A Critical Review of the Proposed Palestinian Public Debt Law

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PALESTINE ECONOMIC POLICY RESEARCH INSTITUTE

FEBRUARY 2005

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Strategic Objectives

- Promoting knowledge-based policy formulation by conducting economic and social policy research in accordance with the expressed priorities and needs of decision-makers.
- Evaluating economic and social policies and their impact at different levels for correction and review of existing policies.
- Providing a forum for free, open and democratic public debate among all stakeholders on the socio-economic policy-making process.
- Disseminating up-to-date socio-economic information and research results.
- Providing technical support and expert advice to PNA bodies, the private sector, and NGOs to enhance their engagement and participation in policy formulation.
- Strengthening economic and social policy research capabilities and resources in Palestine.

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This study was prepared by Palestine Economic Policy Research Institute-MAS research team, particularly by the following researchers:

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Funding: This Study was funded by The International Development Research Centre-IDRC and The Ford Foundation.

Palestine Economic Policy Research Institute (MAS)
Jerusalem and Ramallah

February, 2005

Forward

Governments collect revenues from various sources in order to fund their public expenditures. When deficits arise, these governments are forced to borrow from external or domestic resources to finance the gap between revenues and expenditures. The loans, which form the public debt, then have to be repaid with interest according to agreed-upon payment schedules. When making decisions related to the public debt, governments should therefore take into consideration that servicing this debt eventually becomes the responsibility of future generations of tax payers.

If government loans are spent on improving the investment environment and on promoting economic growth, tax payers are more likely to be able to carry the burden of public debt, since increased incomes generate larger tax revenues which can be used for loans repayment. If, however, the borrowed resources are not productively invested, the government might be forced to take new loans in order to service its debts, creating a vicious circle of growing public debt and economic crisis. The government will be forced either to increase the tax burden or to cut public expenditures and services provision, thereby preventing sustainable social and economic development. Unfortunately, this negative development has occurred in many countries, most of them in the developing world, and the so-called debt crisis has been at the top of the international financial agenda since the 1980s.

With the proposed Palestinian Public Debt Law, Palestine joins the line of countries seeking to avoid a debt crisis by passing legislation to rationalise their borrowing decisions and develop their monitoring management procedures. As part of its preparations to adopt this new law, the Palestinian Legislative Council's Economic Committee asked MAS to critically review the draft law in terms of its ability to improve Palestinian public debt management. In addition, this critical review is expected to form the basis for a public debate that will further develop the draft law before it is ratified.

MAS would like to thank all those who contributed to this study, particularly Dr. Said Al-Khatib for heading the research team, Dr. Atef Alawneh, Deputy Minister of Finance, and Samer Al-Faris, Professor at the Bir Zeit University Institute of Law, who evaluated the study. I would also like to thank everyone who participated in the public discussion of

this study for their valuable inputs and recommendations. Finally, I would like to express my deep gratitude to the Ford Foundation and the Canadian International Development Research Centre (IDRC) for contributing to financing this critical review.

Dr. Samir Abdullah
Director General

Executive Summary

In recent years, and especially since the beginning of the 1980s, poorly structured debt - in terms of maturity, currency, interest-rate composition, and large and unfunded contingent liabilities - has been an important factor in inducing economic crises in many countries. Each country's capacity to service its public debt is shaped by the capital market constraints it faces, the quality of its macroeconomic and regulatory policies, its institutional capacity to design and implement reforms, and its objectives for public debt management. Drafting and enforcing an efficient public debt law can reduce a country's vulnerability to international financial shocks. In the Palestinian Territories this is especially important, since the Palestinian economy has a low degree of diversification, a small base of domestic financial savings, and an undeveloped financial system. The purpose of this critical review – MAS's eleventh so far in the field of economic legislation - was to assist the Palestinian Legislative Council (PLC) and the Palestinian National Authority (PNA) to formulate a modern public debt law which ensures that government financing needs and its payment obligations are met at the lowest possible cost and risk.

The study introduces the different types of public debt, setting them in an international context and reviewing the causes of problems associated with them. It then reviews the growth of the Palestinian public debt during the years of *Intifada*, examining its causes, nature, and implications for the future. It examines the possible risks (such as market risk, liquidity risk, settlement risk, and operational risk) and presents the indicators of external vulnerability. Despite recently sky-rocketing, the Palestinian public debt remains under control because most of it is soft loans given to the PNA to meet its financial needs during adverse conditions. In addition, the public debt to Gross Domestic Product ratio remains low compared to all other countries in the region.

Good public debt management should be characterised by having clear and specific objectives, transparency and accountability, an efficient institutional framework, and the ability to assess risks. The study sought to examine:

- the areas in which there is broad agreement on what generally constitutes sound practices in public debt management;

- the respective roles of monetary policy, fiscal policy, and the Legislative Council in determining the government's financing needs and its payment obligations at the lowest possible cost;
- the transparency and accountability of debt management operations;
- the legal framework that regulates the authority to borrow and issue new debt, and to undertake transactions on behalf of the government;
- the differences between the Palestinian public debt law and equivalent laws in other countries;
- the harmony between the draft law and other Palestinian laws in the economic sphere.

The critical review found that the draft law largely succeeds in its mission to reduce the potential impact on the Palestinian economy of external financial shocks. Twenty-two of its thirty-nine articles are borrowed directly from the well-functioning Jordanian public debt law. In many cases, indeed, it is an improvement on the Jordanian legislation, including, for example, a clause for establishing a special fund for the Ministry of Finance to help it meet its liabilities. It also pays full attention to the recent rapid growth in technology witnessed in developed financial markets, including articles governing the exchange and recording of information electronically. However, MAS's review recommends some changes of substance and emphasis – particularly in the selection of the Public Debt Committee (Article 2) – which MAS hopes will be adopted in the final draft. These include:

a) Clarifying that it should be the Ministerial Council's responsibility to nominate the members of the Public Debt Committee, and suggesting that an independent academic or expert should be chosen to sit on that committee.
b) Explicitly stating the importance of transparency and accountability in public debt management, and adding a clause referring to the qualities and qualifications of those responsible.
c) Guaranteeing the independence of public debt management from the Palestinian Monetary Authority.

MAS also pointed out the conservative nature of the law, which sets the maximum maturity date for loans at 10 years, restricts the ratio of public debt to GDP to only 40%, and requires the approval of the Legislative Council for each new loan.