per capita expenditures in the fourth class are being financed not only by their own per capita revenues, but also by indirect subsidies from electricity revenue for the cities of Hebron and Nablus, which are in the fourth population class.

⁵⁷ This result may be partly explained by urban *agglomeration economies*, which typically may be characterized by greater productivity, which is reflected in higher individual income and profits, which means greater purchasing power for both, private and public goods and services.

Last, the section below compares the municipal revenue sources of the Gaza Strip with those of West Bank municipalities.

Except for the revenues from electricity and the education tax, the revenue sources of the municipalities in the Gaza Strip and those in the West Bank are generally the same. In practice, however, the average per capita revenue levied by the Gaza municipalities is usually significantly lower than the revenue collected by West Bank municipalities from the same sources. For example, this is the case for the per capita revenue of the two most important user charges, water (NIS20.36 in Gaza versus NIS74.89 in the West Bank), and solid waste collection (NIS3.99 versus NIS13.35). A similar situation characterizes the two local taxes: the property tax (NIS0.29 in Gaza, while in the West Bank it is equivalent to NIS22.31) and the education tax (NIS0.00 versus NIS10.87). Among fees, the pattern generally does not change, for example in construction permits (NIS4.27, versus NIS 17.04). There is, however, one relatively marginal exception in fees, for vehicle licensing/registration (NIS17.89 in Gaza, versus NIS13.92 in the West Bank). In the Gaza Strip, however, the *de facto* government collects the vehicle fee and transfers the corresponding proceeds to the municipalities.

Briefly, it may be argued that the specific differences in per capita revenue of the Gaza municipalities as compared to those of the West Bank are due primarily to differences in the ability to contribute by their residents, rather than to the few differences in their revenue sources. A summary of these differences in per capita revenues between the West Bank and the Gaza Strip is presented in Table 37 below.

TABLE 37			
COMPARISON OF MUNICIPAL PER CAPITA REVENUES			
FOR THE GAZA STRIP AND THE WEST BANK			
	GAZA STRIP	WEST BANK	
MAIN REVENUE SOURCES	Per Capita Revenue	Per Capita Revenue	Percent difference
	FY '08	FY '08	(WB/G)
	NIS	NIS	%
USER CHARGES:			
1. Electricity Distribution	0.00	0.00	0.00
2. Water Supply	20.36	74.89	267.83
3. Solid Waste Colletion	3.99	13.35	234.59
4. Sewer & Cesspits charge	3.48	4.00	14.94
5. Fruits & Vegetable Market	1.78	7.22	305.62
6. Slaughterhouse	0.42	0.33	-21.43
TAXES:			
7. Property Tax	0.29	22.31	7593.10
8. Roofing Tax	0.92	1.05	14.13
9. Education Tax	0.00	10.87	N.A.
FEES:			
10. Construction Permit	4.27	17.04	299.06
11. Vehicle Registration	17.89	13.92	-22.19
12. Professional & Indutry Fees	0.30	3.23	976.67
14. Profession license	1.23	3.16	156.91
15. Public Property Fees	2.34	7.55	222.65
16. Parking Fee	0.00	0.22	N.A.

Source: Revenue questionnaire.

N.A. = Not applicable.

3.6 Revenue Growth Constraints and Opportunities

Several factors currently affect revenue growth in user charges. The most common factor is free-riders in the system; they exist due to a weak or nonexistent enforcement system. Social and political factors affect revenue growth and cost recovery. For instance, local enforcement systems to ensure compliance with financial obligations, such as payment of user charges, are fairly weak and rarely used. Also, based on the fact that current collection rates are

very low, revenue growth clearly needs to start with improved compliance. Specifically, it should begin with the elimination of delinquents in the system, before any increase of tariffs is implemented on those who actually pay. The issue of a *horizontal inequity* in the system needs to be addressed. Furthermore, it should be noted that under current municipal financial management, revenue collection targets and revenue performance indicators are neither required, nor applied. Incentives for revenue performance are not usually utilized. In short, there is almost no internal accountability or controls on revenue and financial performance, nor is there any external accountability on local government's fiscal discipline. Additionally, the lack of information on actual service unit cost makes it fairly difficult to set adequate user charges. Also, the lack of authority of the municipalities (no matter their size) to set their own user charge is another important limitation. Municipalities are required to obtain the approval of the CG (MoLG), which may also compromise financial accountability for service sustainability and cost recovery.

On the other hand, the opportunities to mobilize needed local revenues may include, among other things, the following: (i) support of municipal institutional capacity building, particularly in local revenue administration, for example, assistance to local administrations in functions such as billing, revenue collection, and enforcement; and (ii) establishment of the goal of cost recovery in those services in which user charges are currently applied, though it is recognized that in some areas current rates of unemployment (which may be as high as 30%) make cost recovery fairly difficult. Nonetheless, it is also recognized that there are a significant number of beneficiaries of local services that have the *ability to pay (i.e., free-riders)*, but are taking advantage not only of weaknesses in local revenue administrations, but also of the practically nonexistent enforcement systems for both user charges and local taxes. In this respect, consideration may be given, for example, to public-private partnerships to enhance revenue collection, as well as to the upgrading of coverage and quality in local services. It is difficult to enforce compliance with service payments when the frequency (and in general the quality) of service provision is low.

3.7 Conclusion

Revenue assignments in the West Bank and Gaza Strip are different with respect to three local sources. First is the property tax, which is collected in the West Bank by the MoF on behalf of the municipalities, although collections are carried out in only 29 out of 107 municipalities. In contrast, all the municipalities in the Gaza strip are currently allowed to directly collect their own property taxes. Secondly, the education tax is only collected by the West Bank municipalities

(about 46 of them), and thirdly, electricity user charges are only collected by the 58 municipalities that distribute electricity in the West Bank.

Except for revenues from electricity, the property tax, and the education tax, generally the revenue sources of municipalities in the Gaza Strip and those in the West Bank are similar. In practice, however, the empirical results support the argument that the average per capita revenue levied by the Gaza municipalities usually is significantly lower than the revenue collected by West Bank municipalities from the same, or equivalent, sources.

The empirical results also show that per capita revenues increase with municipal size, except for those in the highest population class, apparently due to the low per capita revenue in the largest municipalities located in the Gaza Strip.

Furthermore, and most importantly, the empirical evidence indicates that generally per capita revenues for the sub-sample of municipalities with *hard-budgetary constraints* are significantly higher than per capita revenues for the same sources for municipalities with *soft-budgetary constraints*. This result illustrates some of the perverse fiscal effects of *soft-budgetary constraints*. The negative fiscal impact on municipal finance needs to be addressed mainly through enforcing *hard-budgetary constraints*.

Last, considering among other factors the need to offset the forthcoming negative impact on municipal revenues, special attention needs to be given to the strengthening of key revenue sources. The empirical results suggest significant potential revenues especially from the property tax and the need to enforce solid waste collections charges, so that they cover the cost of providing this service. Furthermore, given the relatively small economic base of several municipalities, amalgamation of small LGUs seems to be, at least in principle, an option to consider, in order to make these municipalities fiscally viable.

CHAPTER IV: MUNICIPAL FINANCIAL SITUATION

4.1 Comparison of Expenditures and Revenues by Services

Both municipal mayors and their staff, especially in the Gaza Strip, generally argue that user charges levied from subscribers do not sufficiently cover the costs of service provision. They also argue that an increase in service tariffs (user charges) would be difficult to implement because many households could not afford it given the current 'cost' of services. Therefore, they argue, if tariffs were raised so that they could actually cover the actual cost of service provision, collection efficiency would be even more difficult, and most likely would drop. The validity of this argument, along with the overall municipal financial situation will be examined in this chapter.

Based on empirical evidence of both executed revenues and expenditures, comparison of the average municipal per capita revenues (in Table 37) with the average per capita expenditures (in Table 17) suggests that for services such as electricity and water, the current average per capita revenue is much greater than the current average per capita expenditure. For example, in FY'08 the per capita revenue from electricity (NIS 119.43) was roughly 23% greater than the per capita expenditure, or direct cost (NIS 96.80) incurred by those who provide this service. Similarly, the per capita revenue for water (NIS 47.39) was about 23.5% higher than the per capita expenditure on water for that year (NIS 38.36). In contrast, and not surprisingly, the financial situation in the provision of solid-waste collection and disposal shows a very large operational deficit (-73.86%) for the 94 municipalities as a whole. Generally it is relatively easier to try to become a free-rider in solid waste collection than in electricity or water, since this service cannot as easily be interrupted as the other two services. Specifically, the direct per capita expenditure in refuse collection (NIS 36.92) is almost three times larger than its per capita revenue (NIS 9.65). However, it should be noted that the expenditures taken into account refer to the *direct* cost of operation and maintenance (O&M), and do not include the *indirect* cost of municipal general administration.

These results, at least on a *cash-flow* basis and with respect to the *direct* cost, do not seem to support the above argument regarding service provision for the average municipality. It is of course recognized that the financial situation varies across both local governments and services, and it is in fact more precarious in the Gaza Strip than in the West Bank as illustrated in the revenue analysis.

Last, it should be noted that on an *accrual* basis some of these results may also vary. For example, the cost of energy provision would be much higher if arrears were included in the calculation. The cash-flow results, including the adjustments for the associated *indirect cost*, are summarized in Table 38 below.

TABLE 38					
COMPARISON OF PER CAPITA REVENUE AND EXPENDITURE					
SERVICES USUALLY FINANCED THROUGH USER CHARGES					
FY '08					
	Revenue	Expenditure	Net Difference	Adjusted1/ Expenditure	Adjusted2/ Difference
	Per Capita	Per capita	Percents	Per capita	Percents
	NIS	NIS	%	NIS	%
Electricity:	119.43	96.80	23.38	114.22	4.56
Street lighting	0	3.99	---	4.71	---
Water:	47.39	38.36	23.54	45.26	4.70
Sewer System	3.67	4.91	-25.25	5.79	-36.66
Wastewater Treatment	0	1.97	---	2.32	---
Refuse Collection	9.65	36.92	-73.86	43.57	-77.85
Solid Waste Treatment	0	0.97	---	1.14	---
Schools/Education Tax	7.50	2.78	169.78	3.28	128.63
Food Markets	3.45	1.74	98.28	2.05	68.03
Slaughterhouses	0.88	2.12	-58.49	2.50	-64.82
Total	191.97	190.56		224.86	-14.63

1/ adjusted by a factor of 1.18 to include associated indirect cost (General Adm.)

2/ Assumes that General Administration cost is proportional to each service expenditure.

Source: Tables 17 and 34.

Electricity and Water: The results, particularly regarding electricity and water supply, show that these two revenue sources must, in practice, contribute to the financing of other municipal expenditures. This is even the case after adjusting the *direct* expenditures to include general administration costs which are not directly related to the provision of such services.

Given that the executed municipal budgets for FY'2008 were still not made public during the first half of calendar year 2009, then, for the purpose of computing the cost of general administration (i.e., the *indirect* cost) the calculation was based on FY'07's executed budgetary figures. It has been

estimated⁵⁸ that the *indirect* average cost is equivalent to 18% of the total current budget, which includes both the Operating Budget and the “Enterprise Budget” (or services budget) which reflects the *direct* operating costs of each service. Consequently in order to make more accurate comparisons, expenditures by service were adjusted upwards by a factor of 1.18. After incorporating this adjustment it still can be argued that electricity and water generate surpluses in the average municipality, as it is illustrated in Table 38 above.

Strictly, it still could be argued that the per capita expenditures by service are conservative estimates since they do not include depreciation costs. However, for the purposes of this analysis the adjusted cost may be considered a fairly good⁵⁹ reflection of the actual financial situation in service provision.

Furthermore, if this analysis were conducted on an *accrual* rather than a cash flow basis, the per capita expenditures on electricity, and to a lesser extent those on water, underestimate the real cost of provision. This underestimation comes from the fact that a significant number of municipalities that supply electricity do not pay the full operating cost of providing this service. This is because most municipalities – as documented by the electricity arrears – do not pay the IEC the full wholesale purchase price of electricity. The average municipality pays about 54.54%⁶⁰ of the electricity wholesale bill, while the rest of the cost (45.46%) constitutes arrears that are indirectly paid through the VAT. Therefore, in practice, there is a fairly large *subsidy* that benefits not only electricity subscribers who do not pay their bills, but also the municipalities who are using part of their electricity revenue for the financing of other expenditures, rather than paying the IEC the entirety of their wholesale bills. The implicit municipal *subsidy* is of course reflected in lower electricity expenditures, as reported in executed municipal budgets.

Regarding the financial sustainability of the electricity service, empirical evidence has also shown⁶¹ that municipalities generally charge a sufficiently higher retail rate than the wholesale rate they must pay the IEC. In practice, this

⁵⁸ This percent comes from computing the ratio: “General Executed Expenditures”/ (“Total executed Operating Budget” + “Total Executed Services Budget”. That is total recurrent expenditures for the consolidated of the 132 municipalities -- i.e., (NIS124,843,557/NIS691,539,781)*100 = 18.05%.

⁵⁹ Considering that there is no municipal cost accounting system by service, the *direct* and *indirect* costs by service (computed for this study) constitute the best available estimates of their ‘cost’ in a cash flow basis.

⁶⁰ Hernando Garzon. “Main Causes of Municipal Electricity Arrears and Expected Fiscal Impact of Transferring the Electricity Service”. Ramallah, West Bank and Gaza. January 28, 2009. p. 8

⁶¹ Dajani, Wafa. “*The West Bank Municipal Electricity Operations*”. Ramallah, West Bank and Gaza. August 28, 2008.

spread or mark-up (which is also applied by the regional utilities) ensures the financial sustainability of this service.

A similar situation, though on a much smaller scale, affects the expenditure structure of water. There are relatively small water arrears, which, in practice, are also equivalent to a subsidy to both the municipal administrations providing the service and the water subscribers that do not pay for using this service. However, in order to ensure the financial sustainability of this service, water tariffs are usually set at a higher price than the actual cost of acquiring the water for distribution. Still, in practice, the sustainability of this service depends on the efficiency rate of billing and collection. Furthermore, due to some subscribers' inability to pay (i.e., because of severe poverty) there is inefficiency in bills collection that needs to be absorbed by both the spread (as an internal/indirect cross subsidy) and by specific external targeted subsidies.

Street Lighting and Electricity Distribution: Considering that user charges cannot be directly applied to the beneficiaries of street lighting, but that the households who benefit from electricity distribution are to a large extent the same as those who benefit from street lighting, it seems justifiable to consider incorporating the cost of street lighting into the tariff for electricity distribution. By doing this, adequate and effective financing could be made available for this service as well. After the electricity service is transferred, the regional utility would collect, on behalf of municipality, the corresponding tariff on public lighting in order to cover its cost. As reported in Table 38 above, the current per capita expenditures on street lighting are relatively small (NIS3.99), as compared to the per capita expenditures on electricity distribution (NIS96.80).

Future financial sustainability of regional electricity utilities will of course primarily depend on the collection efficiency rate⁶² of retail sales, which is fairly low in the municipalities (in FY'07 it dropped to its lowest level of 56.6%)⁶³. Part of this inefficiency in collections is certainly related to an inability to pay – which is estimated to be at least 25%⁶⁴ – and low compliance attributed to *free-riders* in the system (about 18.4%)⁶⁵. Nevertheless, inefficiencies due to inability *to pay* are generally covered by the spread, which in practice operates as an internal *cross-subsidy*, making this service financially viable. For instance, this was the

⁶² In FY'05, the collection rates among utilities fluctuated between 66% at GEDCO to over 100% at JEDCO. The cases in between were HEPCO, with a 98% collection rate, and SELCO at 82%.

⁶³ Garzon, Hernando. "Main Causes of Municipal Electricity Arrears and Expected Fiscal Impact of Transferring the Electricity Service".(2009), p. 7

⁶⁴ This figure is estimated based on the fact that the highest collection efficiency rate in recent years has not been more than 72.8% (in FY'04), which suggest some structural limitations that generally are associated with inability to comply with payment.

⁶⁵ Garzon, H. Ibidem, p. 8.

case of JEDCO in 2005 with a cost recovery over 100%. Additionally, pre-paid cards are helping to eliminate 'free riders' in the system.

Sewer Systems and Wastewater: Regarding the water tariff design, and considering that generally the beneficiaries of water supply are the beneficiaries of sewer systems, it seems justifiable to include the associated cost of the sewer system and (to some extent) the cost of wastewater treatment, in the water tariff structure. However, since the beneficiaries of the wastewater treatment are not only the subscribers to the water supply, but other economic sectors as well, additional financing for wastewater treatment should be considered from the other sectors that also benefit from this service. For instance, the agricultural and farming industry as well as the fishing industries, among others, would benefit from environmental conservation of water resources that are generally polluted for lack of sewer system and waste water treatment plants. A multi-sectoral approach could contribute to the financing of the current deficits in the operation of these two services.

School Maintenance and the Education Tax: The average revenue from the education tax (NIS7.50 per capita) covers not only the average recurrent expenditure on school maintenance and supplies (NIS2.78 per capita), but it also finances construction of classrooms and school buildings, which are reported in the capital expenditure budget (i.e., the "Development Budget"). This allocation in practice has been about one-and-a-half times (169.7%) higher than the allocations for school maintenance.

However, the education tax actually is not available to all municipalities because it depends, at least in principle, on the availability of property tax assessments carried out by the MoF. Also, it is worth noting that since the education tax is based on the rental value of property, similar to the property tax, then from this perspective it could be argued that the actual statutory property tax rate is not 17%, but rather 24%, of which 7% is earmarked for schools. It is also interesting to note that in practice, about 42% of the municipalities in the West Bank (46 out of 107) do collect some of the education tax while the property tax is collected by the MoF in only in 29 of them. Nevertheless, it is important to consider that the buoyancy of a local tax such as an education tax depends entirely on the local economic base, which is very limited in small municipalities.

Food Markets and Slaughterhouses: The empirical results show that services, such as food markets and even slaughterhouses, on the average, could be financed with user charges. Food markets in fact generate a relatively large surplus (98.27%) in contrast to the relatively large operational deficits (-58.49%) of slaughterhouses (Table 38). Generally, slaughterhouses are a self-financed

service, as are electricity, water, and refuse collection. However, in exceptional cases, municipal financial managers in West Bank and Gaza have used cross-subsidies between services as needed. However, to be able to apply adequate user charges, municipalities must have not only specific cost accounting for each municipal service, but also the autonomy to set user charges at a level allowing them to recover the costs of administration, operation, and maintenance. Undoubtedly, this is an area where technical assistance (TA) would be useful.

4.2 Municipal Services Financed Primarily through Taxes

The above section has covered the main municipal services that should be financed by adequately designed user charges that must be collected from their corresponding beneficiaries. This section covers those services that cannot be financed through user charges due to their own characteristics, such as the *non-excludability in consumptions* of these services or the *market failure* for these types of economic goods, so that their provision and maintenance must be financed primarily through local taxes. These public goods and services generally include physical infrastructure that is accessible to all residents, in principle, 'free' of any *direct* charges – hence the need for taxation.

Roads, Streets and other infrastructure: The five most important municipal public works on infrastructure are internal roads, streets, drainage of rain water, sidewalks, and public parks. There are, however, other services unrelated to physical infrastructure that need to rely on adequate local taxes because user charges simply would not be suitable. These include regulation, control, monitoring, transit management, and fire fighting, among other services.

Tax Sources: As previously stated, there are only two municipal taxes that assist in the maintenance of the five types of physical infrastructure. However, these two taxes are not available to all municipalities. The MoF is in charge of administering both property tax (PT) collections (currently being carried out in only 29 of 107 municipalities) and, *indirectly*, determining the possibility of the education tax, since this tax is supposed to be based on property tax assessments. The fact that 17 additional municipalities are actually collecting the education tax (for a total of 46), while the property tax is not being collected in these 17 jurisdictions could be viewed as an indicator of local tax effort, most likely due to the pressing need in some municipalities for additional local revenue sources.

However, it should be noted that if the revenue levied by the education tax were strictly determined by the actual revenue needed solely to maintain and build schools, as in fact is the case, then it could be argued that in practice there is only one municipal tax (i.e., the property tax) that can be used for the financing of all the five types of physical infrastructure. Consequently, it could be asserted that under the current situation the PT, which is in practice undeveloped or underutilized), may in and of itself be insufficient, and not fully adequate⁶⁶, to meet all the current financial needs for infrastructure maintenance and construction.

Non-Tax Sources: Building Fees and Vehicle Licenses: Municipalities have two non-tax revenue sources that are not linked to any particular service; as such, their revenue may be used to finance, among other⁶⁷ expenditure functions, the maintenance of physical infrastructure -- primarily internal roads and streets. These are the building license fee (equivalent to NIS14.05 per capita), and the licensing of vehicles, or transport fee (NIS10.71 per capita). These two revenue sources amount to NIS24.76 per capita, which (as expected) is significantly smaller than the total municipal per capita expenditure (NIS34.78) in these five types of physical infrastructure. Clearly these two sources have not been enough to cover the current expenditures in infrastructure; hence the importance of other sources, such as the property tax.

4.3 Financial Sustainability of Local Physical Infrastructure

As already discussed above, the collection and disposal of solid waste faces the most critical financial difficulties among the services that should be financed through user charges.

Similarly, among physical infrastructure which must be financed primarily through local taxes, internal roads and streets are the main municipal public services lacking adequate financing. Construction permits and vehicle registrations are generally not an adequate source of finance for physical infrastructure. The revenue collected, or that potentially could be collected, from these two sources would be likely insufficient compared to actual needs. The empirical results in the West Bank and Gaza, as illustrated above, provide evidence supporting this argument. The typical sources, by international standards, used to finance the maintenance and rehabilitation of internal roads

⁶⁶ Betterment levies would be more adequate than the PT for the financing of certain public goods. However, betterment levies do not form part of the municipal revenue sources in WBG.

⁶⁷ Such as: Regulation, control, monitoring, transit management, and fire fighting, among others.

and streets, include the property tax, and betterment levies, among others. However, in the West Bank and Gaza, betterment levies do not constitute part of the municipal revenue structure, and the property tax is highly undeveloped. It has been implemented in less than half (40%) of municipalities. It seems that TA could assist in the implementation of the PT as well as any other potential local sources, such as betterment levies.

The section below provides an overall comparison of expenditures and revenues.

4.4 Balance between Expenditures and Revenues

This section examines the balance between specific expenditures and revenues, including all the municipal services for the most recent fiscal years (2007 and 2008). The main empirical findings from this review may be summarized as follows:

- (i) The average per capita expenditure in all services is equivalent to about 8.00 Shekels. During the last two years, per capita expenditures on services have increased by a modest 14.3%, rising from 7.60 Shekels to 8.69 Shekels per capita.
- (ii) Revenues have increased at a slightly slower rate than expenditures. They have grown by the nominal amount of roughly 13.4%. The average per capita revenue increased from 9.07 to 10.29 Shekels per capita during the same time period. These results seem to suggest some growth in both expenditures and revenues, as well as the ability for the average municipality to cover the operation and maintenance of the main services.
- (iii) The FY'07 comparison between expenditures and revenues on services also suggests that municipalities on average operated on balanced budgets. While the per capita expenditure amounted to 7.60 Shekels, the per capita revenue was 9.07 Shekels. Revenues were larger by about 19.3% which covered the average *indirect* cost related to general administration. Still, it must be highlighted that these results include both the large electricity revenue subsidies for some municipalities and, in a smaller proportion, water subsidies; i.e., this balance is only on a cash-flow basis but not in a modified accrual basis – as will be discussed below.

The FY'08 balance between expenditures and revenues showed a fairly similar situation compared to FY '07. While the average per capita expenditure was 8.69 Shekels, the average per capita revenue was 18.4% higher at 10.29 Shekels. It is important to note, however, that these results do not take into account the electricity and water arrears that are being used as implicit subsidies by most of the municipalities that provide these two services.

These results suggest that the average municipality has operated on a balanced budget. However, while this may be true on a strictly cash flow budget basis, it is not generally the case if the arrears in electricity and water are taken into account. The analysis under a modified accrual basis indicates that their yearly financial obligations, for 64.7% of municipalities, are greater than their executed revenues. Therefore, under a modified accrual basis it may be expected that the results will show significant deficits⁶⁸ in operations, particularly on an individual basis among the largest debtors. This situation will be analyzed in the section below.

4.5 Synopsis of the Municipal Financial Situation

Under a modified accrual basis, empirical results show that most municipalities in the West Bank and Gaza (64.7%) are running budgetary deficits that cannot be sustained. The magnitude of these deficits is fairly large, particularly among the LGUs providing the service of electricity distribution. Comparing the financial performance of a sample of 51⁶⁹ municipalities in the West Bank that currently provide electricity to that of the 74 municipalities that do not, shows that the average municipal budgetary deficit among the 51 is about 47% of their operating budget; in stark contrast, the budgetary deficit for municipalities not providing electricity is only 2%. Specifically, more than one third (37.2%) of the electricity providers are running accrual operating deficits greater than 50% of their revenue budgets. Table 39 below illustrates the magnitude of the fiscal deficits across the sample of 51 municipalities that provide electricity distribution.

⁶⁸ Operating budget deficits and surpluses (in both *cash flow* and *modified accrual* basis) for the 132 municipalities were only computed for FY '07, since executed budgets for 2008 were not available.

⁶⁹ Though the number of municipalities that distribute electricity is 58, this particular analysis was done with a sample of 51 municipalities for which there was available information on both their arrears and their executed budgets for FY '07.

TABLE 39
RANKING OF MUNICIPALITIES BY FINANCIAL PERFORMANCE
(After deducting their corresponding yearly arrears)
FY '07

Category	Ranking	Number of Mun.	Percentage
A	Surplus > 10%	6	11.8
B	- 10 < B.B. < 10%	12	23.5
C	- 10 < Def. < - 50%	14	27.5
D	- 50 < Def. < - 100%	9	17.6
E	- 100 < Deficit	10	19.6
Total		51	100.0

Source: Based on 2007 municipal executed budgets and MoF data on electricity and water arrears.

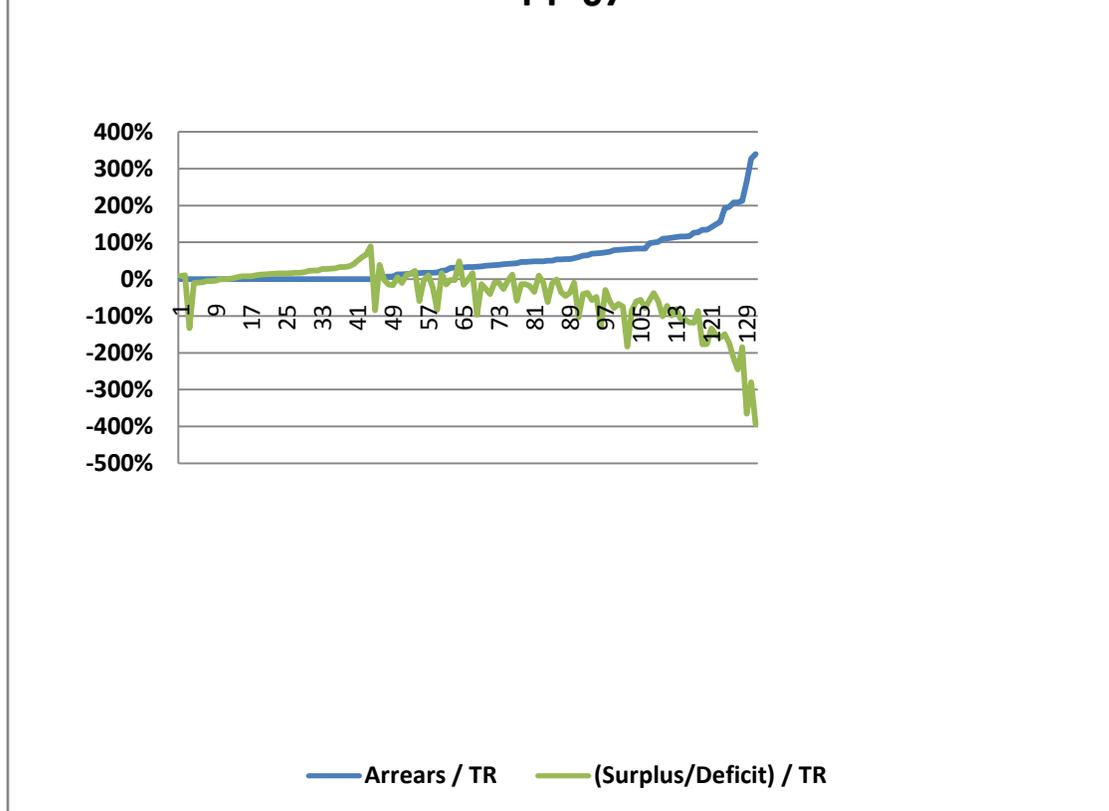
Empirical findings show that there is a direct relationship between the size of the municipal budget deficit, on an accrual basis, and the size of the municipal arrears (Chart 16 below). In other words, most of the *providers* appear to be financing their cash-flow deficits with revenue from electricity which in fact is not being used to pay the IEC for the municipal purchases of wholesale electricity (hence the arrears). For instance, in FY'07 Nablus's accrual basis deficit was about NIS33.5 million, while its arrears (which in practice financed the deficit) were about NIS34 million. The 74 municipalities not providing electricity services during this year obviously could not resort to this *irregular* option for deficit financing. As such, the financial managers for this group of 74 municipalities faced a *hard-budgetary constraint*, in contrast to the group of 51 municipalities in this analysis that, in practice, have operated with a fairly *soft-budgetary constraint*. These results have provided strong evidence of the *moral hazard* and/or financial and fiscal risks associated with *soft-budgetary constraints*, which only emphasizes the importance of eliminating them.

Chart 15 below illustrates the very different financial situations, on a modified accrual basis⁷⁰, for these two groups of LGUs. On the right side of the chart are those municipalities that provide electricity (i.e., those with arrears greater than zero); the left-hand side indicates *non-providers* (i.e., those with electricity arrears equal to zero, since they do not provide this service).

⁷⁰ Though the municipal budgets are prepared on a cash-flow basis, for the purposes of this study they were adjusted by their corresponding yearly arrears in order to determine the real municipal fiscal situation on the equivalent to a modified accrual basis.

Chart 15

**West Bank and Gaza:
Relationship Between Surplus or Deficit and
Arrears
FY '07**



Source: Municipal executed budgets and MoF data on arrears (electricity and water).
TR = Total Revenue (including recurrent operational and enterprise budget).

In addition, it is important to note that full cost recovery (or any amount close to 100% collection efficiency) would not automatically fix the arrears (i.e., net lending) since there is still the issue of municipal revenue *diversion*. This means that even achieving full cost recovery (and assuming adequate⁷¹ pricing of the service)⁷² would not solve the arrears issue as long as revenue *diversion* continues to compromise the payments of wholesale purchases. For instance, in FY '07, nearly half (45.46%) of the municipal electricity revenue that should have been used for payments to the IEC for wholesale purchases was *diverted*. This

⁷¹By “adequate” is meant a tariff structure that can recover the total cost of providing the service, which generally uses internal, or built-in, cross-subsidies among subscribers -- based on their *abilities to pay*).

⁷² For some of the issues in certain municipalities regarding adequate pricing (i.e., tariff structures) of the service, see, for instance: “The West Bank Municipal Electricity Operation” August 28, 2008. This study is available on MDLF’s webpage.

only served to further aggravate *net* lending, which had already been drastically affected by the low collection efficiency rate (56.6%). One must keep in mind that while electricity arrears make up about 85.3% of the total municipal arrears, water arrears are equivalent to only about 14.7%⁷³.

Briefly, the moral hazard of *soft-budgetary constraints* is reflected on the one extreme by fairly large fiscal deficits (in modified accrual basis); while on the other it is characterized by the most extreme case of *fiscal indiscipline*, illustrated by the few municipalities actually running operational surpluses that could be used to eliminate their yearly arrears who have chosen not to do so. These municipalities have decided to keep the relatively large cash-flow 'surpluses' and incur in the arrears, taking full advantage of the lack of accountability in the local government system. This illustrates some of the perverse effects associated with *soft- budgetary constraints*. For example, in FY '07 Qalqilia closed operations with a cash-flow surplus equivalent to 58% of its total current revenue budget, while it had financial obligations to pay equivalent to 48% of its revenue budget. If those payables had been properly covered, this municipality could have still closed operations with a modified accrual surplus equivalent to 10%. This same argument applies to the four other municipalities, as illustrated in Table 40 below. Since in practice arrears are paid off out of the VAT, which is one of the Palestinian national taxes, then it may be argued that while a *few* municipalities benefit from these arrears, *every* Palestinian, in practice, ends up paying (through the Israeli deductions to the VAT) for such *soft-budgetary constraints*.

⁷³ Garzon (2009a). p.59

TABLE 40

MUNICIPALITIES RUNNING SURPLUSES AND ARREARS			
Based on Financial Situation in FY 2007			
Municipality	Surplus in Cash-Flow Basis*	Arrears* as a % of Total Recurrent Budget	Surplus in Modified Accrual Basis*
	%	%	%
Azzun	39	22.81	17
Surif	49	32.95	16
Qabalan	54	42.06	12
Kafr Al Labad	28	17.27	10
Qalqilia	58	48.11	10

SOURCE: Executed Municipal Budgets FY 2007. Arrears provided by MoF
 * Calculated as a percent of the total recurrent revenue budget

Source: Annex Financial Situation

Most municipalities that provide electricity may be characterized by poor financial performance. In fact, more than half of these municipalities (i.e., no less than 60% of them) ran *accrual* deficits in their operating budgets in FY'07 (Table 41 below).

TABLE 41
FINANCIAL PERFORMANCE OF PROVIDERS
WEST BANK

(In modified accrual basis: Deducting electricity and water yearly arrears)
 FY '07

Ranking	Range	Number of Mun.	Percentage
A	Surplus > 10%	10	17.24
B	- 10 < B.B. < 10%	13	22.41
C	- 10 < Def. < - 50%	15	25.86
D	- 50 < Def. < - 100%	10	17.24
E	- 100 < Deficit	10	17.24
Total		58	100.0

Source: Annex 8, based on municipal executed budgets for FY'07, and MoF data on water arrears.

Examples of the magnitude of these deficits may be illustrated by the cases of Jenin (-177%), Tulkarem (- 41%), and Nablus (-14%). The median *accrual* deficit is about -57%. There are, however, some exceptions to this pattern of poor performance. For instance, in FY'07, 10 of these municipalities (16.85% of them) ran *accrual* surpluses greater than 10% of their operating budgets. The median *accrual* surplus was equivalent to 12% of *their revenue budget*. Annex 8 includes the *accrual* deficits and surpluses for each of the 132 municipalities.

As discussed above, the large fiscal deficits of *providers* are primarily financed by electricity arrears and to a lesser extent by water arrears. This particular finding seems to imply that as long as there is the option of a '*soft-budgetary constraint*', very likely this will continue to generate *poor* municipal financial performance.

TABLE 42
FINANCIAL PERFORMANCE OF NON-PROVIDERS
IN THE WEST BANK
(In modified accrual basis: Deducting water yearly arrears)
FY '07

Ranking	Range	Number of Mun.	Percentage
A	Surplus > 10%	25	52.0
B	- 10 < B.B. < 10%	10	20.8
C	- 10 < Def. < - 50%	7	14.6
D	- 50 < Def. < - 100%	3	6.3
E	- 100 < Deficit	3	6.3
Total		48	100.0

Source: Annex 8, based on municipal executed budgets for FY'07, and MoF data on water arrears.

In contrast to *providers*, *non-providers* may be generally characterized by sound financial/fiscal management. In fact, more than half of these municipalities (52% of them) have surpluses greater than 10% of their current revenue budgets. The median surplus for *non-providers* is about 25.5%. This result is in sharp contrast to that for *providers*, only 16.95% of which ran surpluses. Also, considering that about 20.8% of *non-providers* operate balanced budgets, this means that approximately 72.8% of all *non-providers* may be characterized by sound financial/fiscal management (as illustrated in Table 42 above). The result is the opposite for *providers*, of which about 64% actually ran significant deficits during the same fiscal year. It should be noted that this

outcome is consistent with the findings on per capita revenues for *providers* versus *non-providers*. Of course, similar to *providers*, there are some exceptions. About 12.6% of *non-providers* (i.e., six municipalities) ran fairly large operating fiscal deficits. The median modified *accrual* deficit for *non-providers*, was -49% (See Annex 8).

It should be noted that the surpluses for municipalities that are *non-providers* are rather significant. The three LGs with the largest surpluses are Azzaytuna (89%), Turmosayya (67%), and Bedu (59%). This result begs the question as to why some municipalities run such fairly large surpluses in their operations, when the need for maintenance, rehabilitation, expansion, and quality improvement of basic services is pressing. Generally, as per international best practices, surpluses in current account (i.e., savings in operations) are allocated to the capital expenditure budget for the following fiscal year. However, in the West Bank and Gaza the municipal capital expenditure budgets (i.e., the “Development Budgets”) are generally funded by the donor community. Therefore, in practice there does not appear to be a great or pressing need to allocate these funds to the local development budgets and they are usually re-allocated to the operating budget of the following fiscal year.

Also, there is as of yet no Palestinian municipal credit system to tap on these *savings in operations* to leverage credit for the financing of public works in infrastructure. There is also no system of matching grants for urban development that could make use of these savings to upgrade municipal services and infrastructure. In addition, most grants-in-aid from the donor community do not require a local financial counterpart, co-financing or joint-financing to enhance allocation efficiency in the municipal capital budget, and/or reward local revenue mobilization efforts/savings. These findings suggest that, at the very least, there is some potential, among some municipalities, to co-finance the efforts of the donor community in local development – i.e., the same way it is done, though on a broader scale, in international best practices. Clearly, this seems to be an area where it is worth exploring alternative options by which municipalities could capitalize on these savings. TA could effectively contribute in the design of these options.

Considering the particular circumstances in the West Bank and Gaza, which may be characterized by a relatively high level of uncertainty regarding the political and economic stability of their institutions, it makes sense to find some municipalities running surpluses (savings) in their operations. These savings (or emergency funds) would of course facilitate the handling of potential financial/fiscal risks or crises. Therefore, at least part of these surpluses, for *providers* as well as *non-providers*, might be an indicator of *risk adversity*, but

also might indicate a *substitution effect* in financial/fiscal municipal responsibilities due to the convenience of funding (directly or indirectly) municipal Development Budgets through the contributions (in cash or in kind) of the donor community.

TABLE 43
MUNICIPAL FINANCIAL PERFORMANCE
IN THE GAZA STRIP

(In modified accrual basis: Deducting yearly arrears in services)

FY '07

Category	Ranking	Number of Mun.	Percentage
A	Surplus > 10%	3	12
B	- 10 < B.B. < 10%	1	4
C	- 10 < Def. < - 50%	3	12
D	- 50 < Def. < - 100%	8	32
E	- 100 < Deficit	10	40
Total		48	100.0

Source: Annex 8, based on municipal executed budgets for FY'07, and MoF data on arrears.

The municipal financial performance (fiscal situation) in the Gaza Strip is worse than in the West Bank. About 84% of municipalities in Gaza ran modified accrual budgetary deficits in FY'07. The median municipal revenue budget is about half the size of what is actually needed. In fact, the median deficit is - 99% (Annex 8). Only one municipality could be classified as running a balanced budget, and only three ran modified accrual surpluses in their operating budgets (Table 43 above). These results are also consistent with the per capita revenues which, as discussed, are much lower than those for *non-providers* in the West Bank while their expenditure responsibilities are practically the same. Municipalities in the Gaza Strip usually finance their budgetary deficits from a combination of different sources which may include water tariffs, electricity arrears of their own energy consumption, arrears in salaries, and budgetary support from donors. This situation is of course expected to remain essentially the same as long as the current economic situation continues.

TABLE 44
SUMMARY OF THE MUNICIPAL FINANCIAL SITUATION
WEST BANK AND GAZA STRIP
(In modified accrual basis, equivalent)

Surplus or Deficit in Current Revenue Budget	West Bank		Gaza Strip
	<i>Providers</i>	<i>Non-Providers</i>	
Median Deficit	- 57 %	- 49 %	- 99 %
Median Surplus	12 %	25.5 %	23 %

To summarize, the worst fiscal deficits are among municipalities in the Gaza Strip (-99%) due to their current economic conditions, followed by those of municipalities collecting revenue from electricity (-57%), due to their *soft-budgetary constraint*, while the relatively smaller deficits are among those municipalities facing a *hard-budgetary constraint*. Equivalently, the largest median surplus is among *non-providers* in the West Bank, followed by the few best performers in the Gaza Strip, while the smallest surpluses are among those that rely on electricity revenue (Table 44 above).

The surpluses on a cash flow basis are misleading of the real financial situation of local governments. Clearly on the surface (and on a pure cash flow budgetary basis)⁷⁴, the balance between expenditures and revenues gives the impression that most municipalities simply do not have any apparent financial/fiscal need for additional revenue from local sources. For instance, that is the case for a significant number of the cash *surpluses* among electricity providers, as documented below.

One of the arguments regarding municipal finance in West Bank and Gaza is that most municipalities have enough of their own revenues to finance their own operations. In fact, an analysis of the municipal financial and fiscal situation based on the executed budgets of the 132 municipalities seems to support this argument. For example, in FY'07 it can be shown that about 80 municipalities (60.6%) closed yearly operations with cash-flow surpluses greater than 10% of their recurrent revenue budgets. In addition, about 36 municipalities in that same year were able to run their operations with a balanced budget.

⁷⁴ It should be noted that municipalities in the West Bank and Gaza generally use cash flow basis budgeting, and cash-flow budgets by definition do not include arrears. Given this situation, arrears were incorporated into this analysis to try to assess the municipal fiscal and financial situation under a modified accrual budgeting and accounting basis.

These two groups of municipalities make up 106 municipalities (87.3%) operating, as it appears, without any financial or fiscal difficulties. Only a relatively small group of municipalities (16, or 12.1%) ran cash-flow fiscal deficits in their operating budgets. Table 45 below provides empirical evidence that supports this argument.

TABLE 45
MUNICIPAL FINANCIAL PERFORMANCE
IN WEST BANK AND THE GAZA STRIP
(In cash-flow basis: Without accounting for yearly arrears)
 FY '07

Category	Ranking	Number of Mun.	Percentage
A	Surplus > 10%	80	60.6
B	- 10 < B.B. < 10%	36	27.3
C	- 10 < Def. < - 50%	8	6.0
D	- 50 < Def. < - 100%	5	3.8
E	- 100 < Deficit	3	2.3
Total		132	100.0

Source: Annex 8, based on municipal executed budgets for FY'07.

The policy implication, based on this evidence, would be that the financial and fiscal situation of only a few municipalities provides some reason for concern. Based on these results, it could be concluded that no major municipal sector policy reforms appear to be needed.

However, cash-flow surpluses or deficits, in and of themselves, can be highly misleading of the actual municipal financial/fiscal situation. This is because cash-flow analysis, by definition, does not take into account accruals, such as for example arrears in electricity, water, or salaries. Any of these arrears can easily not only balance a cash-flow budget, but can also yield an artificial cash-flow surplus; they can also make a deficit appear much smaller than it actually is.

Since all the above factors that may affect a surplus or a deficit are highly relevant in West Bank and Gaza, particularly arrears in electricity and water, they have been included to calculate modified-accrual-based surpluses and/or deficits. These adjusted figures clearly constitute a more accurate measure of the current municipal financial situation. For example, taking the same FY'07 and adjusting for arrears in the executed budgets of the 132 municipalities, the results suggest that only 38 municipalities, rather than 80, have an operational surplus

greater than 10%. Also, only 25 municipalities, rather than 36, operate with a relatively balanced budget. On the other hand, 69 municipalities, rather than 16, ran operational deficits greater than 10% of their total recurrent revenue budgets. These results, based on empirical evidence, show how misleading an analysis limited only to cash-flow budgeting can be. A summary of these results may be found in Table 46 below.

TABLE 46
SURPLUSES AND DEFICITS IN MODIFIED ACCRUAL BASIS
NUMBER OF MUNICIPALITIES
FY '07

Surplus or Deficit in Modified Accrual Basis	West Bank		Gaza	TOTAL
	<i>Providers</i>	<i>Non-Providers</i>	Strip	
Surplus	10	25	3	38
Balanced Budget	13	11	1	25
Deficit	35	13	21	69
TOTAL	58	49	25	132

Source: Tables for *Providers* and *Non-providers* in Annex 8.

These findings, contrary to the analysis on a cash-flow basis, suggest that there are reasons for concern regarding the current municipal fiscal situation. This conclusion is in fact consistent with the main findings already discussed in the previous chapters, such as the *moral hazard* of *soft-budgetary constraints* and the critical financial situation of the municipalities in the Gaza Strip. Therefore, it may be concluded that the municipal own-revenue sources actually merit careful attention in order to equip municipalities with the tools to deal with the current fairly difficult fiscal situation most of them face (52.3% on an accrual basis versus 12.1% on a cash-flow basis). These results are in fact consistent with the argument of the importance of strengthening the property tax system among other own-revenue sources. These, as already mentioned, are areas that could substantially benefit from technical assistance.

4.6 Conclusion

In general, analysis of the municipal financial/fiscal situation on a cash-flow versus a modified accrual basis yields two quite different results. Given that the accruals in most municipalities are fairly significant, the surpluses in the cash

flow municipal budgets are in fact misleading regarding the real financial/fiscal situation of most of the local governments.

In particular, most municipalities that provide electricity (which in practice operate with a *soft-budgetary constraint*) may be characterized by poor financial performance. In contrast, those that function with a *hard-budgetary constraint* (i.e., the *non-providers*) can be generally distinguished by sound financial/fiscal management. Also, there is a group of municipalities with real surpluses/savings in operations which could be channeled to enhance municipal investment efficiency. TA could effectively contribute in the design of mechanisms (incentives) to capitalize on such savings for the better provision of services.

Furthermore, the results, especially regarding electricity and to some extent water supply, show that these two revenue sources in practice contribute, in some municipalities, to the financing of other municipal expenditures. However, this is being done primarily through revenue diversion (net lending), rather than through real surpluses.

Among the services that may be financed through user charges, solid waste faces the most difficult financial situation, particularly in the municipalities in the Gaza Strip. It would appear that TA on the adequate administration of local revenues (such as user charges from solid waste collection) could be highly beneficial.

On the other hand, funding of the maintenance of roads and streets is confronting the most critical financial situation. These types of public goods necessarily need to be financed through taxes. However, local taxes (such as the property tax and the education tax) are not equally available to all municipalities. Some municipalities have to rely on revenues from either utilities, if at all possible; or on main two fees: the licensing of vehicles and construction permits. However, since the revenue from these fees is generally smaller than the actual expenditures on these public works, it could be argued that the maintenance of internal roads and streets needs financial support that could be provided through greater utilization of the property tax. Considering the above situation, the strengthening of local revenue sources could substantially benefit from the technical assistance that has been requested by MoLG to the World Bank.

CHAPTER V: MAIN CONCLUSIONS AND POLICY IMPLICATIONS

This chapter summarizes the main conclusions and policy implications already discussed above. These conclusions and policy implications have been classified into those that need to be addressed in the short and long-term. They are presented under each of the main topic areas addressed in this paper. The main issues and their related policy implications, listed below, constitute the key areas that should be considered by the PA/MoLG in order to design a technical assistance (T.A.) program. The effort put in this report has been in response to the formal request made by the MoLG to the World Bank regarding the ministry's need for technical assistance. It is anticipated that the T.A. will be the result of the identification of key issues, and their policy implications, that can be the input to start a policy/technical dialogue.

5.1 Overall Conclusion

Main municipal services: Based on the empirical evidence, it may be argued that municipalities play a fairly important role in the provision of local services. However, the number of services provided may vary substantially across municipalities, and in terms of actual spending most of the municipal budgetary resources are allocated to only about five to six main services. These include electricity, water, solid waste collection, streets, and roads. This empirical result is in sharp contrast to the fairly comprehensive list of services listed in the law of local councils.

The law does not make clear which of these functions are *mandatory* and which ones are *optional*, or which of these services are supposed to be provided in *concurrency* with other suppliers, or as the *exclusive* responsibility of the local council.

Differences in service provision between Gaza and the West Bank: The empirical results confirm that the municipalities in the Gaza Strip are worse off in terms of service provision than are their counterparts in the West Bank. There are only three main services that stand out in Gaza based on the magnitude of their per capita spending; these services are solid waste collection and disposal, water supply, and sewer systems. With the exception of sewer systems, per capita spending in the Gaza municipalities is lower than in the West Bank for most other services. In general, it could be argued that there is fairly limited provision of services in the Gaza Strip, and that those services relating to sanitation are the priority.

Current municipal classification: The actual MoLG classification of municipalities into four groups is based on criteria that are not relevant to guide local development. Therefore, this study has proposed a new classification into four different groups, based on population size and number of services provided.

Relationship between number of services and municipal size: Even though the data also indicates that larger municipalities seem to have a greater capacity to provide more services than smaller local governments, regression analysis indicates that there is no linear relationship between population size and number of services provided.

The effects of being a *provider* or a *non-provider* of electricity service: Because of the actual effect on financial management of providing electricity, there are two substantially different types of municipalities: The electricity *providers*, which may be characterized as operating in practice under *soft budgetary constraints*, and the *non-providers*, which in practice have been facing *hard-budgetary constraints*. The revenue from electricity, in practice, has been operating as a PA's *subsidy* to those municipalities that incur in large arrears. None of the municipalities in the Gaza Strip provides electricity service.

Horizontal municipal fiscal imbalances between expenditure functions and revenue sources: Though legally all municipalities have the same expenditure functions (or, at least, are entitled to provide the same set of services), they all do not have access to the same local revenue sources. For instance, the property tax is available to only 29 municipalities in the West Bank, and the education tax, which is primarily based on property tax assessments, is also limited to only certain municipalities. As such, it may be concluded that there is a *horizontal* fiscal imbalance across municipalities, between the services that they are at least entitled to provide, and the actual revenue sources available to them. This *horizontal* fiscal inequity is further worsened by the implicit *subsidy* to those municipalities that incur substantial electricity arrears.

Municipal revenue sources: In contrast to local taxes, user charges are available to all municipalities. In fact, the main municipal services being provided are those primarily financed through user charges. Services whose financing depends, at least in principle, on local taxes, are limited to the tax sources effectively available to them or to other sources such as fees and, of course, the implicit subsidies from discretionary electricity arrears. As such, one of the main municipal financial challenges appears to be the provision and maintenance of

those services that depend on local taxation rather than of those services that may rely on user charges.

Comparison of per capita revenue and expenditures: For services such as electricity and water, the current average revenue is much greater than the average expenditure. However, there are exceptions to this general pattern. There are a few municipalities in the West Bank that actually spend more on the service than they actually collect. Also, in Gaza many municipalities actually cannot cover their cost of water provision with the revenues that they are able to collect. Furthermore, the financial situation in the provision of solid-waste collection and disposal shows a very large operational deficit. This situation generally is more critical among the Gaza municipalities, since they have much lower per capita revenue. These deficits in specific services are usually financed by general revenue, or by surpluses in other user charges, as well as by fees, local taxes, and through arrears.

In contrast to household services that in principle should be financed through user charges, there are several types of physical infrastructure (i.e., internal roads, streets, drainage of rain water, sidewalks, and public parks) which need to be financed primarily through local taxes. These types of infrastructure are the main municipal public services that currently lack adequate financing sources. Construction permits and vehicle registration fees generally are not adequate sources of finance for the maintenance of physical infrastructure.

Municipal financial autonomy: Municipalities do not have the financial autonomy they need to determine, at least within some range or limits, the specific rates for their different revenue sources. User charges, tax rates, and fees need the approval of the PA -- either through the MoLG or the corresponding sectoral authority. Furthermore salaries are established by the MoLG. This lack of autonomy in municipal financial management may be compromising, at least to some extent, financial accountability and performance in service delivery.

Inherent constraints on the performance of small municipalities: A significant number of municipalities are so small that they have hardly been able to generate enough revenue to pay for salaries. This seems to be the case particularly among some LGs in the lower population classes, both in the West Bank and, especially, in the Gaza Strip. One way out of this difficult situation is of course to under-staff their administration and operations; however, this *solution* further compromises the already limited role of the fairly small LGs as service

providers. Amalgamation with other municipalities, at least in principle, is an option that undoubtedly is worth exploring.

Expenditures and revenues patterns across different sizes of municipalities: Empirical results show that larger municipalities appear to spend more, in per capita terms, on the provision of services than do smaller LGs. In fact, per capita revenues for the same revenue sources are higher in larger municipalities than in smaller local councils. These results seem to support the case for amalgamation of small LGs into larger jurisdictions. The large municipalities located in the Gaza Strip seem to be the exception, given their relatively lower per capita revenue generation.

The moral hazard of soft-budgetary constraints: The actual possibility for *providers* to use revenue from electricity, at their discretion, while increasing their arrears, has in practice operated as a *soft-budgetary constraint*. This lack of fiscal discipline, however, has had a negative impact in municipal financial management, which is reflected in, among other things, low local revenue mobilization efforts. In practice, this has constituted one major *moral hazard* of *soft-budgetary constraints*. Empirical evidence has shown that per capita revenues generally are lower among providers of electricity than among non-providers.

Also, the results indicate that the level of spending is higher among *providers*. For instance, the number of staff per capita is generally larger for the group of *providers* than for *non-providers*. The per capita spending on services such as water, solid waste collection, and roads and streets is also higher in this group.

Furthermore, in a narrow *cash-flow basis* analysis, it appears that some municipalities have operational surpluses, while on a *modified accrual-basis* their financial situation generally shows operational deficits financed primarily through electricity arrears.

The virtues of hard-budgetary constraints: In contrast, the empirical results show that among non-electricity providers that in practice operate with hard-budgetary constraints, local revenue mobilization is generally higher in per capita terms. Also, these hard-budgetary constraints generally impose greater fiscal discipline as reflected by yearly financial operations that are much closer to balanced budgets.

Staffing and economies of scale in municipal administration: The results indicate that municipalities, on average, are not overstaffed. In particular cases, however, it may be found that some municipalities may be overstaffed, while others could actually be understaffed. Empirical evidence indicates that while the average number of employees per thousand inhabitants for the West Bank and Gaza as a whole is 2.7, the actual range in number of employees across municipalities fluctuates between 1 and 11. Municipalities in the Gaza Strip, on average, seem to employ a greater number of employees (2.9) than municipalities in the West Bank, comparing both *providers* (2.7) and *non-providers* (2.4). Also, the results suggest that the total cost of payroll across municipalities in both the West Bank and the Gaza Strip seems to be determined more by the number of employees, than by their average salaries.

Furthermore, the empirical results show that the largest cities/municipalities do not necessarily have the greatest number of staff. In fact, the results from regression analysis indicate that there is no linear relationship between municipal population-size and the relative number of employees working in the municipal general administration. As such, it may be concluded that amalgamation, per se, will not automatically result in savings in administrative costs. However, potential economies of scale might still occur in the provision of the different municipal services, through amalgamation or any other equivalent means.

Main Issues and Policy Implications

This section has been divided into parts: The first part refers to those issues and policy implications that are more suitable to be addressed in the short term; while the second part covers the issues and policy implications that would need to be considered more as a long term task due to their own nature.

As already mentioned above, each of these key topics constitutes the areas in which T. A. to MoLG should focus.

5.2 Short Term Issues and Policy Implications

Municipal Revenues and Expenditures

Horizontal Fiscal Imbalance: Most municipalities urgently need adequate revenue sources to cover the costs particularly of physical infrastructure that cannot generally be financed through user charges. Not all

municipalities have access to property and education taxes, while the needs are fairly significant. For example, in West Bank and Gaza roughly 45% of the municipal roads are unpaved; in Gaza City, which is the largest urban area in West Bank and Gaza, only 30% of the streets receive regular maintenance. Furthermore, also as already mentioned, these municipalities only have 82% of the classrooms that they need.

Consequently, consideration should be given to eliminating the fiscal imbalance (*horizontal inequity*) that currently exists across municipalities between municipal services and available revenue sources for their financing.

Recurrent expenditure efficiency indicators and staffing: In order to address municipal fiscal deficits and promote expenditure efficiency and fiscal discipline, particularly among electricity providers, efficiency indicators on staffing and salaries according to the size and budgetary capacity of each municipality should be considered. MoLG, in coordination with MoF, could jointly determine these expenditure efficiency indicators. The empirical results show that about 2.7 staff per 1,000 inhabitants comprises the national average in West Bank and Gaza. The current range fluctuates between one and 11 staff per 1,000 inhabitants, which seems to indicate that there is potential for downsizing particularly in those municipalities with clear evidence of overstaffing. Adjustments due to overstaffing would need to be carefully considered as a component of any municipal fiscal restructuring program (MFRP).

Municipal services cost, minimum standards, and cost recovery: It is critical that the municipalities determine the cost of providing their services. Without establishing this fundamental element, municipalities cannot accurately design adequate service price structures. While some cost estimates do exist, particularly for electricity, water, and solid waste, other municipal services must develop and systematize this information so that adequate user charges can be applied, (i.e., in the case of refuse collection and disposal, slaughterhouses, solid waste treatment, and waste water treatment, among other services). MoLG through MDLF should consider providing technical assistance to the LGs regarding service cost-accounting, minimum standards, service price setting, billing system, beneficiaries' record keeping, revenue collection, and payment enforcement.

A municipal fiscal restructuring program: As municipal electricity distribution service will be transferred to regional utilities while there is a heavy reliance on this revenue by a significant number of municipalities for the financing

of other municipal expenditures, it will be critically important to consider supporting this transition with a municipal fiscal restructuring program (MFRP). Such a program could gradually facilitate this transition and alleviate the negative *net* fiscal impact on the affected municipalities.

5.3 Long Term Issues and Policy Implications

Amalgamation: Taking into account the relatively large number of small size municipalities, (about 27, or 20.5%, have under 5,000 inhabitants), consideration should be given to different options that could contribute to the reduction of the unit cost in service provision (i.e., enhance the economies of scale) in the provision of municipal services. It is, of course, recognized that each option poses different political difficulties that would need to be resolved in order to gain the needed political support. The main policy options listed below include the most ambitious, though politically the most difficult as well as the most modest, and perhaps the least effective, though politically easiest:

- (i) After 1994 and the early 2000s, the PA converted roughly 100 village councils into municipalities. Consideration should be given to revising this decision, particularly for municipalities with less than 5,000 inhabitants. This could imply bringing the small municipalities back to their former status regarding service responsibilities and budgetary obligations.
- (ii) An alternative would be to enable neighboring municipalities to discuss the possibility of becoming a single entity. Merging small jurisdictions would significantly increase their overall population and their economic/fiscal base and would reduce their administrative costs. In this scenario, the decision would be in the hands of the residents of each municipality, rather than being a CG policy decision.
- (iii) Mandating the provision of specific services through the equivalent of JSCs, or service districts, would in principle allow small municipalities to benefit from lower unit costs (i.e., economies of scale).
- (iv) Establishing that the MDP's third window is only for municipal projects from municipalities larger than 5,000 inhabitants; and smaller municipalities would be included only if they associate for joint service provision.

- (v). Encouraging amalgamation using special capital grants (through JSC, special districts, mergers, municipal partnerships for specific public works and service provision, regional providers, and public-private partnerships) awarded through the third window of MDLF/MDP's Capital Allocation Grant System (CGAS).

Municipal fiscal capacity and municipalities with different tax sources: As noted under conclusions, tax sources across municipalities are not uniform, while expenditure responsibilities are the same for all of them. Only some municipalities in West Bank and Gaza benefit from two local taxes: the property tax and the education tax.

The property tax: The potential for the property tax in the West Bank is fairly large; the average yearly per capita property tax is 71 Shekels, and the median of 41.5 Shekels is still significant. Per capita property tax collections range from 3.84 to 428 Shekels. This broad range suggests some potential for substantial improvements in collection efficiency. These results also indicate that this tax could be helpful to both those municipalities in greater need of fiscal resources to maintain their physical infrastructure (particularly internal roads and streets) as well as to those municipalities that will face the most severe negative revenue impact due to the transfer of electricity distribution to regional utilities.

The most pressing limitations blocking the implementation of the property tax in the remaining 78 West Bank municipalities have to do with the need for adequate land registers, which appear to be insufficient. Also, as it appears, by law municipalities first need to have a master plan approved by MoLG, before MoF can proceed with the tax assessments. Other factors are the institutional capacity that needs to be in place to administer this tax; as well as the funding to finance municipal cadastres. Expedient ways and means to overcome each of these constraints should be considered. The roles of the MoF and MoLG are critical to this end. In the meantime, consideration should be given to some form of revenue contribution from real estate property owners, such as a minimum tax which in principle could be directly collected by the largest municipalities. Because smaller municipalities may lack the institutional capacity to collect this minimum tax, they could be given the option to delegate their collection responsibility and still benefit from this potential revenue source.

The education tax: This tax is levied by only about 42 percent of the municipalities in the West Bank, and it is not collected in the Gaza Strip. Specifically, this tax is being levied in about 46 municipalities, whereas the MoF

levies a property tax in only 29 municipalities. This suggests some form of local tax effort by 17 municipalities, because it is supposed to be collected only in those municipalities where MoF collects the property tax, as it is based on property tax assessments.

The education tax is atypical. It is not a common tax on municipal finance. Generally, education is supposed to be a national responsibility. This tax is not only meant for school maintenance and rehabilitations, but also for building schools. These functions (due to the goal of inter-jurisdictional equity and the need of an adequate allocation of public funds across jurisdictions) may not be considered appropriate as local responsibilities particularly in very small municipalities.

Urban and rural betterment levies: Generally, in most countries throughout the world, there is some form of urban/rural betterment levy with the specific purpose of financing urban/rural infrastructure such as the construction and maintenance of the urban transport network as well as rural roads. The Palestinian municipalities do not have this revenue source. Consequently, it is worth considering this levy as a potential source of infrastructure financing; particularly as the current revenue sources for the financing of internal roads and street maintenance are insufficient.

Municipal functions, revenues, and inter-governmental relations: The most suitable revenue sources for municipal infrastructure finance include the property tax and betterment levies. These are relatively long-term actions that are worth considering. In the short term, the increase in the transport registration fee to 90% also seems worth taking into account since it would contribute, though modestly, to alleviating part of the municipal revenue constraints.

Clarity in the assignment and responsibility for municipal functions: Article 15 of the “Local Councils Law” does not seem sufficient to determine legal accountability. The law is ambiguous; on the one hand it states that “the local body *shall assume* the following functions,” while in the same paragraph, it also says “the council is *entitled to assume* these responsibilities”. In practice, however, the numerous functions seem to operate more as a ‘*legal option*’, than as a ‘*legal responsibility*’.

There is a need for legal clarification, in terms of which local services are mandatory, which ones are optional, and what institutions would be ultimately responsible (accountable) for the provision of each service. Assuming that these functions are the exclusive responsibility of the local councils, they may need to be revised. For instance, the functions related to health care centers and social

assistance programs would be more suitable for the central government (CG). In fact, a significant number of these institutions are currently being run by the CG; and most LGs do not provide these services.

Also, clarification of the law should differentiate between three basic concepts in local service provision: *concurrency* in service provision across levels of government, *joint* responsibility, and *exclusive* responsibility over each specific local public good and service.

Furthermore, revision of the law could explain the exact responsibilities regarding local service provision of each different level of government, as well as of each of the different types of LG. Currently, it appears that provision of the public goods and services in the law seem to be assigned to LCs, both municipal and on the village level.

Clear definition of who is ultimately accountable for each function would contribute to improving the coverage and quality of local public goods and services. In addition, it would help to strengthen the respective revenue sources that are needed for financing such functions.

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