

**PRDP-TF: Quarterly Review
April-June 2014**

1. Overall Palestinian economic growth has slowed considerably. After a period of sustained economic recovery between 2007 and 2011 when average yearly growth exceeded 8 percent, the economy has significantly slowed down since 2012. It is estimated that growth fell to around 2 percent in 2013, and even though official estimates by the Palestine Central Bureau of Statistics (PCBS) are not available yet, it is expected that economic activity has further slowed down in 2014. Furthermore, about 26 percent of the Palestinian workforce remains unemployed and a quarter of the population lives in poverty.

2. The PA continues to deal with a difficult fiscal situation. The PA's expenditures were about 5 percent above the notional budget target for the first half of 2014 due to increased spending on goods and services and net lending. Strong growth in clearance revenues and front loaded domestic tax payments caused the PA's revenues to be 9 percent above their forecast. Consequently, the recurrent deficit was almost 2 percent below its half year target amounting to NIS2.3 billion. The PA also reported development expenditures of NIS0.5 billion in the first half of 2014, and therefore, the overall deficit totaled NIS2.8 billion. Total external financing received was less than needed to cover the overall deficit and amounted to NIS1.6 billion, resulting in a financing gap of NIS1.2 billion. The PA had accumulated more than NIS1.4 billion in domestic arrears during the first half of 2014, more than what was needed to cover the gap. Excess financing enabled the PA to reduce its net domestic bank financing by almost NIS115 million.

Revenues

3. The PA's total net revenues for the first half of 2014 exceeded the prorated budget target and were 23 percent higher compared to the same period last year. This is due to a significant growth in clearance revenues and front-loaded domestic revenues driven by financial incentives to pre-pay taxes.¹

4. The performance of clearance revenues has been impressive in 2014. Between January–June 2014, they were more than 30 percent higher than in the first half of 2013 and they have also exceeded their midyear budget target by 12 percent. This is mainly due to higher collections from customs, VAT and petroleum excise which grew by 26, 22 and 40 percent, respectively, in the first half of 2014. Increased receipts from customs and VAT are due to field campaigns conducted by the PA's customs officials to go after Palestinian merchants that undervalue their import declarations. As for collections from petroleum excise, their growth is mainly related to larger imports of Israeli fuel to Gaza as access to the cheaper Egyptian fuel was interrupted following the destruction of the tunnels connecting Gaza to Egypt. Based on historical trends, growth in clearance revenues is usually higher in the second half of the year which suggests that they will continue to exceed their budget target throughout the year. It is highly

¹ Normally, frontloaded revenues would not be counted in fiscal accounts produced on commitment basis using the Government Finance Statistics (GFS) 2001 methodology. The PA uses a hybrid version of this methodology and adds advance revenue payments to its budget execution reports.

important that the transfer of these revenues by the GoI continues to be consistent and on time in order to avoid additional stress on an already tight fiscal situation.

5. Despite a strong performance earlier in the year, domestic tax collection has recently slowed down. In Q1 2014, domestic tax revenues grew by 24 percent in comparison to the same period in 2013. The PA introduced an 8 percent discount on early VAT payments in 2014 on top of the property and income tax incentives that apply to tax receipts in the first 90 days of the year. As a result, a number of large companies and major banks pre-paid their tax duties. Growth in domestic tax revenues in Q1 can therefore be mainly attributed to advance payments rather than a significant widening or deepening of the tax base. In fact, starting April and following the expiration of the early payment tax incentives, domestic revenue started to slow down. Q2 collections were 49 percent less than in Q1 and they were also 27 percent lower than their prorated budget. This is an indication that stronger effort needs to be carried out by the PA to widen the tax base and enhance compliance.

6. The PA's tax refund payments exceeded their prorated budget target by 32 percent during the first half of 2014 mainly due to an increase in fuel tax refunds (subsidies). These subsidies are probably the largest source of inefficiency in the PA's budget. They are provided as tax rebates to gas stations when they purchase liquid fuels from the Palestinian Petroleum Authority, which is the only entity authorized by the PA to import fuel into the West Bank and Gaza. The purpose of fuel subsidies has been to offset the impact of high fuel prices on Palestinian citizens. While the incidence analysis for this particular subsidy has not been done, numerous studies from the region have shown that fuel subsidies not only have distortionary effects on economic activity, but they also disproportionately benefit better-off segments of the population and are therefore a very inefficient poverty reduction instrument. The PA has gradually reduced these subsidies from about NIS70 million per month in the beginning of 2014 to about NIS50 million in June. Ultimately, the PA should aim to fully eliminate these subsidies and rely on the existing well-targeted cash transfer system to offset the impact of any price increases on living standards of the poor.

Expenditures

7. The PA's recurrent expenditures increased by 11 percent year-on-year through June and exceeded their mid-year budget target on the account of strong nonwage expenditures and net lending, while wage spending was kept within its budget target.

8. The wage bill, which represents around half of the PA's recurrent spending, was kept below its midyear forecast due to a delay in some allowance payments. It was 1.4 percent below its prorated budget target mainly because the payment of the cost-of-living allowance has been postponed to the end of the year. In addition, increases in professional allowances for doctors have not been paid so far. The delay in allowance payments offset the increase in the wage bill that resulted from the growth in the net number of employees which totaled 830 new hires, Between January – June 2014. Specifically, 1100 employees were hired in the West Bank while 289 departed from the public labor force in Gaza². The

² In addition, employment in the national fund and in the number of deputies was reduced by 326 while it was increased by 345 in the embassies.

number of employees in the security and health sectors grew by 293 and 295, respectively, while the net increase in the education sector was lower at 103.

9. Transfers, the second biggest spending item under recurrent expenditures, were also kept below the prorated budget. They were about 12 percent below expectations due to savings at the Ministry of Social Affairs (MoSA). The PA reports that this is because the number of new households that MoSA added to the National Cash Transfer Program (NCTP) during the first half of 2014 was lower than expected. Therefore, cash assistance payments recorded under transfers were below their target.

10. Spending on the use of goods and services significantly exceeded the prorated budget. It was 48 percent above expectations due to major overspending at the Ministry of Health. This is mainly a result of the growing cost of outside health referrals. In addition, some of the arrears previously accumulated by the MoH on its operational spending were cleared in 2014. These arrear repayments were not anticipated by the 2014 budget, which explains the jump in this item compared to its prorated budget target.³

11. Net lending has continuously been exceeding forecasts. In the first half of 2014, it was 71 percent above its prorated target and it grew by 59 percent when compared to the same period last year. Reforming the electricity sector and reducing net lending is essential for fiscal consolidation. A recent study conducted by the World Bank reveals that this complex problem is the result of increasing electricity losses, decreasing collection from customers and deteriorating efficiency of the electricity distributors. According to the Israeli Electricity Company (IEC), debt owed by the PA on the account of unpaid electricity bills amounted to NIS 1.5 billion, as of May 2014. Addressing the net lending problem will not only reduce the fiscal burden it imposes on the PA, it would also substantially improve the viability of the Palestinian electricity sector. Recently intensified reform efforts by the PA such as (i) the creation of an inter-ministerial special committee to monitor and address net lending issues; and (ii) the adoption of a decision to impose penalties on electricity distributors not paying their bills to IEC are encouraging and deserve strong support from the international community. It is critical to note that effective and direct collaboration from the GoI is important to ensure a successful and sustainable implementation of some of these reforms.

12. Arrears continue to be a major source of PA financing. The PA's total deficit during the first half of 2014 amounted to NIS2.8 billion while total aid received during that period amounted to NIS1.6 billion (NIS1.32 billion in budget support and NIS243 million in development financing)⁴. Even though the PA has been making efforts to repay its arrears, net arrears accumulated during the first half of 2014 amounted to NIS1.4 billion - more than what was needed to close the financing gap that remained after accounting for external aid receipts. Almost NIS761 million or 54 percent of these arrears are owed to the private sector, while the majority of the rest is to the pension fund. Arrear accumulation, in excess of what was needed to cover the financing gap, enabled the PA to reduce its net domestic bank financing by almost NIS115 million, yielding a stock of debt to local banks of USD1.25 billion, as of end-June 2014. This indicates that the PA, since 2013, has continued implementing a policy that prioritizes the reduction

³ Notably, these arrear repayments show as commitments in the PA's monthly fiscal tables when they should have been recorded as cash expenditures.

⁴ Aid for 2014 is projected to be around its 2013 at USD1.3 billion but it is expected to be back loaded, and hence the majority has not been disbursed yet.

of domestic debt over the repayment of arrears. While this policy saves some interest costs and might enable the PA to create a buffer for future domestic bank borrowing, it could very likely have negative consequences on private sector liquidity and growth, which could ultimately reduce public revenue generation and weaken the PA's fiscal position.

13. Fiscal projections for the remainder of the year indicate that a crisis scenario is unlikely, but a number of risks remain strong. Even though clearance revenues are expected to be higher than budgeted, total revenues are projected to be slightly below forecast mainly due to higher fuel subsidies. Expenditures will exceed budget projections on the account of higher net lending and spending on goods and services. Overall donor financing is assumed to reach USD1.3 billion⁵ and the resulting financing gap will amount to about USD0.36 billion. However, this gap has already been financed through arrears accumulated between January and June 2013 exceeding USD400 million. Thus, the PA is expected to have sufficient financing to cover all of its expenditures in the second half of the year, if current trends continue. However, several fiscal risks and eventualities could arise and widen the financing gap. These include spending pressures following the recent conflict in Gaza, additional expenditures related to expanding the PA's payroll in Gaza, increased Israeli deductions from clearance revenues due to the rising electricity debt to IEC, and a shortfall in donor aid.

Structural reforms

14. The PA has continued to push forward its reform agenda. As part of the World Bank's new budget support operation (DPGVI), the PA has committed to a reform program that supports the goals of its National Development Plan (NDP) 2014-2016. The program builds on previous DPGs and focuses on three main pillars: 1) Reducing the PA's recurrent fiscal deficit; 2) Improving the effectiveness and transparency of public finances; 3) Improving the business climate.

15. Enhancing domestic tax revenues continues to be a priority for the PA. Domestic tax revenues at 5 percent of GDP are low in comparison to other lower middle income countries. Thus, the PA has been focusing efforts to increase collections primarily by eliminating different loopholes in the system and strengthening tax enforcement. Several laws and procedures are being revised and specific plans are being put in place to increase tax registration, as well as to detect and penalize non-payers especially since only 30 percent of the potential tax base is currently covered. The PA has already reduced the size and scope of tax incentives provided in the Investment Promotion Law, as advised by the IMF. Assessments showed that these incentives have been ineffective instruments of encouraging new investments and have benefited few profitable companies at a significant cost in terms of lost tax revenues. Recent amendments to the Investment Promotion Law have narrowed the scope and duration of those tax incentives. The PA also adopted amendments to the Income Tax Law to introduce a 10 percent tax on distributed dividends, which reduces opportunities for tax arbitrage and broadens the tax base. First time revenues generated from this new tax will be collected by the PA in early 2015 once publically listed companies distribute dividends on profits earned in 2014.

16. The PA has continued to implement measures to try and control the growth of the wage bill. At 17 percent of GDP, the public sector wage bill in the West Bank and Gaza remains high by

⁵ Including USD100 million earmarked for arrears repayment and USD100 million for development financing.

international standards. Addressing this issue requires both short-term measures to contain the growth of wages and the number of staff on the PA's payroll, but also deeper structural reforms. The precarious fiscal and political situation is most probably the reason why the PA has so far been addressing this issue through short-term measures. Specifically, the PA has reformed its policy on transportation allowance in 2014 to ensure that staff who are temporarily not coming to work do not receive this allowance and that the amount paid is based on staff's current residences, regardless of where they resided when they joined the civil service. Leadership allowance to security staff in Gaza was also cancelled as of May 1, 2014. The PA also continues to place a freeze on salary payments for all employees that reside outside the Palestinian territories for non-work related reasons. The PA has put in place a zero net hiring policy in late 2012 and has maintained it since. Even though employment figures for June indicate that there has been a net increase in the number of PA employees in 2014 (see paragraph 8), the PA reports that this increase is only temporary and it is caused by the fact that new recruitments usually take place in the beginning of the year while most retirements and other departures occur towards the end.

17. Public procurement reform is another area where the PA has been making good progress.

In December 2011, the PA had enacted a new Public Procurement Law (PPL) which represents a good balance between the current capacity to conduct procurement in the Palestinian territories and internationally accepted practices. As part of developing the supporting institutional infrastructure to implement the PPL, the Higher Council for Public Procurement Policies was established in September 2012, with representation from the public and private sectors. Work was then conducted to introduce several amendments to the law to fill some gaps and remove certain inconsistencies on the basis of inputs from various stakeholders. In parallel, work was also conducted to finalize the Regulation for the implementation of the amended Law. The amended law was signed by the President and the Regulation was adopted by the Cabinet in April 2014. The new legal framework for public procurement will come into effect upon publishing the PPL and its Regulation in the National Gazette. Currently, with the Bank's support, the Council is working on finalizing essential actions to launch the implementation of the PPL including: 1) finalizing the Cabinet's approval of the Council's organization structure and subsequent hiring of key staff 2) preparing the National Standard Bidding Documents, 3) training the procurement workforce, and 4) establishing a single portal procurement website where all procurement plans and contract award notices would be published.

18. Progress in strengthening the PA's PFM systems has been uneven. In the area of cash management, the PA has made significant improvement in regards to its cash planning system. This was done through establishing a cash committee that is in charge of the cash forecasting and management process. The Committee is headed by the Minister of Finance, and includes the Accountant General and the Budget Director. The Secretariat is held by the Cash and Debt Management Department. Based on a template developed with World Bank assistance, the MoF has produced an annual cash plan for 2014 that is adjusted on monthly basis. This has reduced uncertainty related to cash availability and has also helped identify monthly spending priorities. In the area of arrear management, however, there has been no progress. As part of prior actions supported by DPG VI, the MoF committed to implement new functions of the Integrated Financial Management Information System (IFMIS) to strengthen arrears management. These reforms have not been implemented as of yet. Consequently, the system for recording and reporting arrears remains weak as the PA is unable to provide a reliable calculation and a presentation of arrears automatically extracted from the IFMIS. The inability to properly account for arrears represents a major

weakness in PFM systems and needs to be urgently addressed. In addition, the PA has continued to accumulate large arrears in 2014 mainly due to weak commitment controls and insufficient budget discipline.

19. The PA has recently implemented some important reforms to improve the business environment, particularly access to finance. In January 2014, the President promulgated the Leasing Law which is expected to encourage new forms of business financing through leasing companies. Furthermore, an asset registry has been developed with the support of IFC where leased assets can be formally registered and used for public notice. The asset registry will become particularly important once the Secured Transactions Law, which has been adopted by the Cabinet, is promulgated by the President. The Secured Transactions Law will formalize the use of different asset classes as collateral, including contractual future income streams and create a way to formally register pledges of assets used as collateral.