PROGRAM-FOR-RESULTS INFORMATION DOCUMENT (PID)
CONCEPT STAGE

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Program Name	*Third Municipal Development Program*
Region	*Middle East and North Africa*
Country	West Bank and Gaza
Sector	*Social, Urban, Rural and Resilience*
Lending Instrument	*PforR*
Program ID	*P159258*
{If Add. Fin.} **Parent Program ID**	*Not Applicable*
Borrower(s)	*The Palestinian Liberation Organization (on behalf of the Palestinian Authority)*
Implementing Agency	*The Municipal Development Lending Fund*
Date PID Prepared	*August 24, 2016*
Estimated Date of Appraisal Completion	*March 1, 2017*
Estimated Date of Board Approval	*May 18, 2017*
Concept Review Decision	{*Insert the following*} Following the review of the concept, the decision was taken to proceed with the preparation of the operation.
Other Decision *{Optional}*	*Teams can add more if they wish or delete this row if no other decisions are added*

Introduction and Context

A. Country Context

1. **Without a permanent peace agreement, Palestine remains fragmented and heavily dependent on dwindling donor aid to meet its development needs**. As a result of the Oslo Accords, the Palestinian Authority (PA) was established to govern, for an interim period, the territory partly under its control in the West Bank and Gaza. However, the current multilayered system of physical, institutional and administrative restrictions continues to stand in the way of increased economic growth and private sector investment.

2. **The Palestinian economy was making progress towards the twin goals of eradicating poverty and increasing shared prosperity with less than 1% of the population living on less than US$ 1.25 a day.** Between 2004 and 2009, the annual per capita income growth of the bottom 40 percent of the population slightly outpaced the average per capita income growth. Since then the Palestinian economy has been under considerable strain with a sharp deceleration in economic growth, from over 8 percent during 2007-2011 to just 3 percent during 2012-15. Currently, about 25.8 percent of Palestinians are living in poverty according to the national, basic-needs based poverty line. In addition, a GINI coefficient of 40.3 percent indicates a significant

level of income inequality in the Palestinian territories.

B. Sectoral (or multisectoral) and Institutional Context of the Program

Urban management institutions and fiscal systems

3. **Local government units (LGUs) in Palestine have a long history with some municipalities established over a century ago.** LGUs were the only administrative institutions allowed to exist and function officially until the Palestinian Authority (PA) was established**.** With increasing political and geographical fragmentation over the last two decades, LGUs have gained paramount importance providing services to the local population, particularly in areas where the nascent central authority was politically, geographically, and fiscally constrained.

4. **The Ministry of Local Government (MoLG) was established in 1994 by the PA to oversee the development of the local government sector and take the lead in policy formulation.** The Palestinian territories are 75% urbanized with 146 municipalities operating within the West Bank and Gaza. Municipalities have historically been responsible for the provision of key infrastructure and services at local level including but not limited to electricity, water, solid waste management services, and school building maintenance, local roads, parks, and municipal markets.

5. **However, in light of eroding budgets and accumulating arrears, municipalities struggle to address the swelling service needs of their rapidly increasing urban populations, let alone to invest in rehabilitation and upgrading of strained infrastructure networks.** Municipal revenues fall far short in financing the expenditure assignments prescribed in the Local Government Law of 1997. Consequently, only a fraction of the prescribed 27 expenditure assignments are fulfilled by the majority of municipalities, namely solid waste management, local roads, electricity, and water services. Revenues barely cover operational expenditures, let alone capital investments to address critically needed services improvements and extension to rapidly growing municipalities.

6. **Despite these challenges, the PA recognizes the role of municipalities to deliver basic services and facilitate economic development**. For close to a decade, the National Development Plans had included pillars to support local development and recognized the need for LGUs to be better managed and more accountable in order to provide effective services for their citizens.

Key results of the previous phases of Municipal Development Program: 2009 - 2016

7. **The PA developed the Municipal Development Program (MDP) as the centerpiece of government support to the municipal sector.** The MDP established a system to provide performance-based grants to all Palestinian municipalities. The MDP was designed as a multi-phase series of programs with updated Key Performance Indicators (KPI) and elevated targets that measure municipalities' management capability per phase. Municipalities are ranked based on the KPIs they achieve and receive capital investment grants that increase with their performance through the Grant Allocation Mechanism (GAM). In addition to performance

measured by KPIs, the GAM also includes a per capita and needs-based allocation.[1]

8. **The PA funded the MDP with the Bank and key donors in municipal sector, while supplementing the MDP through either theme-specific or geographically limited municipal support activities from donor financing outside of the MDP.** [2] Municipalities have been operating well under the MDP and recognize the benefits of the performance based grant allocations. The program is currently in its second phase which builds upon the performance based grant allocation system[3]and has refined the criteria and rankings to focus further on delivering better services. Currently, seventy municipalities out of 138 graduated up a performance category. The satisfaction rate with municipal services of citizens has increased from 46% to 56% over the course of the project, particularly in the roads sector with 60% of surveyed citizen expressing satisfaction with municipal performance.

Defining Municipal Reform Agenda - Government Program for 2017 – 2022

9. **The PA is currently formulating the Government Program for 2017-2022, including the proposed Performance for Results operation called Third MDP (MDP 3).** To materialize the goal of a National Development Plan (NDP) for 2017 -2022 in municipal sector, the PA is currently formulating a Local Government Strategic Framework (LGSF). The LGSF is to guide creation of the Government Program for municipal sector. The proposed MDP 3 is envisioned by the PA to become the centerpiece of the emerging Government Program by contributing to all of the 4 objectives of LGSF, namely: i) improving the enabling environment under which local governments operate; ii) encouraging better local government performance; iii) promoting local economic development and; iv) stimulating citizen's awareness and engagement in local development. The PA envisions the proposed MDP-3 to become the centerpiece of the emerging local government sector program in the NDP 2017-2022 by contributing to all four objectives of the LGSF.

10. **The proposed MDP-3 would build on the success in incentivizing municipal level reforms and performance improvements.** While the MDP has been effective in improving municipal management performance, additional support is required to improve municipal services' financial sustainability and accountability. The proposed MDP-3 would also start developing the municipal capacity in attracting financing for larger-scale, multi-year municipal investments. Capital investment projects under the past phases of the MDP tended to be small infrastructure projects, such as internal roads, that can be completed within each of the MDP's 18 month cycle and are within MDP's allocation for individual municipalities. Although the MDP allocations were crucial to partially fill the funding gap for municipal investments, there is increasing demand from municipalities to invest in larger projects that would require multi-year financing. In light of the MDP's limited financing envelope and dwindling donor resources, it is critical for municipalities to develop the capacity to formulate investment proposals that can, in the long run, attract

[1] Needs are measured by two proxy indicators: municipal infrastructure needs and poverty rate.
[2] MDP was funded by the Bank, parallel financing from KfW, AfD, the Netherlands, co-financing from Sweden and Denmark (through Partnership for Infrastructure Development Multi-Donor Trust Fund), and 10% of total budget contribution from the PA. However, the PA contribution has been chronically delayed.
[3] Formula during MDP phase 1: population (40%), needs (20%), and performance (40%). The performance element was increased to be 50% weight for MDP phase 2.

financing from less concessional sources.

11. Central level reforms are also required to enable municipalities to enhance the financial sustainability of municipal service delivery. The GAM established under the MDP has been effective to provide incentives for municipal performance improvements. However, the mechanism continues operating outside the PA formal transfer system, despite the original intention to strengthen the PA's inter-governmental fiscal arrangements. In parallel, the lack of a transparent and predictable transfer affects the PA's overall fiscal performance and contributes to the distortions caused by Net Lending. At the same time, the PA's financial contribution to the MDP has been chronically delayed, indicating systematic shortcomings in the way the PA allocates municipal capital investment grants. Municipalities have no reliable revenue source to compensate for the chronical shortage in own-source revenues. In addition, limited transparency and irregularities in the way the PA intercepts the municipal share of tax revenue has been crippling the municipalities' abilities to effectively plan and deliver basic services. Current policies and central level oversight of municipal budgeting, financial reporting, and accounting have further contributed to spilling expenditures and inefficient municipal service management. While the PA seeks additional funding sources to address the large and growing municipal investment gap, a system through which financially sound municipalities can start accessing less concessional financing has yet to be developed. No municipal borrowing framework exists and despite the long-term intention, MDLF has yet to develop the institutional mandate, capacity and internal regulations to become a financial intermediary to materialize the PA's decade old-vision.

C. Relationship to CAS/CPF

12. The proposed MDP 3 directly supports the first pillar of the Interim Assistance Strategy which focuses on good governance and institution building. The proposed MDP 3 will support good governance by providing resources for municipal infrastructure based on performance indicators for participatory planning, financial management, transparency and sustainable delivery of services. The proposed MDP 3 will also further strengthen institutions at the local level to spatially plan larger infrastructure projects and at the central level for the MDLF to launch its path to become the financial intermediary to support municipalities' access to commercial financing in the long run.

D. Rationale for Bank Engagement and Choice of Financing Instrument

13. The Bank is well placed as the recognized technical leader amongst development partners with a broad range of experience in strengthening LGUs. The Bank has also been instrumental in strengthening donor coordination in Palestine and leading the technical design of previous municipal strengthening programs. The effort resulted in an increased number of co-and-parallel financing donors to the MDP from six in the first phase to nine for the second phase of MDP, leveraging the Bank's funding by 7 times.

14. The MDP has demonstrated that municipalities are willing to reform and enhance their performance, however further reforms are needed at the national level to create enabling environment for municipal efforts. The choice of the Program for Results instrument for the proposed MDP 3 is appropriate since reforms at the PA level have proven to be difficult to achieve without proper incentives.

II. Program Development Objective(s)

Program Development Objective and Results

A, Program Development Objective(s)

15. **The program objective is to improve municipal management for accountable and financially sustainable service delivery.** To achieve this objective, the proposed MDP 3 would contribute to all 4 objectives of LGSF as a centerpiece of emerging Government Program.

B. Key Program Results

The proposed MDP 3 will produce enhanced institutional performance resulting in:

- Increased amount of own source revenue at municipal level;
- Improved management of municipal service related arrears;
- Improved municipal infrastructure, service delivery, and Operations and Maintenance (O&M) systems;
- Strengthened accountability in municipal service revenues, expenditures, arrears, and outputs ;
- Strengthened budgetary and performance oversight of municipalities by the PA;
- Unconditional fiscal transfer based on per capita allocation introduced from the PA to municipalities.

16. **The independent annual assessment will be the main tool to assess progress in addition to the KPI assessment done by MDLF.** The proposed program fund will be provided through disbursement linked indicators (DLIs).

Program Description

A. PforR Program (MDP 3) Boundary

17. The proposed MDP 3 will support the PA to implement emerging Government Program guided by the LGSF as the Program's centerpiece. Similar to previous phases of MDP, the proposed MDP 3 will serve as the only performance-based grant targeting all of Palestinian municipalities. Other donors, such as USAID, are currently preparing local government programs to provide either grants to limited number of municipalities or technical assistances in limited thematic areas of municipal capacity development. The MoLG is coordinating donor programs to avoid duplication and to align as much as possible under the principles of MDP to better serve the LGSF.

18. **Indicative commitments from the Development Partners for the proposed MDP 3 are**

estimated at USD 62 million in addition to the Bank's USD 15 million contribution through Special Financing. The total of USD 77 million is roughly half of the estimated MDP 3 financing needs by the PA.

19. Building upon previous phases, the core of the proposed MDP 3 would remain the performance, needs, and population-based grant allocation to incentivize improvement in municipal management. The majority of proposed program funding will, therefore, continue to be individually allocated to municipalities based on their performance on updated KPIs to meet their municipal service investment needs.

20. In addition, the proposed MDP 3 would include a number of new areas necessary to further improve financial sustainability and accountability of municipal service. Firstly, the proposed MDP 3 will enhance municipal capacity in developing bankable multi-year investment projects that are too large to be financed through individual municipal grants based on GAM. The proposed MDP 3 will include capacity development for the municipalities to formulate multi-year investment proposals that can be funded through parallel financing from DPs in the medium term and less concessional financing in the long term.

21. The proposed Program would also support central level reform necessary to create an enabling environment for improving municipal financial sustainability and accountability. Specifically, the proposed MDP3 would support the PA in developing a transparent and regular fiscal transfer to municipalities to improve fiscal stability and reduce Net Lending.

22. Activity 1: Incentives to Improve Municipal Management. Under Activity 1, municipalities will continue to be incentivized to improve municipal management performance through capital investment grants that are allocated based on the performance-based grant allocation formula (GAM). The GAM is comprised of 1) population; 2) needs[4]; and 3) municipal management performance. Under the proposed MDP 3, options would be reviewed to transfer the per-capita based allocation under the GAM as part of a formal fiscal transfer by following the same fund flow as other existing transfers disbursed in accordance with the PA's budget cycle. The performance weight in the GAM may increase to further incentivize municipal management improvements. The municipal management improvements incentivized by the performance-based grant allocation will be in the area of, *inter alia*, own-source revenue mobilization, arrears and asset management, expenditure efficiency, financial management, transparency and enhanced satisfaction in municipal service management, and participatory investment planning. Municipal performance in these areas would continue to be measured by KPIs, yet the content of KPIs would be updated from previous phases to focus on improvements in municipal services in addition to general municipal administration.

23. The achievement of results under this activity will be incentivized through disbursements based on the following Disbursement Linked Indicators (DLIs).

[4] The same proxy indicators as MDP 2 would be used until the new Household Survey is completed toward the end of 2017. The proxy indicators are poverty and municipal equipment collected by Palestinian Central Bureau of Statistics.

- X[5] % of municipalities that move up its municipal management performance ranking.
- X% of municipalities that demonstrate satisfactory level of own-source revenue collection efficiency and own-source revenue generation.
- X% of municipalities that demonstrate X % surplus in operational and enterprise budgets and reduction in municipal arrears to electricity and water suppliers.
- X % of municipalities develop and disclose information on revenue, expenditure, and output per key municipal service to the public on annual basis.

24. Activity 2: Institutional Support to eligible municipalities and MDLF for Larger, Multi-year, and Municipal Capital Investments. Under activity 2, municipalities who perform well in financial management and fiscal position related KPIs will be provided with capacity development support to develop large scale, multi-year, municipal investment proposals. Such proposals are to be funded through either parallel financing from DPs or non-MDP financing donors in the medium term. The investment proposals would be in a larger size than the ones that could be funded by the individually allocated grant under Activity 1. The quality of proposals would also need to be at the level that can be funded by less concessional financing in the long run. Therefore, the capacity development support under this activity would be two-fold; the one for the MDLF to develop its appraisal system for such proposals and the other for municipalities to develop proposals that can be appraised.

25. The achievement of results under this activity will be incentivized through disbursements based on the following DLIs.

- Large, Multi-year capital investment appraisal criteria developed by MDLF.
- X (number) of investment proposals developed by eligible municipalities and appraised by MDLF.

26. Activity 3: Institutional Support to Municipalities and PA. Activity 3 will be split into two sub-activities based on the recipients of institutional strengthening support, namely municipalities (activity 3-1) and PA institutions (activity 3-2). Municipalities will be provided with capacity development support that would enable them to improve their municipal management performance ranking. Such improvement would result in the increased investment grant amount allocated through GAM under Activity 1. In addition, the relevant PA institutions will be assisted to reform intra-governmental fiscal relations in order to address the Net Lending issue, enable municipalities to improve revenue and expenditure performance, and access long term capital investment financing in the long run. Further, the MoLG would be supported to improve its oversight of municipalities by developing budget approval criteria and national bench making system of municipal service delivery performance.

27. The achievement of results under this activity will be incentivized through disbursements based on the following DLIs.

- MoLG develops budget approval criteria and disseminates it with municipalities.
- MoF and MoLG adopts annual and transparent fiscal transfer to municipalities based on per capita allocation.

[5] All of X would be filled upon the completion of KPI formulation exercise and grant allocation simulation based on the agreed KPIs. The completion is anticipated toward mid-November 2016.

- MoLG develops National benchmarking system for municipal service delivery performance and disseminates the result annually to municipal stakeholders.

Initial Environmental and Social Screening

28. An Environmental and Social Systems Assessment (ESSA) is being prepared by the World Bank for the proposed MDP 3 as PforR. It will include the following information: (a) a summary of environmental and social risks and benefits associated with proposed activities required to achieve the PDO and the DLIs for each Results Area; (b) an assessment of the borrower's environmental and social (E&S) management systems which apply to these activities, their risks and benefits; (c) an evaluation of the borrower performance and track record in implementing their E&S management systems; (d) an assessment of the extent to which the borrower's E&S management systems are consistent with the World Bank's core E&S principles spelled out in the Bank policy on PforR and associated Guidance materials; and (e) a set of recommendations and actions which the borrower has agreed to undertake in order to improve the implementation of applicable systems.

29. The overall social and environmental risks are currently proposed as Moderate**,** to be confirmed through the eligibility screening to be applied to the program boundaries as they are developed more fully. The PforR funding amount and all parallel financing are likely to confine physical infrastructural investments to those which meet PforR policy and directive eligibility requirements regarding acceptable E&S risk levels; this will be confirmed as part of the ESSA.

30. Tentative financing

{Same as in AUS}

Program Financing, in US$ Million

Source	**Modality**	**Amount**	**% of Total**
PA	Co-financing	0	0
World Bank	PforR	15	TBD
PID MDTF	Co-financing	TBD	TBD
Total Program Financing		**TBD**	**TBD**

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