

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

Report No.: 100602

Project Name	PALESTINIAN NATIONAL DEVELOPMENT PLAN DEVELOPMENT POLICY GRANT VII
Region	MIDDLE EAST AND NORTH AFRICA
Sector	MACROECONOMIC AND FISCAL MANAGEMENT GLOBAL PRACTICE
Project ID	P156865
Borrower(s)	PALESTINE LIBERATION ORGANIZATION
Implementing Agency	PALESTINIAN AUTHORITY/MINISTRY OF FINANCE
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1. Country and Sector Background

1. The proposed DPG VII is a standalone operation aimed at supporting the Palestinian Authority (PA) in improving the management of public finances and improving the business environment. Specifically, the DPG will support the PA's efforts in augmenting tax revenues and cutting inefficiencies in public spending in order to reduce the fiscal deficit amid declining donor aid. The DPG will also support the PA's effort to reform and further strengthen public finance management, and improve the business environment by facilitating land registration. DPG VII builds upon the reform progress supported by the previous DPGs.

2. As envisaged in the Assistance Strategy FY15-16 for the West Bank and Gaza, DPGs remain a key instrument aimed at supporting the PA's strategic priorities, advancing policy dialogue, and also providing essential financing for the PA's budget. Due to the severity of the political situation, in particular in Gaza, and the impact of restrictions¹ on movement, access and trade on private sector investment and growth, real income per capita in the Palestinian territories has been shrinking for three years in a row. The PA's revenues have also been affected by the decline in GDP and delays in the transfer of revenues collected by the Government of Israel (GoI) on behalf of the PA.

3. The preparation of this DPG is taking place against the backdrop of high political uncertainty and fragility following the failure of last year's peace talks. The peace process between the GoI and the PA led by the US Secretary of State Kerry resumed on July 29, 2013, giving fresh hope for peace, stability, and prosperity in the region. However, the talks broke down in April 2014, resulting in heightened uncertainty about the future and growing pessimism within the Palestinian population, including business community. Soon after the peace talks failed, a war broke out in Gaza (July 2014) leaving the two parties further away from a peace deal. The efforts to create a unified Palestinian government in West Bank and Gaza have not succeeded so far.

4. Against this grueling background, progress on structural reforms has continued, though unevenly in some policy areas. Emboldened by low energy prices, the PA has made very good progress in reducing explicit and implicit energy subsidies (on fuel and electricity). As a way to contain the wage bill, the PA has committed to zero growth in the number of staff on its payroll in 2015 and the

¹ The Government of Israel states that these restrictions are necessary for security purposes.

Cabinet has subsequently committed to reduce the size of civil service. The PA is also making good progress in implementing a subset of required health reforms, but overdue pension reforms are still on hold. Furthermore, the PA has finalized a revenue strategy and started implementing it. However, additional tax policy and enforcement measures are needed to broaden what is currently a narrow tax base by international comparison. Some progress is also being made to improve the public financial management systems.

5. While extreme poverty remains low in the Palestinian territories, broad poverty certainly is an important issue in particular in Gaza, and if the current trend of reduced growth persists, poverty could be on the rise. Almost 26 percent of Palestinians lived in poverty in 2011 according to the national poverty line.² The percentage of extremely poor is small: even if the poverty line is raised from USD1.25 to USD2 per day, the poverty rate is less than 5 percent. However, the overall figure at the national level masks wide regional divergence. In Gaza, the poverty rate was 39 percent, which is more than twice that in the West Bank at 18 percent. This regional contrast was driven by the severe economic shock that hit Gaza following the internal divide, which led to a dramatic poverty increase in 2007, leaving one in two Gazans living below the poverty line. Similar to other countries, larger households in the West Bank and Gaza tend to suffer from higher poverty levels. In 2011, the highest poverty rate of 50 percent was amongst individuals who are part of households comprising 10 or more members. Additionally, the incidence of poverty amongst households headed by civil servants was ten percentage points less than those headed by workers in the private sector. This is explained by the ongoing strain on private sector activity caused by Israeli restrictions. Notably, social transfers have continued to play a key role in reducing poverty levels, especially in Gaza. In 2011, and in the absence of all social programs, the official poverty headcount rate would have been 11 percentage points higher. If these social payments were to be reduced or discontinued, it is expected that a large number of households would fall back below the poverty line.

2. Operation Objectives

6. The reform program covered by the DPG VII aims at supporting the PA in enhancing the management of public finances and improving the business environment. Specifically, the PDOs of this operation are the following: (I) Improve public revenue performance and improve sustainability of public expenditures; (II) Improve transparency of public finances; (III) Facilitate the land registration process.

7. This operation has been designed to support the first two objectives of the Government's National Development Plan (NDP) 2014-2016. The first objective of the NDP is focused on growth, competitiveness, and job creation. It will be supported by this operation through actions taken to facilitate the land registration process, currently deemed an obstacle to private investment. The second objective of the NDP relates to better governance in public institutions, which will be supported through actions aimed at improving public revenue performance and improving sustainability of public expenditures, as well as actions aimed at improving transparency of public finances.

8. Results to be achieved through this operation are expected to strengthen the PA's fiscal position and facilitate land registration. DPG VII supports actions specifically aimed at enhancing the PA's domestic revenue performance. On the expenditure side, the operation covers several actions aimed at reducing the size of net lending³ and the cost of medical referrals outside of the public health system. This operation also supports the PA's efforts in improving the quality of information on intergovernmental fiscal relations between the PA and local governments through publishing online

² More recent poverty data is not available yet.

³ Net lending represents deductions by the GoI from clearance revenues it collects on behalf of the PA for unpaid utility bills by Palestinian public utilities and local governments.

reports that include detailed information on transportation fees. DPG VII also supports the PA's efforts in implementing a commitment system in a number of line ministries. Both these actions are expected to improve the transparency of public finances. Finally, DPG VII includes an action taken recently by the PA to eliminate first time land registration fees and charges. This action is expected to facilitate the land registration process as these fees were considered a barrier to first time registration.

3. Rationale for Bank Involvement

9. As envisaged in the Assistance Strategy (AS) FY15-16 for the West Bank and Gaza, DPGs remain a key instrument aimed at supporting the PA's strategic priorities, advancing the policy dialogue, and also providing essential financing for the PA's budget. The operation supports reforms which are expected to improve sustainability and transparency of public finances and which are expected to facilitate the land registration process in order to encourage private sector investments, which are essential for economic growth. Ultimately, these reforms are expected to contribute to the reduction in poverty and inequality. It is important to stress that the financial significance of this operation is not only in that it provides USD40 million in Bank financing, but that it directly leverages the support of other donors through the Palestinian Recovery and Development Plan (PRDP) Trust Fund in the amount of roughly USD200 million per year. The operation also provides a positive signaling effect to other donors that provide assistance directly to the PA during the time when such assistance is of utmost importance for the Palestinian economy and public finances.

4. Financing

10. This operation will provide US\$ 40 million in grant financing for the budget of the Palestinian Authority. The entire proceeds of this operation will be disbursed in a single tranche.

5. Institutional and Implementation Arrangements

11. The PA MoF will be the main implementing agency for the operation. It will also be responsible for coordinating activities with other relevant organizations within the PA. As has been the established practice with the previous development policy grants, the Ministry of Finance will continue producing regular quarterly progress reports.

12. Bank staff located in the World Bank's West Bank and Gaza office, in Jerusalem, will continue regular dialogue and monitoring activities focusing on the impact outcomes of the program. They will also conduct formal supervision missions. The review will be largely based on the results framework and a set of specific monitoring indicators, which are currently being finalized together with the PA Ministry of Finance. At the same time, the overall status of the Government's program will be monitored to determine whether the actions supported by the proposed operation have been met.

6. Benefits and Risks

Benefits

13. The operation is expected to contribute to enhanced governance in public institutions, improved sustainability of public expenditures, as well as improvements in the land registration process, expected to facilitate private investment.

14. The political and security situation in the West Bank and Gaza is very fragile, as demonstrated by the very recent outbreak of conflict in Gaza, which remarkably increased the level of uncertainty pertaining to the economic and political situation. The recent social unrest and civil service strikes also attest to the fragility of the political situation. The highly volatile political situation could deteriorate, with the consequence of stalled reforms. If the security situation relapses, private sector confidence and investment will decline, public revenues will fall and government reforms may stall. The PA will probably not be able to meet its medium term fiscal goals without substantial economic growth. However, under the recent political uncertainties, the broad relaxation of movement and access restrictions imposed by GoI in both Gaza and West Bank and restrictions on economic activity in Area C have slowed down. The international donor community is continuing to monitor the closure system and its economic impact. What is critical at this juncture is that the PA has continued to implement structural reforms despite the highly difficult economic environment and fiscal pressures and remains committed to continued reforms.

15. Possible reduction in the level and predictability of donor assistance poses significant risks to the PA's fiscal position and growth. While the PA has charted a course toward lesser dependence on external aid and is actively undertaking the relevant reforms, it will take many years for the PA to achieve fiscal sustainability and that will only be possible if there is a political settlement that allows for strong private sector-led growth. Thus, a further reduction in the overall level of donor assistance or its regularity is a significant source of risk to PA's finances and the Palestinian economy as a whole.

7. Poverty and Social Impacts and Environment Aspects

16. **Government actions supported under this operation are not expected to have any negative impact on poor and vulnerable groups in the Palestinian territories.** For instance, measures aimed at improving tax revenue collection will not increase tax rates (rates were recently decreased) or increase the tax liability of the poor and vulnerable groups. They are aimed at improving the collection efficiency and reducing tax evasion by private enterprises and wealthier individuals.⁴ Measures aimed at containing government expenditures and improving their efficiency will not cut any benefits to the poor. In fact, in its 2015 budget, the government has increased the number of beneficiaries in its means tested cash transfer program. Likewise, the aim of other measures is to eliminate waste and financial leakages outside of the Palestinian economy.

17. **Over the medium-term, the reforms supported by this operation are expected to translate into augmented fiscal space for essential poverty-reducing programs and improved prospects for employment opportunities in the private sector, which is particularly important for women and youth.** As argued in the recently finalized Public Expenditure Review, measures aimed at increasing government revenues combined with measures to reduce inefficiencies in public expenditures will increase the fiscal space for essential poverty-reducing expenditure programs. Improved fiscal management is also an important requirement for economic growth and job creation and so is cheaper land registration and a better functioning land market. This would have a positive poverty and social impact in particular on women and youth, whose participation in the labor market is currently low, but the PA is giving particular emphasis to the creation of employment opportunities for these two social groups in its 2014-2016 NDP. Other PFM reforms supported by this operation are aimed at strengthening public finance management practices, which usually strengthen accountability of public

⁴ Individuals with gross taxable annual income of less than NIS50,000, which is significantly above the household poverty line (NIS27,516) are within the 5 percent tax bracket and with allowances pay a maximum of NIS1,000 of tax.

officials, increase efficiency and efficacy of public expenditures, all of which are important determinants of economic growth and development.

Environmental Aspects

18. This operation will not have significant effects on the country's environment, forests and other natural resources. The environmental and natural resource implications are driven by the activities embedded in the design of an operation. None of the prior actions will have environmental impacts or substantial environmental risks.

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