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# APPENDIX 3: EXPENDITURE FRAMEWORK ASSESSMENT

## LGSIP Expenditure Framework Assessment (Draft)

**Review of the existing system of financing infrastructure service delivery in village councils**: As specified in the Local Government Act (LGA) of 1997, LGUs (both municipalities and VCs) are responsible for 27 functional responsibilities. These include most of the common local public services- but not all- that are common in other countries at the local level. The law does not distinguish either between “delegated” responsibilities and “own” responsibilities. In the case of delegated responsibilities the PA would be ultimately responsible for the regulation and financing of those functions but they would be implemented by LGUs.[1] In contrast, for own responsibilities the LGUs would be generally responsible for the services.[2] The absence of conditional grants from the PA to LGUs in the current system of intergovernmental finance, actually of any kind of transfers but for emergency grants and intercepted partial revenue sharing, indicates that there was no intention in the LGA of 1997 to introduce the figure of delegated responsibilities.

The actual provision of local public services by VCs appears to be narrower due to the paucity of financial resources available. The WB (2014b) report *“A Background Note on Villages in the West Bank”* reports that smaller VCs may perform only about 4 functions while the larger VCs something like 8 or 10 functions. These functional responsibilities of VCs are financed through a combination of budget allocations, transfers and own revenues. Capital expenditure requirements of Village Councils is financed mainly through Budget allocations from the Central Government as well as through shared taxes. The recurring expenditures are financed through a combination of subsidies from the Central Government as well as through own revenues.

**Budget Structure of VCs**: In general, LGU’s budgets include 3 main sections:

1. Operating Budget
2. Enterprise Budget
3. Development Budget

Operating Budget: include non-commercial services provided by LGUs. Those services include Health services, Public works, educational services, cultural services, social services and security. Operating budget should only include the operating portion of services provided. Operating Revenues include receipts from Property Taxes, Fees and other service revenues. **Operating expenses** are classified according to the main function they serve. Each category’s expenses is classified in 3 main subcomponents: wages and salaries, General and Administrative expenses and operating expenses. Operating expenses comprise of expenses relating to Street cleaning, maintenance of public facilities etc

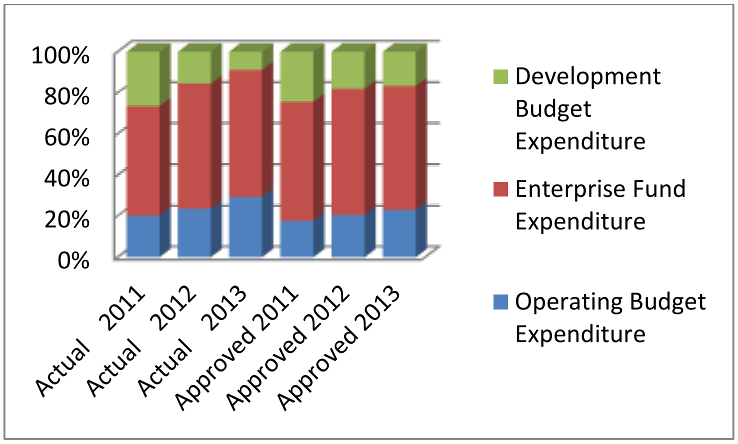
**Enterprise Budget:** commercial services (that incur profits) provided to civilians like water, electricity, sewage, vegetable and fruit market, fish market, slaughterhouse, etc.

**Development Budget (Capital Budget):** all financial resources used to obtain or build primary capital assets. On the receipt side, these include the grants and allocations received by the VC from the PA and on the expenditure side they include all the capital expenditure incurred for infrastructure development and service delivery.

[1] Examples of those in other countries are education, health and social welfare services.
[2] Examples would include, street lighting, local roads, parks and so on.

**<u>Figure 1 . Village Councils: Expenditure allocation by budget type</u>**

**Approved 2011-2013 and Actual 2011-2013 (first 9 months).**




Analysis of the budgets of the previous years (refer to Fig) shows that the budget allocations for development and operating expenditures by VC is very less and is fluctuating over the years indicating that there is a significant paucity of resources available to VCs for infrastructure development and their maintenance. The ability to finance large operational expenditures has not improved much in recent years. Operational average expenditures per capita (in NIS) for VCs barely moved from 2011 to 2012 – with around 54 NIS and increased some to 64.6 NIS in 2013 Compared to this, operational average expenditures per capita for municipalities steadily decreased from 195 NIS in 2010 to 166 NIS in 2012. Similarly analysis of development budget expenditures show that capital expenditures per capita has also reduced over the years and currently stand at approximately 41 NHS. Enterprise budget expenditures per capita have remained fairly stable for the past three three years.

Figure. Village Councils Operating Budget per capita averages: Approved 2011-2013; Three-fourths of Approved 2011-2013; and Actual 2011-2013 (first 9 months) in NIS

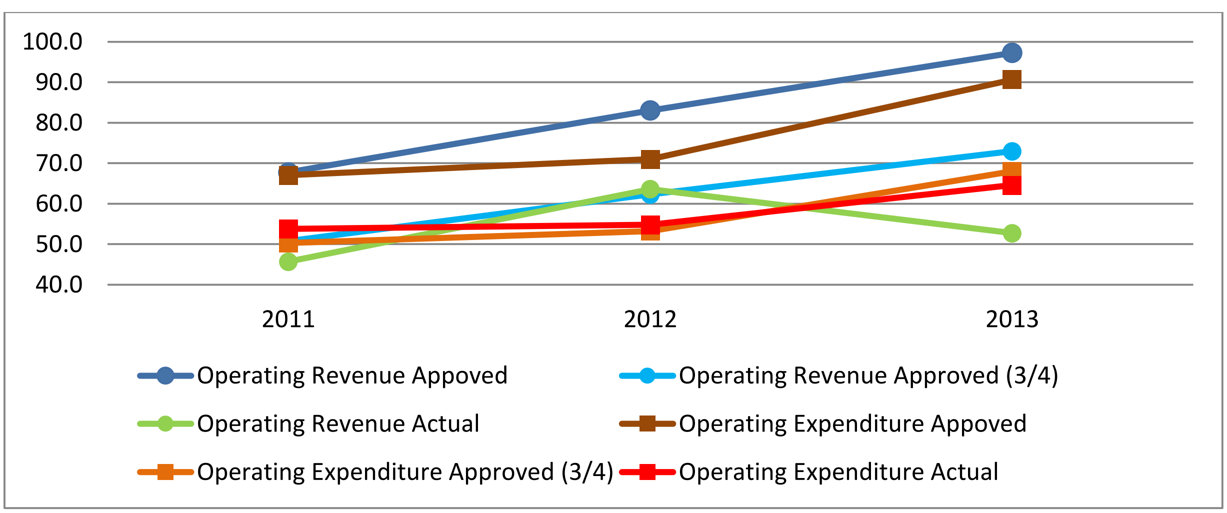
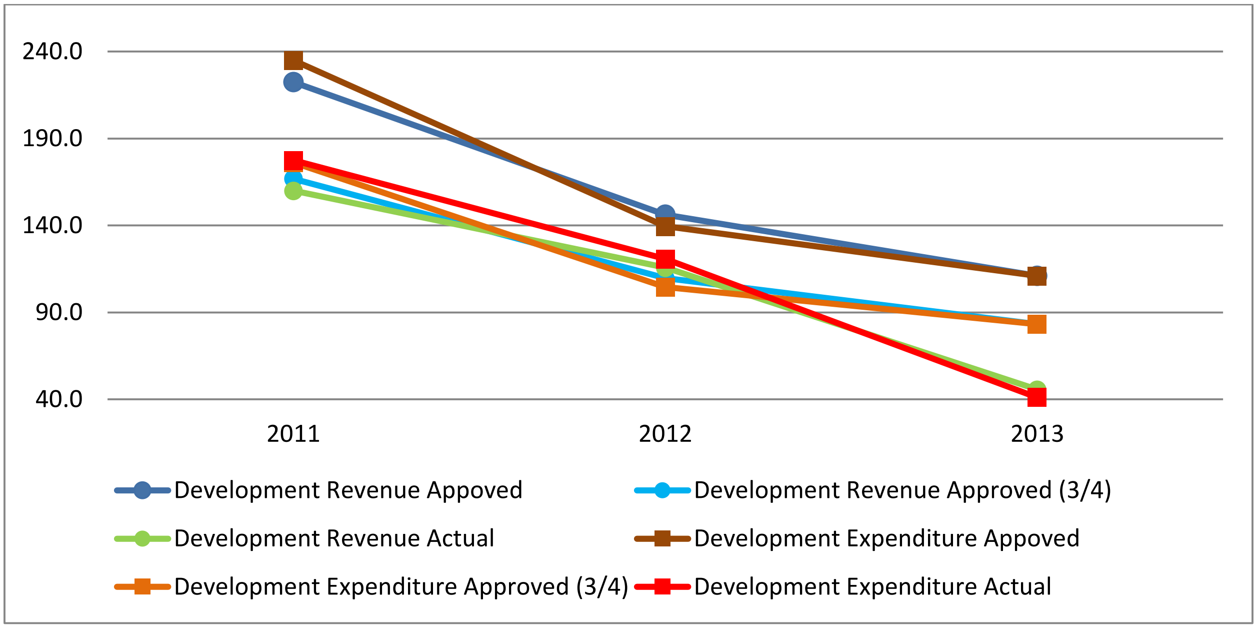


Figure. Village Councils Development Budget per capita averages: Approved 2011-2013; Three-fourths of Approved 2011-2013; and Actual 2011-2013 (first 9 months) in NIS




Note: Actual budgets for 2011-2013 are reported only for the first 9 months for most village councils but some village councils reported data for the first 10 months, 11 months or the full year.

Analysis of VC budgets have shown that VCs quite consistently show on average deficits in the operating and development budgets. This leads to the conclusion that the operating tax and non-tax revenues of LGUs are insufficient to cover the capital and necessary operating costs. Also analysis of the enterprise budgets have also shown that the source of the surpluses in the enterprise budget fund is quite fictitious given that many LGUs in charge of electricity and water distribution do not fully pay their providers and have been incurring in large accumulated payment arrears.

Resourcing of VC budgets: The table shown above shows the relative shares of the different types of revenues in the VC budget. The largest share –between 35 and 45 percent – is for "revenues from the PA" which includes revenue sharing and transfers: the transportation fees, government donations as grants in aid, and contingency budget allocations. The second relatively larger—up to 30 percent depending on the year-- is "services revenues" from user charges such as garbage collection fees—by far the most important item here--, parking lot fees, car inspection fees, etc. The third category is "revenues by the Village Council" which includes the taxes collected by the Village Council (the personal tax, the ceiling tax and the education tax) and other fees collected by the Village Council (such as agriculture products and cattle inspection fees, building license fees, and signboard fees). Surprisingly the VCs also report loans (from the PA and other institutions) as operating revenues; supposedly these are short-term cash bridging loans but they are wrongly reported as revenues since they will have to be repaid.

Last, the not insignificant “miscellaneous revenues” category varies considerably across VCs and covers any kind of revenues that do not fit in the previous categories, such as interest from bank deposits or the sale of property. The analyses of the operating and development revenues and expenditures show that there is a clear gap between them. However at present there are no regular grants or transfers available from the PA to supplement the shortage of LGUs’ own-source revenues. Three types of transfers are currently being implemented from the central level: (i) the transportation fee; (ii) emergency allocations; and (iii) capital transfers only for the municipalities (and not the VCs) through the Municipal Development and Lending Fund (MDLF).

Table Revenue shares: by type of budgets and its share in overall revenue, Approved and Actual 2011-2013 for Palestine Village Councils

| | **Village Councils** | | | | | |
|---|---|---|---|---|---|---|
| | Actual 2011 | Actual 2012 | Actual 2013 | Approved 2011 | Approved 2012 | Approved 2013 |
| **Operating Budget Revenue** | 16.6% | 24.1% | 21.4% | 15.9% | 20.5% | 22.6% |
| **Enterprise Fund Revenue** | 60.0% | 62.5% | 71.0% | 63.0% | 62.6% | 63.3% |
| **Development Budget Revenue** | 23.4% | 13.4% | 7.7% | 21.1% | 16.9% | 14.1% |

The transfer for the transportation fee resembles a form of revenue sharing with a distribution formula to allocate the revenues, which are unconditional in their use. So in that sense this type of funding can be regarded as a means to reduce vertical imbalances. This formula is changed yearly by the MoLG. The formulas used for the years 2008-13 are presented in the table below.

| Year | 2013 | |
|---|---|---|
| criterion of allocation | Percentage | Amount |
| **Population** | 55% | 52,351,487 |
| **Jerusalem** | 5% | 4,759,226 |
| **Financial and Administrative reform** | 10% | 9,518,452 |
| **Support for Village Councils** | 15% | 14,277,678 |
| **Joint Councils and amalgamation** | 10% | 9,518,452 |
| **Marginalized areas, Bedouins, affected by the wall, Jordan Valley** | 5% | 4,759,226 |
| Total Amount | **100%** | **95,184,522** |

| Year | 2012 | |
|---|---|---|
| criterion of allocation | Percentage | Amount |
| **Population** | 60% | 53,905,486 |
| **Jerusalem** | 5% | 4,492,124 |
| **Financial and Administrative reform** | 10% | 8,984,248 |
| **Support for Village Councils** | 15% | 13,476,371 |
| **Joint Councils and amalgamation** | 10% | 8,984,248 |
| Total Amount | **100%** | **89,842,477** |

Of the many factors entering the formula, population, has typically been the most important one, with 55 to 75 percent distributed according to it. The specific criteria and decision making process to arrive at the formula remain quite opaque and the MoLG only releases the formula ex-post after it has been applied. Besides population, other factors that have been used include: Financial and Administrative reform;[3] support of VCs, support of the merging of VCs and joint service councils (JSCs), marginalized areas and Bedouins, support of Jerusalem, etc. This approach leaves LGUs with no means to anticipate and plan accordingly for the revenues they may expect from this transfer. The operation of this transfer gets complicated by fact that the revenues are first collected by the MoT, deposited in the Treasury, with MoF letting MoLG the existing pool of funds for allocations, MoLG deciding on the formula, and finally the MoF typically intercepting the funds to be appropriated to the different LGUs because of the LGUs' arrears for water and electricity.[4] Emergency transfers to LGUs are allocated ad-hoc by the Cabinet of Ministers and no information on the allocation criteria and decision making process are made available on a routine basis.

In summary, the current system of transfers in the Palestinian Territories fails to perform in terms of the three objectives typically pursued by transfer systems —vertical balance, horizontal balance and attainment of sectoral objectives. The existing transfers, for the most part, lack predictability and are too small in size to close the existing vertical gaps. They also lack in incorporating explicit objective equalization criteria and the instrument of conditionality is in its infancy.

Budget execution systems: This area has seen recent reform efforts including the development of a unified chart of accounts and standard budget guidelines. All VCs are now required to report electronically their annual budgets to the MoLG . Analysis of VC budgets show that there is a consistent variance between planned and actual budgets resulting in a significant financing gap for delivery of local services. According to the recent World Bank study on intergovernmental fiscal relations, " *The fact is that there is considerable uncertainty and unpredictability in the funding because basically all sources have been unreliable in the past. There may be also the belief that planned budgets need not to be taken too seriously because at the end of the day many LGUs of the have to function –as is the case for the PA—under cash rationing. There is also the factor that there are no serious consequences for getting it wrong on a consistent basis from MoLG supervision". (*Jorge Velasquez, World Bank 2014). The systematic mismatch of planned budget and executed budget tends to nullify the usefulness of budget planning and the prioritization of expenditures. Budget execution on a sequestering basis – depending on cash availability—may negatively affect the efficiency and fairness of actual expenditure allocations. The mismatch problem is more acute with VCs.

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[3] This item is intended to support LGU's that adopt Financial and Administrative reforms. Examples are LGU's who lay off unproductive employees and need to pay compensation or LGUs that intend to install prepaid meters for electricity.

[4] The property tax interception process only started to get published in quarterly reports at MoF's website in 2013. However, the published reports do not include the intercepted amounts but rather the arrears to be paid to MoF.This information can be obtained at the link: http://www.pmof.ps/documents/10180/363023/property.tax.Q1.2014.arb.pdf/d541fa4e-e3cb-4219-9a99-05d602ae4409

**<u>Table. Average Budget Balance of Village Councils by budget type, Approved 2011-2013 and Actual 2011-2013 (first 9 months) (in NIS)*</u>**

| | **Actual Budget** | | | |
|---|---|---|---|---|
| **Year** | **Operational Budget Balance** | **Enterprise Fund Balance** | **Development Budget Balance** | **Overall Budget Balance** |
| 2011 | -8283 | 126239 | -572560 | **96042** |
| 2012 | 29691 | 92975 | -772597 | **102217** |
| 2013 | -20113 | 150752 | -655259 | **104319** |
| | **Approved Budget** | | | |
| year | Operational Budget Balance | Enterprise Fund Balance | Development Budget Balance | **Overall Budget Balance** |
| 2011 | 9974 | 189885 | -809082 | **167928** |
| 2012 | 43326 | 181135 | -951491 | **213335** |
| 2013 | 34643 | 167367 | -1062696 | **169938** |

Note: Actual budget for 2011-2013 is for first 9 months for most village councils but some village councils reported data for the first 10 months, 11 months and the full year. * The figures are the average of budget balances across VCs. Because across budgets not all VCs have some missing budgets the Overall budget balances do not match the sum of the three types of budgets

Table XX shows for VCs the mismatch between planned and approved budgets for 2011-2013, three-fourths of the approved budgets 2011-2013 and the actual budgets for the first 9 months of 2011-2013. As indicated before in the report, VCs only report consistently budget executions for the first 9 months of the year. As shown in Figure actual budget expenditures tend to fall short of those planned.

One last aspect of budgetary performance is the ex-post audit and evaluation. Even though there is some financial audit performed -- the General Control Office (State Audit Office) reviews annually a sample of VCs —there has been little or no performance evaluation of LGUs' budgets to understand to what extent local programs are achieving their intended goals and at what cost. The MoLG has recently issued instructions for all VCs to get themselves audited annually using the services of independent external auditors. This is an excellent step to strengthen local government accountability.

**Expenditure Framework Assessment:** Analysis of local government fiscal data and public financial management systems have shown that, while VCs have a rudimentary fiscal and financial management framework in place, there are several gaps and weaknesses that need to be addressed. There is a consistent gap in the resources available to VCs to address their capital and operating expenditure requirements. Even where such funds are available (such as the transportation fee), their allocation and distribution is not in a transparent and predictable manner. The absence of a stable and predictable intergovernmental fiscal transfer system to VCs has resulted in a consistent gap between the planned and actual budgets of VCs, which in turn has affected their capability to address local service delivery and infrastructure development priorities. The recent initiatives by the MoLG to improve the performance and accountability of local government PFM systems by insisting on electronic submission of annual budgets as well as the annual financial audit of LGUs need to be followed up and implemented rigorously. The Program design for the proposed LGSIP has taken into account these issues and the Program design includes several features to address these key issues.

The Program Expenditure Framework relies on the country systems and is expected to strengthen the transparency and predictability of financing of VCs along with strengthening accountability and institutional performance of VCs. Recognizing the need for enabling VCs to meet their development requirements in accordance with locally driven priorities, the Program is setting up an intergovernmental fiscal transfer system that will provide resources to VCs on a predictable and transparent manner. As such, the Program will allocate annual capital grants to eligible VCs which will enable them to finance their annual capital investment plans (ACIPs).Consistent with the intention of the PA to strengthen the capacities of large VCs and help them make the transition to become municipalities in the medium term future, the Program will provide capital grants directly to large VCs who will be responsible for the custody, utilization and reporting of the funds. For the smaller VCs the capital grants will be channeled through the MDLF, who as Program Manager will be responsible for the custody, disbursement and reporting of the funds.

The Annual Capital Grants for VCs will be programmed into the PA budget under the budget head for the MoLG. Within the Budget Head, the budgetary allocations for the three elements of the Program (viz capital grant allocations to VCs, allocations for joint projects to the MDLF and the allocation for capacity building to the MoLG) will be shown under specific budget line items for each. Since the timely allocation and disbursement of the Capital Grants to VCs is critical for the achievement of the Program Results, and previous experience has shown that there are delays in the allocation and disbursement of budget funds, the Program has agreed with the Ministry of Finance (MoF) and the MoLG that the annual Capital grant allocations will be disbursed within a prescribed time period after the approval of the annual budget. In addition, the Program will be incentivizing the timely allocation and disbursement of the annual capital grants through a DLI.

Complementing the Program design of setting up of a system of annual capital grants to VCs, the Program will also be supporting the Government to reform the existing system for the allocation and disbursement of the Transportation fee. The Program will support the Government's intention to make the MoLG's inter se allocation of the transportation fee among the VCs to be more transparent and formula based. Considering the potential of the transportation fee to be a stable source and predictable source of revenue for VCs, the Program will incentivize the MoLG to move forward quickly on the reform of the transportation fee through a specific DLI.

The Program will enable the PA to put in place a stable and predictable channel of financing VCs. The technical assessment undertaken as part of the Program shows that the Program will supplement the existing per capita capital investment allocation of 25 NHS with an additional 25 NHS thereby providing additional resources to the VCs to finance their ACIPs. In addition to the cofinancing brought in by development partners into the Program, the parallel financing provided by development partners such as KfW will also flow to VCs that will supplement the resources available for undertaking infrastructure development and service provision. The reform of the Transportation fee planned to be undertaken as part of the Program, will put in place the foundations for a sustainable source of financing for VCs to undertake their capital and operating investments.

The Program will rely on the existing Public Financial Management Systems of the PA for the disbursement, reporting and oversight of the Program funds. The Program funds will be part of the National Budget and will be disbursed following the budgetary allocation and disbursement procedures. The eligibility conditions that VCs are required to comply with for obtaining the capital grants incentivizes VCs to comply with standard good governance practices. The Program will strengthen the MoLG's intiatives for the timely and electronic submission of annual budgets and for the annual external audit of VCs by incorporating them into the Program design and Program Action Plans. The Prior Actions for the Program will put in place the necessary steps for enabling efficient budget execution by VCs through the finalization of the Procurement Instructions by the MoLG.