

LOCAL GOVERNANCE AND SERVICE IMPROVEMENT PROGRAM (LGSIP)

FIDUCIARY SYSTEMS ASSESSMENT REPORT

April 2015

Contents

Executive Summary	3
Section 1: Introduction.....	5
1.1 Program Design and Expenditure Framework.....	5
1.2 Institutional arrangements for Program Implementation	6
Section 2: Program Financial Management Systems:.....	8
2.1 Institutions involved in Program Financial Management	8
2.2 Planning and Budgeting	10
2.4 Accounting.....	13
2.5 Financial Reporting At MDLF Level(TBC):.....	14
2.5 Controls and Audits	14
2.6 Disbursement arrangements from the Bank.....	15
Section 3: Program Procurement Systems	15
Section 4: Fraud and Corruption Risks and Mitigation	18
Section 5: Program Implementation, Audit and Disbursements:.....	20
Section 6: Program Fiduciary Risk Assessment	20
Section 7: Program Action Plan.....	23
Section 8: Implementation Support.....	24

Executive Summary

As part of the preparation of the *Local Governance and Services Improvement Program (LGSIP)*, the Bank task team carried out a Fiduciary Systems Assessment (FSA) of the Program in accordance with OP/BP 9.0. Based on the findings of the FSA, it is concluded that the Program Fiduciary Systems provide reasonable assurance² that the financing proceeds will be used for intended purposes, with due attention to the principles of economy, efficiency, effectiveness, transparency, and accountability. . At the same time there are several gaps and weaknesses in the existing system that could affect the ability of the Program to achieve its intended results. Considering these existing weaknesses in Program Fiduciary systems, the residual fiduciary risk rating for the Program is rated as **Substantial**.

The Program will support the Palestinian Authority's in strengthening the governance and financing structure of all VCs to provide better coverage and improved quality of local services in a fiscally stable manner. The PforR Program intends to strengthen the local government financing mechanism and improve local service delivery in the target areas.

The design of the PforR Program relies on the existing institutions and systems of local Governance and Public Financial Management in Palestine. The Program will be implemented through the Municipal Development and Lending Funds and the Ministry of Local Government (MoLG), and will use the PFM system of the PA. Program funds will be deposited into the Single Treasury Account and will be budgeted for under the Ministry of Local Government allocation. Funds will flow from the Single Treasury Account to MoLG, MDLF, and to large Village Councils (VCs). .

Procurement for the Program will be carried out in accordance with the new Public Procurement Law (Law No. 8 of year 2014), which will come into effect in December 2015. The new Law, which applies to all public procurement activities, including those carried out by local government units, represents a good balance between the current means of the country and internationally accepted practices. It lays down an acceptable institutional and organizational set-up for public procurement; provides comprehensive provisions on procedural matters; sets out provisions on transparency and accountability; establishes a complaint/dispute review mechanism; and provides for routine dissemination of information on public procurement through a single portal procurement website. The Palestinian Authority, through the newly established High Council for Public Procurement Policies (HCPPP), is putting in place the components which are pre-requisites for effective implementation of the Law. Those include, inter alia: development and issuance of National Standard Bidding Documents and National Procurement Manual, establishment of a single portal procurement website, establishing the Dispute Review Unit and training of the procurement workforce. Some of these components will need to be completed by Program effectiveness, whereas others (e.g. capacity building and training of VCs/JSCs and MOLG on the new procurement rules and procedures) will be supported by the Program or through parallel technical assistance.

Qualifying VCs and JSCs meeting the eligibility criteria will be responsible for implementing individual and joint capital investment projects, including project design and preparation, procurement and contract management, under MoLG and MDLF supervision, respectively. MoLG will be responsible for carrying out procurement under Component III. The fiduciary systems assessment has concluded that the procurement processes and procedures introduced by the new Law and the existing capacities within the

various entities are adequate for the efficient implementation of the Program, provided that a set of pre-requisites and improvements detailed in this assessment are introduced.

. The Program will rely on the existing systems for the mitigating fraud and corruption risks in the Program. The Palestinian Anti- Corruption Commission (PACC) is responsible for the investigation of complaints relating to corruption. In accordance with the INT's guidelines for PforR operations, the Bank will rely on the PACC for the investigation of any complaints/allegations involving Fraud & Corruption (F&C) and will accept the findings of such investigation. The MDLF will maintain an updated list of contractors in the Program and make sure that no contractor from the World Bank's debarred list of contractors is involved with any aspects of the Program. e..

Section 1: Introduction

As part of the preparation of the PforR Program, the World Bank task team carried out a Fiduciary Systems Assessment (FSA) of the Program in accordance with OP/BP 9.0 of the World Bank Operations Manual. In addition, the FSA was carried out according to the OPCS Guidance Notes for PforR Operations. The objective of the Assessment was to examine whether Program systems provide reasonable assurance that the financing proceeds will be used for their intended purposes, with due attention to the principles of economy, efficiency, effectiveness, transparency, and accountability.

The FSA was carried out by an experienced team of World Bank staff that included Financial Management and Procurement Specialists. The team went through the existing country and sector reports, discussed with client counterparts both at the Central Government as well as at the Local Government levels. The team also visited a sample of VCs and JSCs to assess the systems on the ground. The initial findings were discussed with client counterparts to get validation on the findings and conclusions. Based on the feedback, the draft assessment was finalized. The findings of the assessment will be incorporated in the Program documents for the proposed PforR operation.

Program Design and Expenditure Framework:

The proposed PforR Program involves a total financing of \$25 million (a grant of \$5 million from the World Bank and \$20 million cofinancing from other Development Partners). The development objective of the proposed LGSIP is to strengthen the local government financing mechanism and improve local service delivery in the target areas. The proposed PforR operation takes a subset of the Government's program and supports it. This subset called the Bank financed Program (the "Program") intends to support the following components:

Delivery of local services through VCs: VCs will utilize the Capital grants to implement various investment projects that are approved under their annual plan and are included in their annual budget.

- . The Program intends to strengthen the systems and capacities of eligible VCs by providing a untied capital grant based on pre-specified eligibility conditions. VCs who qualify for entry to the Program (upon satisfying the entry criteria set by the Program) will receive an annual capital grant that they can use to implement their participative annual investment plan. The participating VCs who receive the capital grant will be responsible for the implementation of projects and activities in the annual investment plan in accordance with the Procurement procedures for local governments. While large VCs can use the capital grant to implement projects on their own, small VCs will be implementing their projects through the JSCs.
- Infrastructure Service Delivery through joint projects: This component would finance capital investment grants for projects that cut across VCs and are identified in a joint or consolidated ACIP. The JSC is an institutional structure set up by the Government to address the inability of small VCs to implement projects and activities in an efficient and effective manner due to shortage of adequately trained staff in core areas such as project design, contracting, project management and supervision. Accordingly, the VCs as part of their mandated responsibility will be responsible for the preparation of annual investment plans. All VCs will be required to be a member of a JSC. Capacity Building

for strengthening local governance at the Central and Local level: This sub-component would finance capacity building activities to support VCs and JSCs meeting the program eligibility criteria, preparing and implementing ACIPs, and strengthening their core functions such as planning, procurement and financial management. The sub-component would also finance institutional strengthening targeting central level institutions to improve local governance, service delivery and financing. Activities to be financed would be identified and updated in an annual capacity building plan prepared by the MoLG.

- The preliminary fiduciary assessment, which was based on sample field visits and inquiry with MoLG staff, identified that a number VCs maintain satisfactory financial managements arrangements including: 1) timely submission of annual budgets, 2) qualified FM staff, 3) proper accounting system, 4) submission of audited financial statements.

The Program will be implemented by the MoLG and the MDLF. MoLG would be responsible for all fiduciary supervision arrangements for eligible large VCs. Also MoLG would be responsible for delivering the capacity building packages designed as part of the Program. While MDLF would be responsible for all supervision arrangements for joint projects under component II. . MoLG and MDLF would use Program funds exclusively for the implementation of the agreed Program using the government financial procedures that are currently used by the MoLG and MDLF respectively.

1. **Institutional arrangements for Program Implementation:** VCs will utilize the Capital grants to implement various investment projects that are approved under their annual plans and are included in their annual budget. Capital Grants will be allocated according to a predetermined allocation formula.

1.1 **Program Implementation at the VC level:** Generally, s. Most VCs lack capacity and many hire only a few staff on less than full time or none at all. Not having a permanent core staff (e.g. Accountant) will negatively affect sustainability and revenue collection. However, the program will mitigate this risk through requesting VCs to satisfy certain minimum “entry criteria” upon which they will be allotted their eligible annual Capital Grant allocations. Depending on the size of the VCs, the entry criteria is determined as follow:

- Under Component I large VCs will be required to achieve some minimum eligibility conditions before they get funds from the Program. The first of these eligibility conditions is to have access to a minimum corps of essential staff such as , an accountant, administrator and an engineer. The VC may either have these staff on a full or part time basis or can make arrangements for getting access to such staff on a sharing basis with other VCs or the Provincial Governorates. ;These and other eligibility conditions such as the submission of annual budgets electronically and the timely preparation of the ACIP in a participative manner provide assurance on the efficient utilization of the capital grants provided through the Program. . Large VCs in the Program will be responsible for the custody and management of the financial resources transferred to them directly as part of their annual budget, and will utilize them in accordance to the provisions of the LG FM Manual¹. Eligible large VCs will \ be subject to MoLG’s fiduciary supervision, and will be required to meet the program’s minimum entry criteria on an annual basis.
- Small VCs do not maintain satisfactory financial management arrangements. The expenditure cycle in such VCs is not subject to independent review procedures, and capacity constrains exists in the fiduciary function. Although MoLG has to approve VCs annual budget, MoLG exercises limited control and oversight procedures on VCs budget execution. However, small VCs will

¹ LG FM Manual issued by MoLG in June 1999

delegate the implementation of their annual investment plans to JSCs who will implement the projects under the technical and administrative oversight provided by the MDLF as the Program Manager.

Program Implementation at the MDLF level: MDLF has a proven track record of effectively operating in the complex political and institutional environment West Bank. This record has been established over the last 5-8 years in successfully implementing three Bank-supported Projects. During this period, MDLF has effectively administered Bank and donor funds, and their respective fiduciary arrangements. Furthermore, MDLF Financial and Administrative department includes experienced and qualified financial management team. The Finance and Administration Department structure is comprised from Finance and Administration Manager, Financial Controller, Senior Accountant, and two Accountants which allows for proper segregation of duties. MDLF will act as a program manager and would be responsible for the implementation of Financial Management (FM) and Disbursement arrangements for medium and small VCs. Also, MDLF would be responsible for ensuring that VCs meet minimum entry criteria, each year during the life of the Program, and for supporting the effective selection and implementation of investments, funding including fiduciary responsibility for sub-project implementation.

Program Implementation at the MoLG level: As mentioned above, the Program will use existing government Public Financial Management systems. MoLG will be responsible for monitoring and overseeing the implementation of the ACIP in large VCs as well as the implementation of the capacity building activities under the Program. . A Program Committee would be established to ensure coordination among the main program stakeholders and development partners towards meeting the Program results.

1.3 Transparency and Accountability

In Palestine, the lack of access to information is perceived as the major constraints to operate effectively as a watch dog holding government accountable for its actions and decisions. The Program aims at ensuring that VCs undertake public expenditures and deliver local services in a transparent and accountable manner. It will strengthen accountability systems at the VCs and will support: (a) transparent and independent annual financial audits of VCs to ensure their financial accountability; (b) systems and processes to bring greater transparency in VCs affairs and strengthen citizen voice in planning, budgeting, execution and monitoring. (c) Training elected VCs staff on financial management, procurement and project management. VCs are subject to the oversight of the existing system of public sector oversight that includes the Supreme Audit Institution (SAI) in Palestine.

Transparency: The Governance system in Palestine is making rapid progress to embed the principle of transparency in the public sector including local governments.

The Program aims to strengthen transparency through the following specific measures:

- VCs Strategic planning and development initiatives are performed in a participative manner with citizens
- VCs Budget preparation process is performed in a participative manner.
- VCs audit financial statements are made available to the public.

Accountability: The current local government laws put in place a sound accountability framework for local governments. The PforR Program reinforces this mandate through the capital grants system that will provide resources to VCs to meet local service delivery responsibilities. VCs will be incentivized to prepare Annual Plans and Budgets in a participative manner, which will need to be validated by their residents in dedicated public meetings. VCs will be accountable to their citizens as well as to the Central Government for meeting their institutional and service delivery responsibilities. The Program will strengthen downward accountability of the VCs to its citizens, and better reflect citizens' service priorities through the strengthening of citizen participation in the municipality's planning and budgeting process.

Section 2: Program Financial Management Systems:

Financial Management of the Program is proposed to be carried out using the Palestinian Authority's existing systems and processes for Public Financial Management. The Program will be part of the country's budgetary framework that will rely on existing institutional systems for implementation.

2.1 Institutions involved in Program Financial Management

1. The Ministry of Finance: According to the 2013 PEFA indicators, the PFM system revealed a more positive picture compared to 2007 assessment. While the PA achieved significant progress during the past years such as increased transparency and scrutiny, and improved accounting, significant weaknesses in other areas such as budget preparation and execution were also revealed. The PFM system is deemed to be adequate insofar as the Bank's criteria and standards for approval of pforR operations are concerned. However, more improvements need to be adopted to further consolidate progress and address the challenges facing the PFM systems. As part of the NDP process, a PFM strategy was developed by the PA. Key elements of the strategy with respect to fiduciary control include:
 - Significant improvements are needed in expenditure planning and control in budget execution. Reducing generation of new arrears requires a Cash Plan and a commitment control system to limit incurrence of additional expenses to the forecasted cash available. An annual cash Plan on a monthly basis is in place since early 2014 with non-discretionary and optional expenses. This was seen as a positive achievement.
 - Strengthening accounting and reporting by fully adopting International Public Sector Accountings Standards (IPSAS), and by increasing budget transparency. Financial statement for the year ended 2010 have been audited by SAACB in 2013 with a number of qualifications against IPSAS (especially on financing gap). Financial statements for 2011 have recently been issued with a delay of around three years with correction of error balance of more than USD 100 million. This correction of errors related to the reconciliation between 2010 ending balances and 2011 beginning balance and banking statements. The Bank has provided substantial TA on IPSAS and how to issue financial statements (3 TA missions in Oct 2013, March 2014, and July 2014 this latter in cooperation with SAACB).
 - Enhancing the legal framework of the SAACB that supports its audit responsibilities. The World Bank recently provided technical assistance support to the SAACB through the preparation of the Supreme Audit Institution (SAI) Performance Measurement Framework (PMF)². SAACB experiences *de jure* and *de facto* limitations to its independence from the

² The SAI PMF is a comprehensive assessment of performance that will help the SAACB in its strategic and capacity development. Donors, including the Bank, can also use the SAI PMF results to target their provision of support

Executive. Despite these factors, SAACB has been able to position itself as an important contributor to increased accountability and transparency in the use of public funds in the West Bank.³ An important example is the audit and publication of the final accounts of the PA for 2010. This audit revealed several shortcomings in the financial management in the Palestinian public sector. The SAI PMF assessment shows that SAACB has laid the foundations for providing high standard audits to the PA authorities and the public, but that more work is needed to sustain and institutionalize recently improved audit methodologies. More importantly, the limited independence and limited legal protection of the President of SAACB from the Executive also entails a constraint against improved performance, as he/she can risk removal from office for performing his/her duties⁴. This has been confirmed with the Donors partners who recommended strengthening the legal framework of the SAACB to comply with INTOSAI independence standards.

- Building capacities for financial management at the MoF. Assuming the current political context, additional risks may be associated with situations of conflict and fragility such as liquidity constraints, potential diversion of funding, weakening of payroll and other expenditure controls, and limited capacity of financial management to perform relevant tasks, among others.
2. The Ministry of Local Government (MoLG): The Ministry of Local Government is taking the lead on policy formulation and oversight of the local government sector. The MoLG is mandated with a monitoring and supervision role as well as a policy and advisory role towards VCs. The MoLG approves VCs Budget and monitors its implementation, and in particular, in relation with the donors' grants transferred to VCs. The General Directorate of monitoring and direction that is in charge of managing the implementation of VCs' budget and transfers to VCs from central government. To date, there is no mechanism in place to ensure that VCs receive equitable and transparent transfers for current spending.
 3. On average, VCs revenue collection practices are weak and there is scope for significant improvement. At the same time, efforts are needed to unify local tax administration systems, and strengthen the link between improved revenue collection and better services for citizens. In the absence of a predictable and transparent intergovernmental transfer system, almost all VCs struggle to remain fiscally viable and to finance even basic operating costs. The MoLG made annual budget document submission mandatory for VCs in 2013 and 2014; hence data on the VCs' budgets is available.
 4. However, the FSA concluded that MoLG suffers from serious capacity limitations in overseeing VCs financial management arrangements. Furthermore, monitoring and oversight over VCs is weak with respect to outputs, costs, quality, and so on, and data are scattered and not aggregated at the central level. MoLG supervision seems to be irregular and inefficient. The expenditure cycle for VCs is not subject to the same controls as for central government expenses. There is control review of payments at the commitment stage. The lack of the ex-ante control increases fiduciary risk. The team confirmed this assessment with SAI team responsible for auditing the local government sector. The Program task team was informed of this assessment and has

³ The assessment covered SAACB's audit activities carried out in the West Bank, as the branch office in Gaza is not operational.

⁴ In early June, 2014, the media announced that the President of the SAACB had been replaced. This change was confirmed by the PA Presidency. Currently, a new permanent SAI president (Dr. Iyad Tayem) was officially assigned for Palestine yesterday. Dr. Iyad Tayem was the deputy Minister for the Ministry of Justice, is a judge, and is an active member in the Supreme Judicial Council.

designed targeted capacity building packages to both MoLG and VCs to strengthen their capacities.

5. The Municipal Development and Lending Fund (MDLF): The MDLF has the legal mandate to provide direct development assistance to municipalities through transparent, rules-based and efficient financing. MDLF is also the PA's preferred mechanism for channeling reform and development assistance to local governments.

2.2 Planning and Budgeting

6. The budget allocations for Program elements will be transferred from the Treasury Current Account at the MoF. The Program will be included in the annual budget of the PA under the budget head for MoLG. The allocation for the three components of the Program will be identified through three specific line items. . , The Annual budget allocations will be disbursed from the MoF to the MoLG within a specified time period. The MoLG will then transfer Program Funds to large VCs and the MDLF. During Program preparation several discussions were held with MoF and MoLg to ensure that the funds flow within the Program will be carried out in a speedy and efficient manner. These arrangements will be finalized by Program appraisal. . annually In case the annual capital grant allocations are not fully spent within a fiscal year, they will be carried forward to the following year, and the carry forward will follow main budget classification. The budget department controls all carry forward transactions to ensure correctness, accuracy and completeness..

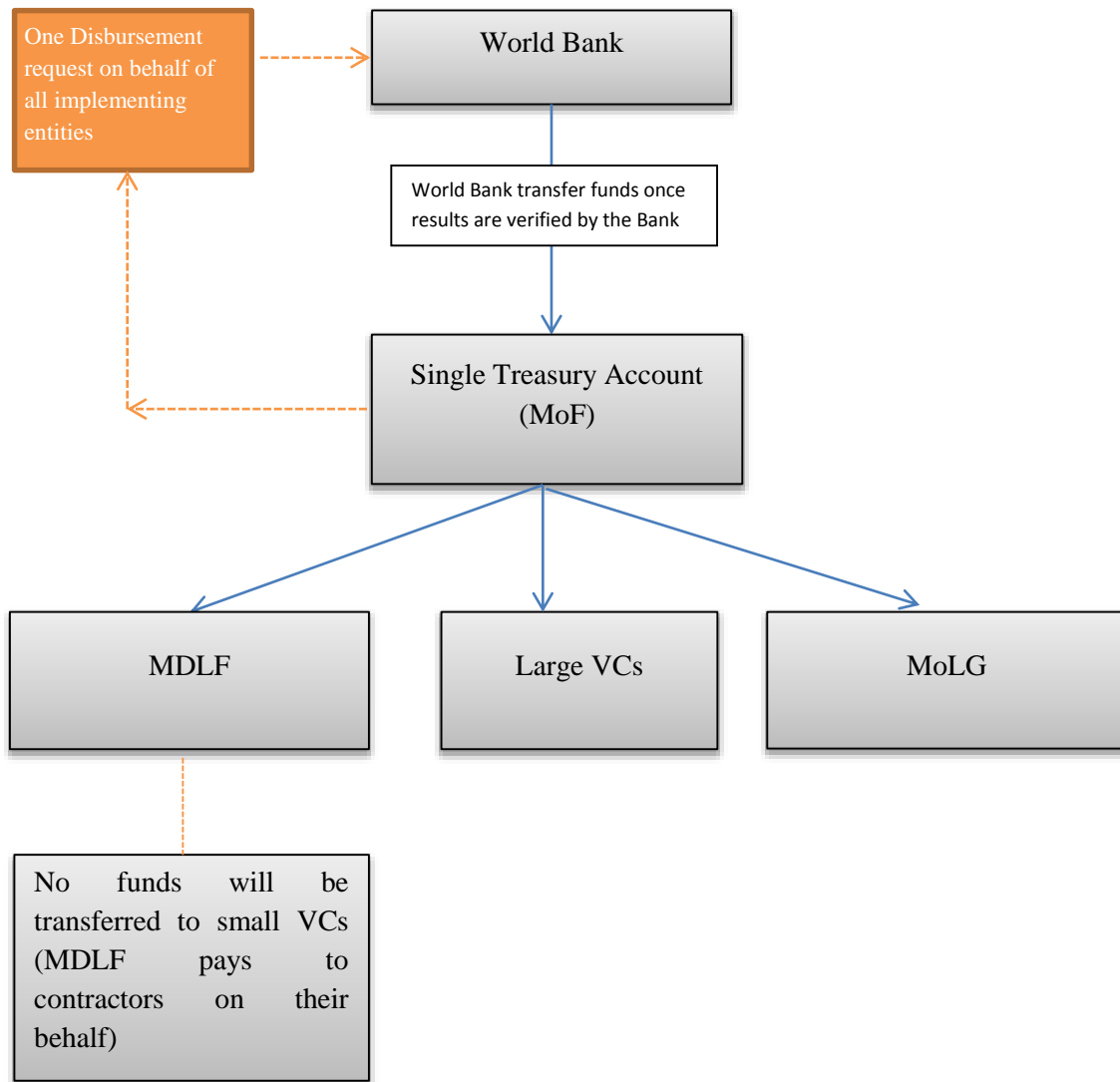
Flow of Funds:

. There are three types of fund flow arrangements (see flow of funds diagram below) that will be applied to the program as follow:

- 1 **Funds Channeled from MoF to MoLG:** In accordance with the general budget and its detailed provisions, MoF informs line ministries about their available budget ceiling on a quarterly basis, and the cash is deposited in a designated account- linked to the Single Treasury System to be managed by the line ministries. Likewise, MoF will inform MoLG of the available budget for component I and for the ceiling for the capacity building packages . The payment will be transferred from MoLG to the VCs. No special designated account will be opened at MoLG.
- 2 **Funds Channeled from MoF to MDLF:** Program Funds will be disbursed from MoF to MDLF bank account. However, funds will not be channeled to small VCs, and MDLF will have the sole responsibility to disburse on behalf of small village councils to suppliers and contractors. Similar to the ongoing Municipal Development Program II, subproject payment requests will be reviewed and approved first by the technical team before being further processed to provide assurance that payments related activities are in line with physical progress and for goods actually supplied and installed. To minimize the risk of commingling of Project's funds with other financing partners' funds, MDLF will maintain a comprehensive sub-grants allocation sheet, this sheet should include all VCs. This tool will enable MDLF to track the financial and the physical status of each sub-project.

- 3 **Funds Channeled from MoF to large Village Councils:** **Large** VCs that satisfy program minimum entry criteria will receive funding for their annual investment plan. Fund flow for results would be transferred to such VCs following established government processes similar to the processes for transferring the PA contribution of transportation taxes to VCs.

▪ **Flow of Funds Diagram:**



The following table presents total funds transferred from MoF treasury account to support VCs “development projects” (in million USD):

Description	2012	2013	2014
Development projects from capital budget	24	8	12
LGU support/ from operating budget	4.5	1	2
Total	28.5	9	14

2.4 Accounting

- **Accounting At MoF Level:** The unified government accounting system (BISAN) will be used by MoF to record program funds. BISAN is part of the country systems and is capable of recording project transactions by implementing entity and by Donor. BISAN is a computerized accounting system. It is not linked to MDLF or VCs accounting systems, but it is linked to MoLG (decentralized to all line Ministries). BISAN accounting system is capable to track and report on Project's funds separately by Component and by Financing Partner.
- **Implementation of Integrated Financial Management System (IFMIS):** The IFMIS has been rolled out to all line ministries and is considered the official country system to account for public financial resources. Transactions are entered by the line ministries with approval for the transaction by Financial Controllers who are decentralized to all line ministries. IFMIS modalities have been updated which has led to improvements in terms of consolidation of the financial statements, quality of financial reports and the orderly exchanges between line ministries and the MoF. The IFMIS has controls for payments against cash ceilings but it is not used to prevent arrears from being accumulated. The IFMIS also has a commitment module but this module is generally not used.
- **Single Treasury System and Bank Funded Projects:** The PA budget preparation and execution process has been supported by IFMIS since 2009. All tax revenue is paid directly into the treasury account, and most operational payments and transfer expenditures are executed by line ministries in a devolved Treasury model. Reconciliation between the Treasury subaccount and payment is made on a daily basis. There are three main Treasury Accounts: (i) Clearance Revenue Account; (ii) a Donor Fund Account; and (iii) an account catering to domestic revenues and expenditures. Each Treasury Accounts has subaccounts which are consolidated each day to ensure zero balances in the subaccounts. All accounts are managed online and a daily cash report is produced.
- **Accounting at MoLG Level:** A separate cost center on BISAN will be authorized and opened by MoF to account for program transaction, MoLG will use this cost center to record financial transaction pertinent to Component I and Component III.
- **Accounting At MDLF Level:** MDLF maintains an acceptable, Oracle based, accounting system. The accounting system is not part of the country systems since MDLF is an independent semi-government organization. The accounting system is not linked to MoF accounting system. However, the accounting system is computerized, and is able to capture Component II related transactions. The accounting system is capable to track and report on Project's funds separately by Component, Financing Partner, and by each beneficiary VC. In close coordination with MoF, and MoLG, MDLF will maintain the consolidated accounting records by combining/ compiling (MoF and MoLG) accounting records.
- **Accounting At the VCs Level:** VCs follow the financial management manual approved by the MoLG in 1999. This manual details the chart of accounts for the formulation of the Budget as well as for accounting. This is a cash-based double entry accounting. Eligible VCs will use their

accounting system to record capital grants and to report on the receipts and uses of funds. On the other hand, small VCs will not receive any funds, and MDLF will record relevant financial transaction in its Oracle accounting system.

2.5 Financial Reporting At MDLF Level (TBC): MDLF will be responsible for preparing the Program's consolidated financial statements and the semiannual (IFRs). The consolidated financial statements will comprise of (i) Consolidated Statement of Cash Receipts and Expenditures, showing funds received from the World Bank and from all financing partners separately, for each period and cumulatively from program inception. They will also include expenditures (by category, component and subcomponent for each financing partner) for each period and cumulatively from Project inception; (ii) Comparison of Budget vs. Actual for the period and cumulatively from project inception, with justification of significant variance; .

The Audited Program Financial Statements should be submitted to the Bank no later than 45 days after the end of the fiscal year. . Supporting documents will be kept in MDLF and MoLG respectively for three years from the closing date, after the last audit of the project.

2.5 Controls and Audits

Currently the MDLF follows a good set of internal control procedures before making disbursements to municipalities. The funds are released through a check which cannot be used for other purposes than the payment it is meant to cover. The MDLF keeps a separate accounting ledger for each municipality and VC.

- **MDLF has no Internal Audit Department.** In 2012, MDLF hired an Internal Audit Manager, but the latter was not performing satisfactorily. Therefore, MDLF has to discharge him from his responsibilities. However, MDLF is currently is in the process of hiring a new internal auditor.
- **Internal Control at MoLG:** it was concluded during the FSA that the current public disbursement process of development projects executed by VCs is not efficient. There is a prolonged delay (ranges from 3-4 months) between submitting payment request to contractor and issuance of check. Briefly, the disbursement process is as follow:
- After approving VCs budget and securing funds, the contractor performs the contracted works and submits invoice to VC.
- VC acknowledges the delivery of work and sends payment request and all supporting documents (e.g. invoice, guarantees...etc) to the Project unit at MoLG. Projects unit performs technical review and approves, and sends file to Finance department for review, then to MoF to reserve the funds and obtain Minister of Finance signature, then to MoLG financial controller, then to MoLG Minister, the again to MoLG finance department to record the transaction and issue the check to the contractor.
- It is worth to mention that, in the current public Financial Management System and due to limited to VCs fiduciary capacity, VCs do not receive funds. Rather, MoLG pays to contractors on their behalf. VCs could play a substantial role in increasing the efficiency of the disbursement process. Therefore, building their FM and procurement capacities would result in submitting complete supporting documents in accordance with MoLG procedures and regulations, thus reducing disbursement delay.

- **Internal audit:** The central Internal Audit Department (IAD), at MoF, covers MoLG. The IAD was created in 2004 within the MoF with the dual mandate of performing the central internal audit, and decentralizing the internal audit function from the MoF to line ministries. The scope of the Internal Audit Function across the Palestinian National Authority (PNA) is governed by regulation No. 11/2011 (the Charter) issued in August 2011, which clarifies roles and responsibilities of the IAD as well as reporting requirements. A Central Harmonization Unit (CHU) was established within the MoF pursuant to article No. 5 issued by the Minister of Finance. According to the law, the CHU is responsible for setting and updating the internal audit methodology as well as providing advice to the internal audit units in line ministries. The CHU also supervises the decentralization transition process and reports to the Internal Audit Committee. The IAD adopted the International Internal Auditing Standards (published by the Institute of Internal Auditors) that were customized to meet the country context. In practice, the internal audit and the CHU are not yet fully operational and decentralized due to capacity and financing constraints.
- **External Audit:** During the past 2-3 years, MoLG has requested from all VCs to submit external audit reports of their accounts as part of the budget approval process. In other words, all VCs are required to submit their external audit reports in order for MoLG to approve their annual budget. Independent external audits on an annual basis are an important instrument for ensuring oversight as well as to enforce public sector accountability. In Palestine, the Supreme Audit Institution (SAI) has the mandate to carry out the external audit of VCs. However, due to the wide mandate to complete the audit of the Central Government and its agencies, the SAI is not able to carry out the audit of the VCs on a regular and timely manner. Currently, the SAI audits a sample of VCs, but with an average regularity between 3 to 5 years. These audits are meant to be compliant with INTOSAI norms and vary in intensity and modalities based on the size and risk level of the VCs. As part of the Program design, it has been agreed that a private external audit firm, acceptable to the Bank, will carry out annual external audit of the Program within a reasonable time period after the end of the financial year.

2.6 Disbursement arrangements from the Bank

Disbursements of the Program proceeds will be made at the request of the recipients upon achievement of DLIs. Grant proceeds will be disbursed into a single treasury account held at the MoF. MoF will submit disbursements requests to the Bank using the Bank's standard disbursement forms. It was identified that advances up to 25% under the PforR operation might be necessary in order to allow the recipients to achieve the results for several DLIs, quantification of specific needs for advancement as well as determination of the need of prior results are identified in the body of the Program appraisal document.

Section 3: Program Procurement Systems

3.1 Country Procurement System

Public procurement in the Palestinian Authority has so far been subject to two principal laws (Law No. 9 of 1998 on General Supplies, and Law No. 6 of 1999 on Procurement of Public Works). Local

government procurement has so far been governed by the Regulations for Procurement and Execution of Public Works in Local Government (Decree No. 1 of 1998) issued by MOLG, which grants the responsibility to Local Government Units (LGUs) for carrying out procurement, under the supervision of MOLG. In April 2014, the Palestinian Authority promulgated a new Public Procurement Law (no. 8 of year 2014) and issued its implementing regulation (no. 108 of year 2014) in November 2014. The new Law, which applies to all public procurement activities, including those carried out by local government units, represents a good balance between the current means of the country and internationally accepted practices. It lays down an acceptable institutional and organizational set-up for public procurement; provides comprehensive provisions on procedural matters; sets out provisions on transparency and accountability; establishes a complaint/dispute review mechanism; and provides for routine dissemination of information on public procurement through a single portal procurement website.

Procurement arrangements under the new Law are a mixture of centralized and decentralized procurement. The implementing regulation to the new Law set thresholds for procurement to be carried out by the various categories of procuring entities (ministries, municipalities and village councils). Procurement for contracts estimated to exceed the set thresholds (see table 1) are to be issued centrally through the Central Tenders Department of Ministry of Public Works and Housing, in the case of works and consulting services; or by the General Supplies Department within Ministry of Finance, in the case of Goods and Non-Consulting Services. The new Law also includes provisions for entering into framework agreements for commonly used goods and services.

Table 1- Financial Thresholds for Procurement to be handled by Village Councils

Procurement Type	Threshold (US\$)
Goods	40,000
Works	150,000
Non-Consulting Services	25,000
Consultants' Services	15,000

Open Bidding is the default procurement method set by the new Law. The thresholds for various procurement methods, as defined in the implementing regulation to the new Law, are listed in table 2.

Table 2- Financial Thresholds for Procurement Methods

Procurement Type	Threshold (US\$)
Shopping -Goods	20,000
Shopping Works	50,000
Shopping-Non-Consulting Services	10,000
Direct Contracting (Goods, Works or Non-consulting services)	5,000
Consultants Services without advertising a REOI	100,000

Procurement for LGSIP will be carried out in accordance with the new Law, which will come into effect in December 2015. In the meantime, the Palestinian Authority, through the newly established High Council for Public Procurement Policies (HCPPP), is putting in place the components which are pre-requisites for its effective implementation. Those include, inter alia: development and issuance of National Standard Bidding Documents and National Procurement Manual, establishment of a single

portal procurement website, establishing the Dispute Review Unit and training of the procurement workforce. Some of these components will need to be completed by Program effectiveness, whereas others (e.g. capacity building and training of VCs/JSCs and MOLG on the new procurement rules and procedures) will be supported by the Program or through parallel technical assistance.

The new law indicates that procurement decisions by LGUs will be subject to prior approval by MOLG, based on a specific instruction to be issued by HCPMP, in consultation with MOLG, for this purpose. Moreover, the Law assigns the responsibility for ex-post review of procurement decisions to the State Audit Bureau (SAACB).

3.2 Procurement Responsibilities

Under Component 1- Local Service Delivery by VCs, eligible VCs will utilize per-capita investment grants to implement various investment projects either directly (provided that they meet the qualification criteria for implementation) or through a qualified JSC. Qualified VCs and JSCs will be responsible for the entire procurement process, under MOLG supervision and oversight. This will include planning, preparation of bidding documents, receipt and evaluation of bids, award of contract, to contract supervision and management, and processing of payments to contractors/suppliers.

Under Component 2: Infrastructure Service Delivery through Joint Projects, eligible JSCs (or alternative equally strong entity) will implement joint investment projects for the benefit of eligible VCs, under MDLF supervision. The JSC will handle the whole procurement process and will advise MDLF on the release of funds to the respective contractor/supplier.

Under Component 3: Capacity Building to strengthen local governance, MOLG will be responsible for handling procurement and selection of consultants for the delivery of MOLG Annual Capacity Development Plan, which covers the needs of MOLG departments and district offices as well as VCs and JSCs.

3.3 Capacity assessment of entities involved in procurement

As part of the FSA, the Bank team assessed the capacity of the various entities involved in the project for handling procurement; either through implementation or supervision/oversight. In general, the various entities were found to possess the capacity to implement procurement for the Program, provided that they receive support in terms of staffing and training.

VCs/JSCs: a sample of VCs and JSCs were assessed. Large VCs and JSCs were found to have experience implementing procurement for investment projects and possess adequate capacity, whereas small VCs tend to lack such capacity. To be qualified for project implementation, VCs and JSCs would be required to have access to a qualified engineer with procurement experience. The Program will finance capacity building of eligible VCs and JSCs on procurement and contract management.

MOLG: MOLG will be responsible for providing procurement oversight and supervision for individual VC projects, as well as for implementing procurement under Component 3. Two MOLG District Offices were assessed and found to possess the capacity to provide procurement oversight for VCs and JSCs. The detailed responsibilities for such oversight (between MOLG Projects Department and District Offices), prior review thresholds and business standards for the provision of approvals will be defined in the Local

Government Procurement Instruction, which has to be adopted by MOLG as a prior result. Staff of MOLG Projects Department and MOLG District Engineers will receive training under the Program on the new procurement rules and procedures. On the other hand, MOLG capacity to handle procurement for Component 3, which would mainly consist of consulting services, is limited. MOLG relevant departments will receive training on the selection and management of consultants contracts.

MDLF: MDLF will provide procurement oversight for joint projects. MDLF has long experience implementing procurement under Bank-financed projects and possesses good capacity (both in terms of knowledge and staffing) to assume this responsibility. The procurement audit and control structure currently in place for MDP will be used for joint projects under LGSIP.

3.4 Handling of Procurement-Related Complaints:

The new Law establishes a robust complaint handling mechanism and sets standard times for responses to be provided by the procuring entities to the complainants. Furthermore, the new Law sets up a dispute review unit (DRU), within HCPMP, to look into appeals filed by bidders who do not receive an acceptable response to their complaints from the respective procuring entity. The implementing regulation to the Law specifies the grievances of the DRU, the procedures of filing, the procedures of dealing with the complaint, the decision of the DRU and mechanism of issuing the DRU's decisions. Complaints which prove to involve fraud and corruption practices will be forwarded by the DRU to the PACC for further investigation and prosecution.

Section 4: Fraud and Corruption Risks and Mitigation

The fiduciary assessment also specifically examined the potential fraud and corruption risks to the Program and the risk mitigation steps. . Discussions were held with key institutions responsible for the policy and implementation aspects of addressing fraud and corruption. This section summarizes the findings of the assessment and proposes a Program Action Plan that recommends additional measures to mitigate the risks relating to governance and corruption for the proposed Program.

The Palestinian Authority has shown that it is getting more serious about its responsibility to continuously to combat fraud and corruption. In this view, a national anti-corruption plan, namely “The National Strategy on Anti-Corruption (2012- 2015)” was developed to coordinate and join the efforts of official institutions, civil society organizations and all the parties charged with monitoring and accountability. However, the lack of a functioning legislative assembly in Palestine continues to undermine the possibility for oversight and control over the executive. Therefore, the role of the civil society organizations becomes at particular importance.

The Palestinian Anti-Corruption Commission (PACC): The PACC is tasked with collecting, investigating, and prosecuting allegations of public corruption. The anti-corruption commission is also responsible for public information on corruption. It is also in charge of holding declarations of financial status and request any additional information or clarification, reviewing the financial status of those subject to the provisions of this law and investigating reports of illicit gain.

The Palestinian Anti-Corruption Commission (PACC) has the main responsibility in both policy and implementation aspects of addressing fraud and corruption in the PA legal system. In the absence of a functional PLC, the PACC was formed under presidential decree No. (7) in 2010

Pertaining to the Amendment of the Law of Illegal Gain No. (1) 2005⁵. This law gives them the right to question everyone in government including the president, members of legislature and the judiciary, among others⁶. They can and have prosecuted ministers in the past. This law also established the Corruption Crimes Court, which is a specialized court where fraud and corruption cases are tried. The PA has acceded to the United Nations Convention Against Corruption (UNCAC)⁷ and has also signed an Administrative Cooperation Agreement with OLAF, the European Anti-Fraud Office⁸.

Complaints Handling: The PACC has a well-functioning complaint mechanism where anyone can make a complaint. They take complaints over the phone, fax, email, facebook, or their website <http://www.pacc.pna.ps/ar/index.php?p=complain>. The complaints can be anonymous and they have a legal mandate to ensure the protection of the informant⁹. They also have their own committees who track media reports and hold discussions with civil society organizations and non-governmental organizations and can follow up if there are suspicions of fraud or corruption. After a process of documenting and verifying the complaint, they have an in-house legal team which decides whether to refer the complaint to other units of government such as the police or the state audit or whether they will investigate and prosecute if necessary.

The PACC has an in-house legal team which prosecutes the cases in the specialized court. All trials are open to the public. There are some delays in the judicial system but the law specifies timelines that they try to abide by.

Institutional Arrangements for Program Oversight: The PACC system for handling complaints is adequate as described above and will be relied on for the Program. If complaints are received regarding the Program, the PACC will use the existing complaints handling mechanisms and will use their process to investigate and prosecute as necessary. The PACC will relay any results to the Bank. For the VCs receiving individual funds, if a system of complaint handling is not already in place, the PACC will provide training to the VCs to set up such a system. The Program Manager and the MoLG will also report to the PACC any irregularities found in annual audited financial reports provided to them by the VCs or JSCs. The Operating Manual will describe the procedures of the complaints handling mechanisms and the procedures of sharing the results of the investigation. The assessment of the country level institutions for handling complaints and for the investigation of instances of Fraud and Corruption Risks have been found to be satisfactory and acceptable to the Program.

The INT guidelines for PforR Operations will be applicable to the Program. Based on the assessment of the country level institutions and systems for complaints handling and investigation of complaints relating to Fraud & Corruption, it was agreed that the Bank will rely on the country system for the investigation of specific complaints relating to Fraud and Corruption in the Program. Upon receipt of any such complaint the PACC will investigate the

⁵ *Improving Governance and Reducing Corruption*, World Bank, 2011.

⁶ Article (5), Parties Subject to the Provision of the Law,

<http://www.pacc.pna.ps/ar/cp/plugins/spaw/uploads/files/Anti-Corruption%20Law%202010%5b1%5d.pdf>

⁷ <http://www.unodc.org/unodc/en/treaties/CAC/signatories.html>

⁸ http://ec.europa.eu/anti_fraud/documents/international-cooperation/list_signed_acas_en.pdf

⁹ Article (11), Provision of Information, <http://www.pacc.pna.ps/ar/cp/plugins/spaw/uploads/files/Anti-Corruption%20Law%202010%5b1%5d.pdf>

complaint in accordance with its procedures and the the Bank will rely on the findings and conclusions of such investigation. The Bank will retain the right to do any additional investigation only on a case to case basis and after discussion and agreement with the Government counterparts.

Debarment of Contractors: In accordance with the Bank’s Anti-Corruption Guidelines for P4R operations “*Guidelines on Preventing and Combating Fraud and Corruption in Program-for-Results Financing*” dated 2012, the Program must take steps to ensure that debarred individuals or entities are not awarded contracts. MDLF will maintain a database of all contractors awarded contracts under their respective components, which will be updated on a monthly basis for all projects. MDLF will periodically check all names in the database against the Bank’s list of debarred contractors to ensure that no such contractor is awarded a contract under the Program.

Civil society: While there are more than 4,000 active NGOs in Palestine¹⁰, few focus specifically on governance and corruption issues. The most active of these is as the AMAN Coalition for Integrity and Accountability, the Palestinian chapter of Transparency International (US Department of State, 2011). According to both AMAN and Global Integrity, NGOs do not experience harassment as a result of their corruption related activities and operate in a relatively positive and supportive environment. There have been no known attempts by the government to hinder the establishment and operations of anti-corruption organizations. The lack of access to information is perceived as the major constraints to operate effectively as a watch dog holding government accountable for its actions and decisions.

Section 5: Program Implementation, Audit and Disbursements.

MDLF will act a project manager and will be responsible for maintaining the fiduciary aspects regarding the capital grants to of small VCs. While MoLG will be responsible for maintaining the fiduciary aspects regarding capital grants for individual projects, as well as managing the fiduciary aspects of the related capacity building and TA activities.

The program consolidated financial statements will be subject to an annual audit by an independent external audit firms, acceptable to the Bank and in according to terms of reference (ToR) approved by the Bank. The audit will be comprehensive and will cover all program grants. In addition to the financial audit, the ToR will include a provision for technical audit.

Section 6: Program Fiduciary Risk Assessment

It is assessed that Program’s Financial Management arrangements relying on country system are acceptable in terms of procedures and results after appropriate mitigation. However, Program’s FM systems present significant risks against result achievements, with respect to Program resources management and financial information for the stakeholders. The country system helps central government and local governments (i) to keep close control of fiscal risks and to maintaining overall budget discipline, (ii) to plan and execute the budget in line with its set priorities; and (iii) to manage public

¹⁰ http://www.transparency.org/files/content/corruptionqas/314-Overview_of_corruption_in_Palestine.pdf

resources to deliver services. The country PFM system at central and local levels gives assurance that fiduciary risks would be maintained at Substantial level and could be mitigated through the implementation of appropriate mitigation measures. The Program can be implemented through the existing PFM system, provided that some identified challenges, at the country and local levels, are addressed, through accounting and reporting, internal and external audit. Based on the elements above, the overall fiduciary risk is rated Substantial.

Assessment of Program Financial Management Systems: limited FM capacity was observed at the VCs level, in particular at small VCs. There are weaknesses in the VCs revenue management system. For example, there are no unique names for tax payers to track collections, and no quality assurance procedures to monitor the expenditure process and to ensure accuracy of data entry.

The FSA concluded that the overall FM risk rating for the Program is “Substantial” after mitigating measures, mainly due to:

- Risk of cost overruns and liquidity shortfalls due to non-delivery or insufficient outputs by VCs.
- MoLG supervision is not robust and is not satisfactory, and constitutes a major risk of not achieving Program desired results, mainly due to weaknesses in implementation and monitoring capacity.
- The control and external audit framework related to VCs provides some level of fiduciary comfort, but at the same time, these controls are redundant and overlapping and seem to create risk of delay in disbursement.
- Lack of coordination between implementing entities.

The following measures are designed into the proposed Project to mitigate FM-related risks:

- The Program design has included a set of Mandatory Minimum Conditions (MMCs) that VCs need to comply with before access is granted to the capital grant funds.
- To strengthen the accountability framework of VCs it has been agreed with the MoLG that VCs will have to submit annual audited financial statements conducted by an independent external auditor.
- The capacity-building element of the Program will provide the necessary support to the MoLG and VCs accordingly.
- To coordinate efforts, a Program Committee would be established for decisions requiring all key stakeholders.

FM Remedial actions to be included in the Program Action Plan: The following activities are suggested under the Program Action Plan for improving the performance of financial management systems supporting the Program implementation:

- Improve the financial management capacity of the MoLG to improve budgetary and accounting standards as well as the quality of financial information for VCs.
- Improve the quality of information provided in the central government financial information (Budget, annual accounts) on fiscal transfers to VCs.

Assessment of Program Procurement Systems:

Overall, the procurement processes and procedures introduced by the new Law and the existing capacities within the various entities were found to be adequate for the efficient implementation of the Program,

provided that a set of pre-requisites and improvements are introduced to address the weaknesses and mitigate the associated risks. The adoption of the instruction, to be issued by HCPPP, on the prior review of LGU procurement decisions by MOLG (or MDLF), was agreed as a prior result. In addition, the following components of the system will have to be completed by Project Effectiveness:

- National Standard Bidding Documents for Goods, Works and Consulting Services issued by HCPPP for use by all procuring entities, including LGUs, and National Procurement Manual prepared. The issuance and mandatory use of the SBDs and manual presents a number of advantages for the procurement system including: helping to standardize and harmonize implementation of procurement proceedings; promoting transparency and predictability in public procurement proceedings, helping to mitigate the effects of low levels of procurement capacity in the public sector; facilitating participation by small businesses; facilitating oversight, regularity control, and audit of procurement proceedings;
- Introductory training of all VCs and JSCs, and MDLF and MOLG concerned staff on the new public procurement system. The training will familiarize participants with the key aspects and innovations in the new legal, institutional and procedural framework and to provide participants with a basic introduction to the key steps and procedures in the procurement process, from planning through acquisition (bidding and contract award), until the completion of contract implementation and administration;
- Setting up the Dispute Review Unit (complaint handling mechanism); and
- Developing the single portal procurement website, where all procurement notices, procurement plans and contract award notices will be published.

Moreover, the Program will support the following capacity building activities during the first year of program implementation:

- Training of large VCs and qualifying JSCs on National Standard Bidding Documents and Contract Management; and
- Training of MOLG respective departments on the selection of consultants and the management of consultants contracts.

The main procurement risk to the program arises from possible delays in putting in place the above-mentioned necessary components for effective functioning of the new public procurement system. Other possible risks include delays in the processing of procurement by the two central departments within Ministry of Finance and Ministry of Public Works and Housing of contracts above the applicable thresholds. Moreover, the local government procurement instruction could be prepared to include low prior review thresholds and excessive prior review requirements, which could result in substantial delays. Based on the assessment the procurement risk is rated substantial.

Assessment of Fraud and Corruption Risks Mitigation Systems:

The FSA found that the current PACC system for handling complaints is adequate and will be relied on for the Program. If complaints are received regarding the Program, the PACC will use the existing complaints handling mechanisms and will use their process to investigate and prosecute as necessary. The

PACC will relay any results to the Bank. For the VCs receiving individual funds, if a system of complaint handling is not already in place, the PACC will provide training to the VCs to set up such a system. The Program Manager and the MoLG will also report to the PACC any irregularities found in annual audited financial reports provided to them by the VCs or JSCs. The Operating Manual will describe the procedures of the complaints handling mechanisms and the procedures of sharing the results of the investigation. The Bank will retain the right to investigate.

Based on the assessment, it is concluded that the Program Fiduciary Systems is adequate to manage the capital investment grants and are capable of producing accurate and timely information and reports. However, there are significant gaps and weaknesses in these systems which need to be addressed as part of Program implementation. These gaps and weaknesses have the potential to make the fiduciary risk of the Program to be high thereby impacting the ability of the Program to achieve its intended results. Therefore, a Program Action Plan is prepared based on the findings and conclusions of the Fiduciary Risk Assessment that will mitigate to a large extent the fiduciary risks and weaknesses identified. Considering the existing weaknesses in Program Fiduciary systems and the time and effort required to implement the Program Action Plan and the capacity building initiatives, the residual fiduciary risk rating for the Program is rated as **Substantial**.

Section 7: Program Action Plan

Sl #	Program Action	Base line	Responsibility	Schedule	Verification
1.	All VCs to submit their budgets and annual plans, annual financial statements and audit reports to the MoLG.	Currently 40% of VCs submit their budgets and annual plans, annual financial statements and audit reports to the MoLG	MoLG and VCs	Starting with the second year of the Program	Annual Performance Assessment and Program Reports
2.	VCs Councils to prepare annual action plan to address audit findings within a period of six months after the receipt of the audit report	No such action plan exists	VCs	Starting from the first year audit report received	Annual Performance Assessment and Program Reports
3.	Staff capacity and skills of VCs in financial management to be assessed and a suitable capacity building program to be designed and implemented	No such assessment is in place	MoLG	Starting from the first year of the Program	Performance Assessment
4.	Training of all VCs and JSCs, and MDLF and MoLG concerned staff on the new public procurement system,	No such training exists	MoLG and MDLF in coordination with HCPPP	Prior to project effectiveness	Training Reports
5.	Qualified VCs, JSCs, MDLF and MoLG use National SBDs in procurement under	SBDs being finalized	HCPPP, MoLG and MDLF	Starting from the first year of the Program	

	the Program				
6.	Qualified VCs, JSCs, MDLF and MOLG post their procurement and contract award notices on single procurement portal	Single portal does not exist	HCPPP, MOLG, MDLF, VCs and JSCs	Starting from the first year of the Program	
7.	Procurement complaint handling mechanism and Dispute Review Unit operational	DRU does not exist	HCPPP	Starting from the first year of the Program	Complaints database
8.	Training of large VCs and qualifying JSCs on National Standard Bidding Documents and Contract Management	No such training exists	MOLG and MDLF in coordination with HCPPP	First year of the Program	Training Reports

Proposed DLIs for Program

1. Local Government Procurement Instruction adopted by MOLG prior to project effectiveness

Section 8: Implementation Support

Implementation support will focus on implementation of the Program Action Plan, and will be part of the implementation support provided by the World Bank for the LGSIP. From a fiduciary perspective, the implementation support will focus on the following:

- Fraud and corruption: Supervise the implementation of the agreed fraud and anti-corruption measures under the program and provide guidance in resolving any issues identified;
- Financial Management: the task team will review the Program financial statements and audit reports as well as the Program reports such as the Results Verification reports prior to disbursement. The task team will coordinate the results reporting for the DLIs with the disbursement of the IDA credit funds.
- Procurement: the team will review of procurement performance of LGUs and oversight provided by MOLG and MDLF. And help coordinate and follow up the capacity building provided to LGUs.

The Bank has a strong fiduciary team based in West Bank and Gaza who will play the lead role in implementation support. Additional support will be provided by international staff as part of the implementation support missions.