PRDP-TF: Quarterly Review
July– September 2017

1. **The Palestinian Authority's (PA) efforts resulted in an increase in domestic revenues in the first three quarters of 2017.** Between January and September 2017, domestic taxes grew by 14.5 percent year-on-year following a strong pick up in all major tax categories. Income tax receipts grew by 19 percent due to higher collections from local tax offices as well as the Large Taxpayers Unit (LTU) following enhanced tax administration efforts by the PA. Collections from domestic customs on cars also grew by an impressive 22 percent due to a rate hike implemented in mid-2016. Revenues from excise on tobacco increased by 6 percent due to additional collections following the establishment of a new local tobacco company in 2017.[1] Nontax revenues also performed well mainly as a result of a license payment by the Palestine Telecommunications company in June 2017.

2. **Clearance revenues[2] also performed well with a year-on-year growth of 3.5 percent[3] in the first nine months of 2017.** They were driven by an increase in customs, VAT and petroleum excise – in line with an increase in Palestinian imports, as reported by the PCBS. Notably, the GoI transferred to the PA in March a lump sum payment of NIS131 million covering income tax collected from Palestinians working in Israel over a period of several months, in addition to NIS107 million in health fees and equalization levies transferred in June. These transfers also helped boost the PA's revenues.

3. **A drop in transfers was the main contributor to a 4 percent decline in PA spending in the first three quarters of 2017, relative to the same period last year.** Data from the Ministry of Finance and Planning (MoFP) show that transfers dropped by 8 percent as only half of the first quarter payment of the National Cash Transfer Program (NCTP) was disbursed, while the remainder is yet to be paid to poor households. Hence, this is not seen as a sustainable decline, but a delay in spending. Also, spending by line ministries on the use of goods and services so far in 2017 was lower than in the previous year as expenditure plans were delayed due to delays in approving the 2017 budget. But, spending is expected to increase again towards the end of the year. Net lending[4] declined by 6 percent due to a drop in electricity related costs which comprise the largest share of this spending item. The decline in electricity net lending offset the increase in water related costs which have continued to rise in 2017. The wage bill, the PA's largest spending item, was slightly lower than in 2016 due to recent measures to cut the salaries of PA employees in Gaza and the decline in the number of public servants as some employees were referred to early retirement in 2017. In fact, according to figures from the MoFP, the total number of PA employees dropped from 156,718 in December 2016 to 144,313 as of September 2017. The majority of the drop took place in Gaza where 12,002 employees exited the public service while in the West Bank the decline was limited to 398 employees.[5]

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[1] A new local tobacco company was licensed by the PA and established in 2017. The company is in charge of buying all local rolling tobacco produced in the West Bank and selling it to the local market. Prior to the establishment of the company, rolling tobacco was produced in the West Bank and sold in the black market, hence the PA was not collecting any taxes on it.

[2] Clearance revenues are VAT and import duties collected by the GoI on Palestinian imports and then transferred to the PA on a monthly basis.

[3] This year-on-year growth figure is calculated after adjusting for transfers by the GoI to offset fiscal leakages under the revenue sharing arrangements between the two parties in 2016 and 2017 in order to get a better idea of the underlying growth without these one-off transfers.

[4] Net lending represents deductions by the GoI from clearance revenues to offset utility bills owed by Palestinian Local Government units (LGU) to Israeli suppliers.

[5] Employment in the national fund increased by five employees.

4. **Despite an 8 percent decline in the total deficit year-on-year, the fiscal situation remained tight during the first nine months of 2017**. The PA's total deficit amounted to USD731 million between January and September 2017. Aid received amounted to USD444 million (USD344 in budget support and USD100 million for development financing), resulting in a financing gap of USD287 million. Notably, aid received was 23 percent lower than in 2016 mainly due to a drop in budget support while development financing actually increased. Despite the reduction in the deficit and as a result of the drop in budget support, the PA resorted to domestic sources of financing to close the gap. It therefore increased its net domestic bank financing by close to USD100 million resulting in its total domestic debt reaching USD1.5 billion, as of September 2017. The PA also resorted to arrears accumulation and despite repaying some dues from previous years, net accumulation in the first nine months of 2017 reached about USD200 million.

5. **The financing need for 2017 is expected to remain large.** The PA's total deficit for 2017 is projected at USD1.2 billion or 8.4 percent of GDP, while aid inflows are projected at USD661 million. As a result, the size of the financing gap could reach about USD540 million – before external debt repayment. If some of the recent fiscal measures in Gaza are reversed following the reconciliation, the gap is expected to rise to around USD660 million. The gap is expected to be even higher in 2018 as the PA assumes its responsibility in Gaza. If no additional donor support is identified, the gap, as in previous years, may be closed through further local borrowing and additional arrears to the private sector and the pension fund. However, the limit imposed by the PMA on the PA's borrowing only allows for USD200 million in additional credit from domestic banks. Further, the level of private sector arrears is already high at USD500 million and it poses a serious negative risk to economic activity. Arrears to the pension fund are estimated at USD1.6 billion and if current trends continue, the fund will become insolvent in a couple of years. Hence, these financing options will soon be exhausted, and the PA needs to accelerate reform efforts to align its spending and revenue capacity. However, in the short-term, actions by the PA alone will not be enough to close the financing gap. Therefore, in the short term, there is no feasible alternative to budget support as a key source of financing.

Reform progress

6. The World Bank has been working closely with the PA to develop a set of reforms to be supported by the Bank's upcoming Development Policy Grant (DPG). Reforms supported by the new DPG focus on (i) improving transparency of fiscal transfers to local service providers; and (ii) improving the business environment. Below is a description of the reform actions supported by the DPG and progress to date.

7. **Prior Action 1: At the direction of PENRA, at least 90 percent of all municipalities, village councils and DISCOs have opened a separate bank account to deposit funds collected from electricity bills to pay the Palestinian Electricity Transmission Company (PETL).**
Nonpayment of electricity bills owed by Palestinian distributors (i.e. DISCOs, municipalities or village councils) to the Israeli supplier has led to the net lending crisis and a high accumulation of outstanding debt. The creation of mechanisms to ensure that electricity revenues collected by Palestinian electricity distributors are not diverted to other municipal expenditures is a priority. Hence, the Bank has supported the PA in its efforts to contribute to the increased financial viability of the electricity sector through the reduction of net lending by supporting the creation of separate bank accounts where electricity distributors would deposit 90 percent of their electricity revenue. This action will increase payments by Local Government Units (LGU) to PETL for power purchased from the Israeli Electric Company (IEC), which will prevent the diversion of collections from electricity bills towards other municipal expenses.

8. **Prior action 2: At the direction of the Palestinian Water Authority (PWA), at least five LGUs have opened a separate bank account to deposit funds collected from household water bills to pay the West Bank Water Department.**

In the water sector, service providers are running a net deficit of about NIS130 million (USD35 million) per year, underwritten largely by the practice of net lending. Similar to the energy sector, restoring the financial viability of the water sector requires the establishment of mechanisms that ring-fence water revenues to pay for bulk water purchased, avoiding further accumulation of debts. To tackle this issue, the Ministry of Local Government (MoLG) and the PWA drafted a Memorandum of Understanding (MoU) to request all LGUs to establish independent sustainable water utilities, while in the meantime open separate bank accounts to deposit revenues collected from household water bills. Five LGUs (Salfeet, Jenin, Tubas, Tulkarem, and Qalqilia) have so far opened separate bank accounts, and more LGUs are on the way.

9. **Prior Action 3: The Ministry of Health has (i) signed an MoU to establish a framework over the purchase of referral services with at least six national hospitals and (ii) published harmonized standard procedures for medical referrals online.**
The Palestinian health system faces critical challenges with severe weaknesses in its capacity to constrain health expenditures, specifically for medical referrals outside the public health system. Over the last 15 years, the number of referrals has grown rapidly from 8,123 in 2000 to 74,654 in 2016, while its corresponding cost has also increased significantly from less than USD10 million in 2000 to as much as USD210 million. Currently, unpaid bills to outside service providers amount to more than NIS500 million (USD142 million), which has been threatening the sustainability of the health system and the PA's finances. The previous DPG supported reform actions to reduce the oversized spending on referrals to Israeli hospitals. This new operation attempts to build on gains made by the previous DPG through supporting the PA's reform actions to further advance efficiency improvements in health spending, as envisaged in the Medical Referral Master Plan ("Master Plan"), which was approved by the Cabinet in September 2016. By implementing the recommendations of the Master Plan, the MoH has signed MoUs with the six largest private Palestinian hospitals (3 in the West Bank and 3 in East Jerusalem) to regulate the contractual arrangements for referrals. Negotiations with three additional national hospitals are underway. In addition, the MoH has developed harmonized standard procedures for medical referrals, which include the following manuals and protocols: (i) Procedure manuals for local hospitals and Israeli hospitals; (ii) National Referral Protocols (Oncology, Ophthalmology, Cardiology, Neurology, Nephrology); (iii) Diagnostic Related Group (DRG) User Manual (for Israeli DRGs); and (iv) Financial Audit Manual.

10. **Prior action 4: The MoFP has issued an instruction mandating its Accounting Department and the Projects Department of the Ministry of Local Government to produce annual reports that include information on: (i) the Ministry of Local Government's capital budget allocated per LGU; (ii) the amount of revenue deductions or interceptions by the MoFP from transfers to each LGU; and (iii) an annex to the existing transportation fees report with the breakdown of the share of each LGU based on the endorsed allocation criteria by the Council of Ministers.**
Intergovernmental fiscal transfers from the PA to local governments suffer from a lack of transparency and predictability. Previous DPGs have achieved some success in improving the transparency of intergovernmental fiscal transfers through requesting the MoFP to produce quarterly reports on the committed and transferred amounts of transportation fee, property tax, and professional fees. This operation builds upon these previous actions through expanding the reports to include the MoLG's capital budget allocated per LGU. Also, the MoFP will be creating a new report which summarizes the amount of deductions made by the MoFP from transfers to each LGU and net accumulation of water and electricity arrears by each LGU. This measure will contribute to the improvement of transparency in the intergovernmental fiscal relations between the PA and LGUs. It would also allow LGUs to carry out better financial planning given that they will have access to information about the amount of net accumulated arrears they owe which affects revenue transfers they expect to receive in the coming years.

11. **Prior action 5: The Ministry of National Economy has established and implemented the movable assets registry, which allows firms to secure loans and other financing by using movable assets.**
In recent years, the PA has made significant progress to enhance the business environment in the area of access to finance. The new Secured Transactions Law adopted in April 2016 has helped in facilitating access to credit to the private sector, specifically by strengthening lenders' rights in movable assets. The establishment of a collateral registry is a key milestone in this reform as it allows small businesses to leverage movable assets such as inventory, equipment etc. to access financing. The online system for the movable assets registry was established in June 2016 and the relevant authorities had it fully operational by April 2017.

12. **Prior action 6: The MoNE has submitted to the Council of Ministers a new Companies Law that included simplified business registration procedures, new types of companies and shares, and good practices for protecting minority investors and resolving insolvency.**
The passing of this new law would be a very important step in modernizing the current legal framework governing doing business in Palestine. For example, at present, sole proprietors represent a large share of small businesses that are not governed by the current Companies Law, hence excluded from the protection against personal liability afforded to companies. This means that small, sole-proprietor businesses are exposed to greater risks, which translates into less access to finance, less scope for growth, and unequal treatment under the law compared to larger firms. The new Companies Law will allow for the establishment of one-person companies which will improve the business environment for small enterprises and facilitate entry. Having a registered company status will afford many small businesses—currently either unregistered or registered as sole proprietors with no liability protections—better access to finance, markets, and legal protections. The new Companies Law was submitted to the Cabinet for approval in June 2017. The Cabinet has received comments from the Ministry of Justice and other ministries. The adoption of the law is expected by the end of 2017.

13. **Prior action 7: The MoH, in collaboration with the MoNE, has submitted to the Council of Ministers amendments to the Annexes of the Law of Crafts and Industries of 1953 (updating the 3-tier classification of the approvals requested for licensing businesses and the fee structure for licensing).**
This action aims to simplify the approval process and reduce the cost of licensing. Currently, a 100 percent of applications for a general business license for a shareholding company go through the Ministry of Interior (MoI) for clearance. The proposed amendment to the Act of 1953 that is supported by the DPG will modernize the Annex of the Law of Crafts and Industries of 1953 by (i) reviewing the activities that require MoI clearance to focus the attention of the MoI on the very few applications that do have a security concern and free up the remainder to go through the other approvals much faster; (ii) modernizing the list of activities based on the International Standard Industrial Classification (ISIC) 4; (iii) proposing a simpler and lower fee structure that would provide incentives for businesses to get licensed. The MoNE, as the champion of business environment reforms, has worked together with the MoH (the stakeholder mandated by the Act of 1953 to amend the Annex) to finalize the draft Cabinet Decree and the explanatory note, which was submitted to the Cabinet in mid-September 2017.