

PRDP-TF: Quarterly Review ¹
April - June 2012

1. In the first half of 2012, the PA continued to deal with an increasingly difficult fiscal situation. The recurrent deficit was 32 percent above its budget target because revenues were lower than expected and expenditures were higher than the prorated projections. In addition, external budget support was 21 percent less than anticipated. As a result, the PA was forced to increase domestic borrowing and incur additional arrears. Salary payments for June were delayed and were paid in two tranches. This has increased uncertainty and served as a drag on the economy. Real economic growth for Q1 2012 was estimated at around 5.6 percent in WB&G – below the 6.2 percent projection contained by the budget. The tight fiscal situation coupled with high economic and political uncertainty led to a slowdown in the implementation of the reform agenda. Nevertheless, the PA has recently adopted some measures to try and achieve progress on public procurement and enhance domestic revenues.

2. The recurrent deficit for the first half of 2012 was 32 percent above its budget target amounting to NIS 2.4 billion. Total expenditures and net lending were 5 percent above budget while total revenues were 7 percent below their target. The recurrent deficit was also 5 percent higher than the deficit in the same period in 2011. In the first half of 2012, the PA reported development expenditures of NIS 444 million. Thus, total need for external financing, including recurrent and development, amounted to NIS 2.8 billion. However, total external support received was NIS 1.7 billion. Support for the recurrent deficit was NIS 395 million less than budgeted and development financing was almost NIS 390 million less than anticipated. Consequently the PA had to make additional local borrowing in the amount of USD 112 million in Q2, raising its overall local debt to USD 1.2 billion as of June 2012, which is probably close to the limit that the local banking sector can sustain. It also had to incur additional arrears in the amount of NIS 1.1 billion in the first half of 2012, 42 percent of which is owed to the private sector. It is estimated that the total stock of private sector arrears accumulated since 2009 now stands at about USD 0.5 billion.

3. In the first six months of 2012, gross domestic revenues were NIS 1.4 billion and almost 11 percent lower than called for by the budget. They only grew by 1 percent when compared to the same period last year, even though the budget calls for them to increase by 17 percent. Tax revenues for the first half of 2012 were 10 percent lower than their budget target. However, their performance improved when compared to the same period last year, whereby income tax collections grew by 45 percent, property tax receipts increased by 6 percent and VAT collections were almost unchanged. The rise in domestic tax receipts can be attributed to the PA's efforts in widening the tax base and enhancing the collection of tax arrears and liabilities from the largest corporations. The PA reports that advance income tax payments under the new 20 percent bracket that was applied in the beginning of the year also boosted tax receipts.² Additionally, fifteen private sector companies agreed to voluntarily give up all tax exemption privileges granted by the Palestinian investment promotion law for a period of two years. Despite all these efforts, the PA reports that tax revenues will not be able to achieve their optimistic end of year target. As for non-tax receipts, they were 12 percent lower than their budget projections for the

¹ All figures cited in this report are on commitment basis.

² The income tax rate on upper income categories was raised from 15 to 20 percent in January 2012.

first six months of 2012. Nevertheless, this item is expected to surpass its end of year target as higher than budget investment profits were received from PIF in Q3 2012.

4. Clearance revenues performed well throughout the first half of 2012 despite not hitting their optimistic budget target. They totaled NIS 2.8 billion, and were 6 percent lower than their half year target. However, they were 13 percent higher than the same period last year. Customs, VAT and petroleum excise tax all increased by 9, 20, and 10 percent, respectively when compared to the first half of 2011. The growth witnessed by clearance revenues is a positive achievement for the PA, which has made a strong effort to ensure it receives the VAT and import duties it is owed. However, additional work needs to be done in cooperation with the GoI in order to reduce leakages. It has recently been reported that the PA and the GoI reached a bilateral agreement for expanding trade between the two parties and streamlining clearance revenues' procedures. According to statements made by the parties, the Israeli Customs will start sharing real time data on direct imports to the Palestinian territories, as well as information on VAT receipts issued by Israeli traders to Palestinian importers. Additionally, advanced technologies will be employed to facilitate and monitor trade between the two parties, and special bonded warehouses are to be established on the Palestinian side to allow Palestinian Customs to assume responsibility on the clearance of direct imports to the PA from third countries. Such measures could substantially reduce tax leakage and increase clearance revenues which in turn could improve the PA's fiscal situation and reduce the financing burden on donor countries. Thus, it is hoped that the parties will implement the agreement starting 2013, as planned.

5. In the first half of 2012, total expenditures and net lending amounted to NIS 6.3 billion and were 5 percent above their budget target. They were also 8 percent higher than in the same period in 2011, and Q2 expenditures were 12 percent more than Q1. The main reason behind the increase in this item is the above than budget growth of nonwage expenditures and net lending. On the other hand, the wage bill which represents 54 percent of current expenditures was kept almost exactly on its budget target which calls for a 6.8 percent increase in 2012. In Q2 2012, net growth of the public labor force was 138 employees - significantly lower than the previous quarter's figure of 827. Overall, PA employment rose by 237 new hires in the West Bank and decreased by 101 in Gaza.³ Notably, the PA continued to increase employment in the security sector where 240 new employees were added to the payroll system during Q2 2012: 194 in the West Bank and 46 in Gaza. In the education and health sectors, 1,022 and 2 new workers were added, respectively.

6. Nonwage expenditures for the first half of 2012 exceeded the budget by 9 percent and were 7 percent higher than the same period in 2011, amounting to NIS 2.7 billion. Transfers which represent 27 percent of current spending were 19 percent above their budget target even though the budget calls for these payments to decrease by 10 percent. The PA reports that the majority of the higher than target transfers is related to pension payments to retirees from the security sector. These pension payments were not accounted for in the 2012 budget. However, The PA has continued to pay them which explains why transfers were above budget for the first half of the year. The MoF reports that transfer expenditures will exceed their end of year projected target.

³ In addition, net employment for permanent deputies, the Palestinian National Fund and the embassies rose by two employees.

7. In order to offset the increase in transfer payments, the PA had to place tight control on operational and minor capital expenditures. In the first half of 2012, operational expenditures were 3 percent lower than their target even though they are projected to grow by 9 percent in 2012. They were also 4 percent lower than their amount in the first half of 2011. The PA has adopted policy measures to keep its operational expenditures under control including withdrawing car privileges from all PA employees ranking below heads of institutions and their deputies. It has also limited air travel to economy class, and rationalized other transportation and supervisory allowances. As for minor capital expenditures, the PA decided to delay any major spending in this area during the first half of 2012. As a result, minor capital expenditures were 76 percent lower than their projected target even though the budget calls for these expenditures to grow by 35 percent in 2012.

8. Net lending continues to be above its budget target since late 2011. In the first half of 2012, net lending was 37 percent higher than projections even though it is expected to decrease by 20 percent throughout the year. It was also 23 percent higher than the same period in 2011. The increase in net lending is mainly due to higher than usual deductions from clearance revenues by the Israeli Electric Corporation to clear electricity arrears owed by the PA. These deductions are reported as net lending which explains some of the recent jump witnessed in this item. Additionally, the MoF reports that there has been an overall decline in electricity payments from municipalities to the PA. This is because the PA has not been making regular transfers to the municipalities due to the lack of funds. If municipalities fall out of the routine of regularly paying their utilities bills to the PA, previous progress achieved on net lending could be lost, and it may be very difficult for the PA to regain control over this item.

9. Development spending for the first half of 2012 amounted to NIS 444 million and was 33 percent lower than its budget target. It was also 38 percent lower than the same period in 2011. Q2 development spending, however, was 8 percent higher than Q1. In its Q2 2012 reporting, the PA provided information about the main categories of development expenditures and their main sources of financing. According to this information, about NIS 167 million of development spending was financed through the PA's budget. However, almost 35 percent of these expenditures were stated as "other projects" with no information about their type or nature. Therefore, additional information would be helpful.

10. In Q2 2012, progress achieved in electricity reform has continued to slowdown. These reforms aim at enhancing the sector's efficiency and reducing net lending by transferring electricity distribution to commercially run companies including NEDCO in the north, and SELCO and HEBCO in the south. In Q2 2012, the Palestine Energy Authority (PEA) has continued to deploy additional pre-paid meters in an effort to reduce late or non-payment of electricity bills, whereby 25,500 new meters have so far been installed in the West Bank during 2012. NEDCO now covers 84 thousand consumers and is responsible for 40 percent of electricity distribution. However, it is proving difficult to draw additional municipalities and villages to the utility. PEA reports that none joined NEDCO in Q2 2012. The PA had previously convinced local governments to join the distribution companies by offering them additional payments to make up for lost electricity revenues. However, the MoF has not been making these required transfers due to the lack of liquidity. This has been discouraging municipalities from joining the distribution companies. If current trends persist, electricity reforms will continue to slow, and it will very difficult for the utilities to achieve their ultimate targets of covering around 85 percent of consumers in the north for NEDCO, and 75 percent of consumers in the south for SELCO.

11. During Q2 2012, MoSA has continued to provide assistance to households in WB&G through the National Cash Transfer Program (NCTP). June payment was made to 96,369 households: 48,919 in the West Bank and 47,450 in Gaza. Of which, 923 were added to the system in Q2 2012 which is considered a sizeable increase given the system's limited resources. 19,226 of those that received assistance were above the deep poverty line.⁴ These households were previously admitted into the program on a temporary basis and were supposed to have been removed by June 2011. However, MoSA introduced a category of vulnerable households to its database in order to accommodate them in the system.⁵ In late March 2012, MoSA launched a new campaign for updating data of all West Bank households in the NCTP. The campaign was recently concluded and more than 30 thousand West Bank households were visited. During the field visits, the living conditions of 1,893 vulnerable and poor households were found to have improved above the poverty line. Consequently, MoSA reports that these households were blocked out of the system, and will no longer be receiving assistance. New households from the waiting list are currently being admitted into the system to replace the ones that were blocked out.

12. The PA was not able to achieve any progress in pension reform in the first half 2012. The Council of Ministers has not yet dealt with the proposal previously presented by the Palestinian Pension Authority (PPA) suggesting legislative changes required to implement the pension reform plan. Nor has the Council issued any of the decrees that the PA's pension reform plan called for in 2011.

13. The PA enacted a new public procurement law in July 2011. The next step should be establishing the Higher Council for Public Procurement Policies which will be the main regulatory body in charge of an efficient implementation of the law. The Council should constitute 8 members: 4 representing the MoF, MoP, MoNE and MoPWH respectively in addition to 4 non-civil servant procurement experts. Nominations for the Council membership were recently finalized and submitted to the Cabinet for approval. The Cabinet's final decision is expected by late August.

14. The SAACB has so far only finalized the audit of the PA's 2010 Balance sheet and work is still being done on the other financial statements. According to the goal expressed in the DPG IV policy matrix, the audit for all financial statements should have been finalized by December 2011. As part of the capacity building project that is funded by the European Union (EU), SAACB employees have wrapped up the second phase of the specialized English training, and the third phase has recently been launched. SAACB employees have also concluded a leadership skills course that is also part of the EU project.

15. The MoF is currently conducting efforts to enhance revenue generation and modernize its tax administration system. This work is being done with support from multiple donors including the IMF, DFID and USAID. A revenue strategy focusing on enhancing tax performance and widening the tax base is currently being drafted and is expected to be finalized before the end of the year. Several new committees were also established at the MoF in order to assess some of the most outstanding issues related to improving tax performance, including: setting up a legal framework for regulating the unification of revenues, establishing an organizational structure for the tax departments, merging the

⁴ For a reference household of two adults and three children, the deep poverty line for 2010 was set at NIS 1,783 or about USD\$ 478 per month, and the poverty line was NIS 2,237 or about USD\$ 609.

⁵ The vulnerable household category covers families who are headed by a female or an elderly person above 60 years of age, or a person who is chronically ill or disabled

customs and VAT directorates, in addition to developing a new computerized tax system. The committees are supposed to provide their recommendations to the Minister by the end of August at the latest.

16. During the first half of 2012, the PA's dire fiscal situation continued to persist. Total revenues were lower than expected and expenditures were higher than the prorated projections. As a result, the recurrent deficit was above its budget target. External budget support and development financing were both lower than anticipated, which further exacerbated the PA's finances. It appears likely that the PA's fiscal situation will worsen by the end of 2012. Recent projections illustrate that the recurrent deficit for 2012 will amount to USD 1.22 billion – about USD 270 million above the USD 953 deficit called for by the PA's 2012 budget. However, only around USD 922 million in donor-funding has so far been identified. This leaves a sizeable gap of almost USD 300 million. Given the fact that the PA's local debt is almost at the limit that the banking sector can sustain, it is unlikely that the banks will be providing additional financing. It is also doubtful that private suppliers will be providing further credit given the mounting amount of PA arrears to the private sector. If no additional donor funding is identified, the PA may be forced to finance the gap through accumulating additional arrears to the pension system and cutting some of its basic spending such as wages. The economic, political and social impacts of such cuts would be of concern.