PRDP-TF: Quarterly Review
October – December 2017

The PA's Fiscal Performance in 2017

1. **The PA's efforts succeeded in growing domestic revenues in 2017**. Between January and December 2017, domestic taxes grew by 15 percent (year-on-year) following a strong pick up in all major tax categories. Income tax receipts grew by 22 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 19 percent due to a rate hike implemented in mid-2016. Revenues from excise on tobacco increased by 12 percent due to additional collections following the establishment of a new local tobacco company in 2017.[1] Nontax revenues also performed well despite a strong decline in investment profits from the PA's sovereign wealth fund, the PIF, due to a pickup in collections from domestic fees and charges.

2. **Clearance revenues[2] also performed well with a year-on-year growth of 3 percent[3] in 2017.** They were driven by an increase in customs and VAT– 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. Another NIS225 million was transferred by the GoI towards the end of the year to offset some VAT leakage. These transfers also helped boost the PA's revenues.

3. **The PA managed to reduce public expenditure in 2017, predominantly but not only due to cuts affecting Gaza**. Data from the Ministry of Finance and Planning (MoFP) show that public expenditure in 2017 was 2.5 percent lower than in 2016, due to a decline in all major spending categories. The largest spending item, the wage bill, declined by 2.6 percent following 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. According to figures from the MoFP, the total number of PA employees dropped from 156,718 in 2016 to 137,114 by the end of 2017: 18,941 employees exited the public service in Gaza while in the West Bank the decline was limited to 667 employees.[4] Transfers, another major spending item, declined by 2 percent in 2017 (year-on-year) as the first quarter payment of the National Cash Transfer Program (NCTP) was not fully disbursed to poor households. Net lending[5] declined by 7 percent following a reduction in electricity-related costs which comprise the largest share of this spending item. The decline in electricity net lending offset the increase in water and sewerage related costs which continue to grow.

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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] Employment in the national fund increased by four employees.

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

4. **Despite an increase in revenues and a decrease in expenditures, the PA's financing gap persisted mainly due to less than needed budget support, and was filled by bank credit and arrears**. The PA's total deficit amounted to USD1.14 billion in 2017 (7.7 percent of GDP). Aid received amounted to USD719 million (USD544 in budget support and USD175 million for development financing), resulting in a financing gap of around USD420 million. Notably, aid received was 11 percent lower than in 2016 mainly due to a decline in budget support, while development financing increased in 2017. To fill the gap, the PA resorted to domestic sources of financing. It increased its net domestic bank financing by USD85 million resulting in its total domestic debt reaching USD1.5 billion, as of December 2017. The PA also resorted to arrears accumulation and despite repaying some dues from previous years, net accumulation in 2017 reached USD338 million.

The 2018 Budget

5. **According to the PA's 2018 budget, the financing gap will remain large at around USD500 million.** The budget projects a 5 percent increase in revenues compared to 2017, mainly due to economic growth and a license payment of USD63 million from a telecom operator. As for PA expenditure, it is budgeted to increase by 2.9 percent as a result of a rise in wage and non-wage spending. In fact, the wage bill is projected to grow by 3.2 percent, on the back of a 1.25 step wage increase mandatory by law, and additional hiring and promotions. Non-wage expenditure is expected to grow by 3.5 percent driven by pension salaries to employees that were referred to early retirement in 2017. The budget projects net lending to decline by around 6 percent in 2018, relative to its 2017 level. The recurrent deficit is projected to reach USD743 million, while development expenditures are expected to total USD530 million, leading to a total deficit of USD1.27 billion (8.3 percent of GDP). The budget assumes that aid will amount to USD775 million (USD600 million in budget support and USD175 million in development financing), resulting in a financing gap of around USD500 million.

6. **The 2018 financing gap could be lower according to World Bank estimates, but the options for closing the gap continue to pose some risks.** Growth projections underlying the revenue target in the 2018 budget may be too optimistic and the budgeted decline in net lending could be high. Based on previous years' trends, development spending may be lower than assumed by the budget. Aid inflows are projected to reach USD745 million -- slightly lower than expected by the PA. Put together, this will result in a financing gap of about USD440 million (2.9 percent of GDP), according to Bank estimates. If no additional donor funding is identified, the PA will resort to domestic sources to fill the gap. With limited potential for additional bank borrowing, one option would be to accumulate further arrears to the pension fund and private suppliers. Debt to the pension fund already stands at 12 percent of GDP and additional arrears could cause the PA to falter on its dues to pensioners, as the Bank projects that the fund will become insolvent in a few years. The stock of arrears to the private sector currently constitutes about 6 percent of GDP and is highly damaging to the economy. Additional private sector arrears could further worsen the PA's fiscal situation as private companies run out of cash to pay their taxes to the government. An alternative option, would be for the PA to not meet its wage commitments and its social transfers to the poorest of the population. Both options would risk social unrest. These options could also spill to the banking sector if the PA and its employees are unable to repay their loan installments in due time.

7. **Internal reconciliation could result in significantly increasing the PA's financing gap in 2018**. The reconciliation agreement signed in October 2017 between Hamas and the PA prioritizes the need to address the issue of civil service integration. This is key for sustaining service delivery in Gaza particularly as employees of the *de facto* authority have been providing key services to the Gaza population over the last decade. Additional wage spending by the PA to pay the salaries of around 20 thousand civil employees hired by the *de facto* authority post 2007, is estimated at USD234 million (This figure is based on salary amounts that the *de facto* authority has been paying to its employees and not on average remuneration paid by the PA). Moreover, the cost of operationalizing line ministries in Gaza is estimated at USD247 million

- in addition to USD300 million to finance development projects in the Strip. In total, the PA's spending in Gaza is expected to increase by USD781 million in 2018 as a result of the reconciliation. Even though the internal reconciliation will increase the tax effectiveness of the PA in Gaza allowing it to collect more domestic tax, nontax and clearance revenues, widening the tax base and improving tax administration in the Strip will take some time to bear fruit. Hence, the PA is expected to only collect an additional USD250 million in revenues from Gaza in 2018. Consequently, the PA's financing gap in 2018 is projected to be around USD1 billion, if reconciliation progresses.

8. **While the PA needs to further accelerate reforms that align its spending and revenue capacity, in the short-term actions by the PA alone will not be enough to close the financing gap.** The PA has proposed a number of measures to help generate more revenues and reduce spending. The MoFP has submitted to the Cabinet revisions to the income tax law to increase the rate for high-income earners from 15 to 17 percent. It is also in the process of revising some public fees upwards including those paid by gas stations, in addition to land registration and court fees. The MoFP also proposes to introduce a 5 percent dividend tax. Efforts will also focus on rationalizing expenditures through reducing net lending and health referrals. If implemented, these measures are expected to generate an additional USD325 million in savings, according to the MoFP, which will not be enough to offset the financing gap. Limited additional financing may be available through borrowing from domestic banks, but this will also not be sufficient to close the financing gap and will further increase risks linked to the banks' credit exposure to the PA.

Reform progress

9. The World Bank has been working closely with the PA to keep track of progress achieved in reforms supported by the Bank's latest Development Policy Grant (DPG): progress on which is also the basis for disbursements from the PRDP Trust Fund. Reforms supported by the 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.

10. **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).** Non-payment of Israeli power import bills by Palestinian electricity distributors such as DISCOs and municipalities and village councils (collectively referred to as Local Government Units, LGUs) has led to the so called "net lending" crisis and a high accumulation of outstanding debt. The creation of securitization mechanisms to ensure that electricity revenues from DISCOs and LGUs are not diverted to other municipal expenditures is a priority to improve the financial viability of the sector. Following a Cabinet decision in September 2016, almost all electricity distributors have opened separate bank accounts to deposit funds collected from electricity bills to pay the PETL as of today.[6] While an agreement was reached on September 2016 between PENRA and the Israeli Electricity Company (IEC) that sets the vision for the Palestinian energy sector,[7] signing of a new long-term PPA is still under discussion pending an agreement on the payment guarantee. Once the PPA is signed, PETL will start taking over the connection points (to the individual service providers) in a phased manner and it is expected to take on the role of single buyer in a few years. PETL is currently supplying electricity only to the Northern Electricity Distribution Company (NEDCO) through the Jenin substation. For the past 6 months, PETL has been issuing invoices to NEDCO which has been settling payments in full. All other DISCOs and LGUs are still receiving bills from IEC and paying directly to them.

[6] The evidence (the name of electricity distributors and bank account numbers) will be provided by PENRA and verified by the Bank team in the next few weeks.

[7] The agreement allowed for the settlement of past accumulated debt and laid out the vision for a new Palestinian power market with imports channeled through the new high voltage substations and tariff set according to a new long-term Power Purchase Agreement (PPA). According to this vision, PETL would act as the Palestinian 'single buyer' purchasing power from the IEC and selling it on to the DISCOs.

11. **Prior action 2: At the direction of the Palestinian Water Authority, at least five (5) Local Government Units (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, hidden subsidies provided to service providers, mainly to the municipal water departments, have resulted in a substantial net deficit, underwritten largely by the practice of net lending. Similar to the electricity sector, restoring the financial viability of the water sector requires the establishment of mechanisms that ringfence water revenues to pay for bulk water purchased, avoiding further accumulation of debts. Supported by the DPG, the Palestinian Water Authority (PWA) initiated a pilot project that requires eight LGUs (Hebron, Yatta, Salfeet, Jenin, Tubas Joint Water Services Council, Tulkarem, Qalqilia, and Jericho) to open separate bank accounts to deposit revenues collected from household water bills -- with the plan to extend this pilot to the rest of LGUs in due course. All eight LGUs have opened separate bank accounts so far. By the end of 2018, the PWA aims to put in place a national framework for sustainable municipal water utilities and has already drafted about 10 regulations to help achieve this goal, including the National Water Company Bylaw, Regional Water Utilities Bylaw, the tariff Bylaw, and the licensing (of service providers) Bylaw. All these Bylaws are expected to be submitted to the Council of Ministers in the next 3-4 months.

12. **Prior Action 3: The Ministry of Health has: (i) signed a Memorandum of Understanding to establish a framework over the purchase of referral services with at least six (6) national hospitals; and (ii) published harmonized standard procedures for medical referrals online.** The Palestinian health system faces critical challenges to constrain health expenditures, specifically for medical referrals outside of the public health system, so called Outside Medical Referrals (OMRs). With the aim to reduce the oversized spending on OMRs, the MoH signed MoUs with 6 Israeli hospitals to regulate prices in the referral process and to ensure the use of standardized procedures in 2015. In addition, 7 MoUs have been signed with Palestinian non-governmental hospitals (3 in East Jerusalem and 4 in the West Bank) in 2017. Regarding standardizing manuals and protocols for medical referrals, the Services Purchasing Unit (SPU) has successfully produced a number of manuals and referral protocols on oncology; ophthalmology; cardiology; neurology and nephrology. The SPU is reviewing these protocols and manuals on a regular basis to ensure they remain updated. Furthermore, similar protocols are being drafted for kidney transplant and endoscopy procedures.

13. **Prior action 4: The Ministry of Finance and Planning has issued an instruction mandating the Accounting Department at the Ministry of Finance and Planning and the Projects Department of the Ministry of Local Governments to produce annual reports that include information on: (i) the amount of Ministry of Local Government's capital budget allocated by the Ministry of Local Government per LGU; (ii) the amount of revenue deductions or interceptions by the Ministry of Finance and Planning per LGU; and (iii) an annex to the existing transportation fees report with the breakdown of each LGUs' share based on the endorsed allocation criteria by the Council of Ministers.** Intergovernmental fiscal relations between the PA and LGUs suffer from insufficient revenue assignments, coupled with the lack of transparency and predictability of fiscal transfers and mechanisms to allow the accumulation of net lending. To introduce predictability and transparency to fiscal relations between the PA and LGUs, the MoFP has made significant progress in the reporting of revenues collected on behalf of the LGUs (e.g., transportation fees, property tax, professional fees, etc.) and on the allotment to LGUs from these revenues. Information on local revenues generated during a fiscal year and the allocation to LGUs for the following fiscal year are provided by the MoFP to the MoLG on the 15th of January of each year. The MoLG confirmed that this reporting process is indeed carried out and informed the team that the MoFP has decided to make the disbursement to LGUs in eight instalments, in particular, for property tax. The reporting on availability of resources for LGUs and the commitment to release funds even on a staggered basis are important steps in making the intergovernmental fiscal transfer transparent and predictable. The MoLG has already shared the data required for reports with the MoFP in the beginning of the year. The MoFP is currently validating the data.

14. **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.** Following the Secured Transactions Law adopted in April 2016, which contributes to increased access to credit to the private sector, the online system for the movable assets registry was established in June 2016 and it became fully operational by April 2017. To ensure successful implementation of the registry, the IFC team has been supporting the Ministry of National Economy (MoNE) in ensuring knowledge transfer and a smooth operation of the registry through workshops. Awareness raising events and training sessions for MoNE IT staff were held last year. In addition, the Palestinian Monetary Authority (PMA) has been playing a key role to promote the use of the online registry in collaboration with commercial banks.

15. **Prior action #6: The Ministry of National Economy 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.** Adoption of a new Companies Law would positively impact business start-ups, strengthen the rights of minority shareholders, address corporate governance principles, and introduce new provisions related to insolvency. The new Companies Law was submitted to the Council of Ministers for approval in June 2017. Comments from the Ministry of Justice and other ministries have been received. At the Minister of National Economy request, the Bank team has been providing technical assistance to the ministry on improving the draft Companies Law presented to the Cabinet for the first reading back in July. The Bank team, together with MoNE advisors and local lawyers have been reviewing the draft law to include good practices, taking also into account the comments of the private sector. A revised draft of the law is expected to be presented by the MoNE to the Council of Ministers for the second reading at the beginning of April 2018.

16. **Prior action #7: The Ministry of Health, in collaboration with the Ministry of National Economy, 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).** Updating the Law of Crafts and Industries of 1953 supports a key reform in business licensing by simplifying the approval process and reducing the cost of licensing. The MoNE together with the MoH (the stakeholder mandated by the Act of 1953 to amend the Annex) has finalized the draft decree as well as the explanatory note and submitted them to the Council of Ministers in mid-September 2017. The Bank team has been providing technical assistance to the MoNE throughout the approval process, including assisting it during meetings with other Ministries who submitted comments to the Council of Ministers, to explain the reform and address their comments. After addressing the last round of comments received, the decree will be submitted to the Council of Ministers for the third reading or approval by the end of March or early April 2018.