The PA’s fiscal situation turned increasingly acute in Q1 2015 due to the Israeli decision to withhold clearance revenues. Without as much as 70 percent of its income, the PA had to resort to substantial cash rationing, accumulating NIS2.5 billion in arrears, of which: NIS1150 to the pension fund, NIS NIS852 in wage arrears, NIS551 to the private sector. The PA also had to increase its borrowing from local banks by about NIS809 million in Q1 2015 leading to a total stock of debt of NIS5.2 billion, as of March. PA efforts to deal with the fiscal crisis brought about by the freeze of clearance revenues are commendable, particularly since the delivery of public services was well maintained throughout this period.

Given the Israeli decision to withhold clearance revenues, the PA passed an “emergency cash rationing budget” by the end of March 2015 -- within the legal deadline. The emergency budget is built on the assumption that domestic revenues and donor grants are the only revenue sources and that domestic revenues will increase by 6 percent in 2015. On the expenditure side, the emergency budget assumes partial wage payments and only half of non-wage expenditure payments in cash while the rest of expenditures would be financed through payment arrears. Fortunately, clearance revenue payments resumed as of late April. Thus, the PA will need to pass a supplementary budget.

A preliminary and unrealistic deficit target for the 2015 budget has been set at $1.17 billion. The target is based on the expectation that donor budget support will amount $1.2 billion, while the Bank and the IMF project only $850 million based on current donor commitments. Furthermore, the both the revenue and expenditure targets in the budget are slightly too optimistic, in particular the target on net lending expenditures, which so far have continued rapid growth. Consequently, we project that the budget will have a financing gap of about $170 million only to maintain the level of arrears at the 2014 level, while the planned reduction of arrears by -$316 would bring the financing gap to about half a billion dollars. The Bank assesses that additional measures will be needed to boost revenues and control expenditures, but more donor aid would also be desirable to buffer the impact of fiscal consolidation on the economy.

Domestic revenue performance in Q1 2015 was significantly worse than in the same period in 2014. Collections from domestic taxes declined by 14 percent in Q1 2015 (y-o-y) due to a decline in all major domestic tax categories. Income tax collections dropped by about 1 percent probably as a result of a slowdown in economic activity in the West Bank where the economy is thought to have contracted in Q1 2015 due to the liquidity squeeze brought about by the withholding of clearance revenues. Receipts from excise on tobacco decreased by 45 percent as customers have been shifting to imported tobacco and possibly also rolled tobacco sold in the informal market due to recent elimination of tobacco subsidy to domestic producers. Despite the continued exemptions to prepay VAT duties earlier in the year, collections from VAT significantly decreased in Q1 2015 compared to the same period in the previous year by 32 percent. This steep decline cannot be solely explained by the economic contraction in the West Bank, in particular given that the VAT collected on imports stayed at last year’s level. A part of the drop is explained by the introduction of the deposit insurance scheme, which reduced the tax base for banks and bank tax payments.

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1 Notably, figures reported here differ from those reported by the MoF because in the MoF’s fiscal execution tables the share of local governments in property tax and transportation fees were added to the PA’s revenues as “earmarked collections” and the same amount was also added to the expenditures as “earmarked payments”. Even though this doesn’t affect the overall fiscal balance, this reporting does not follow the IMF’s Government Finance Statistics (GFS) manual standards. In addition, since the share of local governments in property tax and transportation fees were never included in the MoF’s tables as PA revenues and expenditures in previous years, they should be deducted when comparing 2015 figures to those of 2014 for the sake of consistency.
by about NIS72 million. Legal uncertainty as to whether Jawal, the mobile operator, should be paying taxes pertaining to its Gaza operations has also affected VAT payments, but these two issues do not explain the drop in VAT entirely.  

On the other hand, clearance revenues grew by 4 percent in Q1 2015, on commitment basis. This is partly due to higher collections from petroleum excise which grew by 4 percent as a result of larger imports of Israeli fuel into Gaza. Receipts from customs, which are only collected on non-Israeli imports according to the Paris protocol, also grew by 16 percent in Q1 2015 (y-o-y) as there has been a growing trend among Palestinian consumers, particularly since the 2014 Gaza war, to substitute products imported from Israel by others from other countries. Even though trade data for March 2015 is not available yet, data for January and February shows that non Israeli imports grew by 22 percent relative to the same period in 2014. Notably, the GoI withheld clearance revenues for the months of December 2014, January, February and March 2015 and finally released them on April 20. The GoI deducted NIS237 million from February revenues to clear electricity debt, on top of the usual monthly deductions. The PA contests the unilateral deductions by the GoI and states that the majority of the electricity debt is owed by the Jerusalem District Electricity Company (JDECO) which is privately owned, and hence the debt should not be deducted from public funds.

Expenditure growth in Q1 2015 was high amounting to 24 percent driven by a significant increase in spending on the use of goods and services which almost doubled relative to Q1 2014. Based on the information that was made available by the PA’s MoF, the main reason behind growth in this expenditure category is the frontloading of procurement in the healthcare sector, while based on some preliminary data, growth in spending on medical referrals outside the public system, which has been the main driver of growth in this category of expenditures has started to drop already in 2014. However, these are only preliminary numbers and subject to verification. Notably, though, the MoH has been trying to control the issue of referral costs and given that the highest unit cost for referral cases is charged by Israeli hospitals, recent efforts have focused on reducing the cost of referrals to Israel. Therefore, the MoH has already negotiated the price list of services provided with several major Israeli hospitals. It was also agreed with these hospitals that invoices will be audited and scrutinized by the MoH before any deductions are made from clearance revenues to cover the cost. Furthermore, several hospitals committed to admitting Palestinian patients only when valid referral documents produced by the MoH are presented in order to eliminate self-referrals. As a result, the MoH reports that the cost of referrals to Israel between January and March 2015 was reduced by USD4 million compared to the same period in 2014. These efforts are commendable; however, reforming the extremely generous Health Insurance System, which is the primary source of hemorrhage, should also be a priority. In its current status, the Health Insurance System allows individuals to gain access to health services through paying a minimal yearly registration fee that grants them immediate access to the referral system. This creates a large imbalance between the system’s revenues compared to its expenditures and ultimately, places a strain on the overall public health system.

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2 A decline in the share of domestic revenues to GDP is another indicator of a relatively poor revenue performance in 2015. Domestic taxes as a percentage of West Bank GDP stood at about 10 percent in 2014. Since GDP is considered a good proxy for the tax base and assuming no changes in tax policy and equal collection efficiency, one would expect domestic taxes to GDP ratio to remain the same in 2015 as it was in 2014. Nevertheless, our calculations show that the ratio of domestic taxes to GDP declined by about two percentage points in 2015.

3 Withheld revenues for the four months of December-March totaled NIS2.5 billion, and deductions made amounted to NIS650 million leaving NIS1.86 billion that was transferred to the PA.

4 Even though referrals to Israel represent 11 percent of the total number of referred cases, the associated cost is about 47 percent of the total referral cost.
The PA has successfully managed to reduce fuel subsidies. Aided by a drop in global fuel prices, the PA’s fuel subsidies were reduced by more than half in Q1 2015 compared to the same period in the previous year and they now average about NIS27 million per month.

According to the MoF, the wage bill grew by 2.4 percent in Q1 2015, but the PA has slightly underestimated its wage bill commitments. Figures reported by the MoF on the wage bill do not include the planned Cost of Living Allowance (CoLA) payments that are yet to be disbursed. If CoLA payments are added, growth in the wage bill would be higher at about 3 percent. The PA has also paid its employees an annual increase of 1.25 percent in 2015 which contributed to the growth of the wage bill. In addition, there was a net increase in the number of PA employees by 529 as of March 2015: 267 employees departed from the public labor force in Gaza while 796 were hired in the West Bank. Employment in the security, health and education sectors increased by 68, 276, and 116, respectively. Despite the increase in staffing during Q1, the PA has restated its commitment to the net zero hiring policy for 2015.

Transfers, the second biggest spending item, grew by 24 percent in Q1 2015. This is mainly due to an increase in social spending provided to poor households through the National Cash Transfer Program (NCTP). The MoF reports that the number of beneficiaries in the NCTP increased by 7,239 households in 2014. In addition, to growth in the number of beneficiaries, the Cabinet issued a resolution in March 2015 approving an additional monthly payment of NIS50 to every West Bank household registered in the NCTP to pay its electricity bills, given that the household installs a prepaid meter. This will add additional fiscal pressure on the NCTP particularly given its limited financial resources, but on the other hand, this measure is expected to reduce net lending.

Net lending also increased by a staggering 115 percent in Q1 2015 compared to the same period in 2014, largely due to extraordinary deductions made by the GoI from February clearance revenues. If figures are adjusted to assume standard deductions from February revenues, net lending would have increased by 38 percent, which shows that this continues to be a major fiscal burden. The PA has recently taken some encouraging steps including passing a resolution that prevents municipalities from using electricity fees to finance their expenditures, which will hopefully bind municipalities to transfer collected fees to the PA. In late 2014, the Cabinet also passed another resolution on the reconciliation of debt between the Palestinian MoF and some of the electricity providers. Other actions were also taken to increase the collection rate including installing additional prepaid meters and passing a resolution preventing consumers from obtaining clearance to some civil services, including renewing a driver’s license, applying for a visa, and obtaining travel permission, if they have accumulated unpaid bills. Furthermore, the Palestinian MoF and the Palestinian Electricity Transmission company (PETL) are negotiating a Power Purchase Agreement with the Israeli MoF and IEC.

Reforms needed to strengthen the PA’s Public Financial Management system have not advanced as hoped. The system for recording and reporting arrears remains weak and this represents a major shortcoming that needs to be urgently addressed. The good progress made by the PA to reform its public procurement system has also marked a halt over the recent months. A new Public Procurement Law (PPL) and implementing regulation were enacted in April 2014. Following, the Higher Council for Public Procurement Policies (HCPPP), the main entity in charge of policy setting and oversight of all public procurement activity, was established. The Cabinet also approved HCPPP’s organization structure in December 2014. However, hiring of key staff necessary for HCPPP to assume its envisaged role is still lagging behind, and pending the allocation of necessary financial resources. This delay, and the financing shortages for key components of the reform (single procurement portal, capacity building, etc.) has reflected negatively on progress, and threatens to undermine the achievement made so far. The HCPPP organized information and awareness raising workshops, however the introductory training which will provide participants with a basic introduction to the key steps and procedures in the procurement process has not started yet. National Standard Bidding Documents have already been drafted, but not yet finalized. The
design of the single portal procurement website where all procurement information (plans, notices, etc.) will be posted was completed with USAID financing, however, its actual development falls short of funding.