PRDP-TF: Quarterly Review
April – June 2015

1. Despite the Palestinian Authority’s (PA’s) commendable efforts in managing the fiscal crisis resulting from the withholding of clearance revenues in early 2015, the fiscal situation remains precarious and expenditure growth is a concern. As a result of the PA’s decision to join the International Criminal Court (ICC), the Government of Israel (GoI) withheld clearance revenues from December 2014 until April 2015, leaving the PA without 70 percent of its revenues. As a result, the PA resorted to severe cash rationing only paying partial salaries while delaying most other expenditures and accumulating large arrears to the private sector and the pension fund and increasing its borrowing from local banks. Despite the sharp liquidity squeeze during the first four months of the year, public service delivery was well maintained and the PA’s efforts in managing the fiscal crisis were successful. In addition, the PA managed to achieve some progress in reforms related to health referrals to Israel and net lending. However, the fiscal situation remains difficult due to lower than expected domestic revenues accompanied with high expenditure growth. As a result, the recurrent deficit increased by as much as 28 percent in the first half of 2015 relative to the same period in 2014. Targeted efforts by the PA to boost domestic revenues and contain expenditures especially on the wage bill, goods and services and net lending remain a key priority.

2015 Budget

2. In June, and after a delay due to the Israeli decision to withhold clearance revenues, the PA passed the 2015 baseline budget with a financing gap of USD0.4 billion. Initially, the PA passed an emergency budget in March 2015 built on the assumption of a freeze in clearance revenues. After the resumption of clearance revenues in April, the PA approved the 2015 regular budget which was signed by the president on June 30. The budget assumes that total net revenues will increase by 9 percent while expenditure growth will be limited to about 3.6 percent. Particularly, the wage bill is expected to grow by 3.8 percent to account for an annual increase of 1.25 percent, a Cost of Living Allowance (CoLA) adjustment of 2 percent in addition to a 5 percent raise for teachers with the enforcement of a zero net hiring policy. Spending on goods and services is expected to decline by 4.6 percent, whereas transfers are expected to increase by 17.8 percent due to higher social spending in Gaza following the 2014 war. Notably, the PA plans to reduce net lending by 21.7 percent in 2015 which is highly optimistic. Based on the above, the recurrent deficit is projected to decrease by 7 percent year-on-year and amount to USD1.13 billion. The overall deficit, however, is expected to be much higher at USD2.28 billion due to large development spending for Gaza reconstruction. The budget projects total aid in 2015 to be USD1.9 billion (USD800 million in budget support and USD1.1 billion in development spending) leading to a financing gap of about USD0.4 billion. Notably, the budget assumes that the PA’s total stock of arrears will be reduced by USD300 million in 2015 and that net domestic borrowing will increase by the same amount.

3. Bank staff projections are in line with the PA’s regarding the size of the financing gap but not its contributors. Bank staff projects revenue growth to be slightly lower than the PA’s budget and expenditure to be higher, mainly on net lending. Compared to the PA’s projections, staff also projects development spending in 2015 to be significantly lower due to the slow pace of the reconstruction process in Gaza. This is expected to lead to an overall deficit that is smaller than what is in the PA’s budget. The
budget also significantly overestimates aid which staff projects at USD0.9 billion. In contrast to the budget, which assumes a substantial reduction in the stock of arrears, and based on the trend during the first six months of the year, it is expected that the stock of arrears to the private sector and the pension fund will grow during 2015. 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.

Actual performance during the first half of 2015

4. The performance of domestic tax revenue deteriorated in the first half of 2015 with a decline of 7 percent compared to the same period in 2014. This is mainly due to a major drop in receipts from VAT which constitute 46 percent of overall domestic tax revenue. VAT receipts declined by 22 percent partly as a result of the introduction of the deposit insurance scheme, which reduced the tax base for banks. Legal uncertainty as to whether Jawwal, a mobile operator, should be paying taxes pertaining to its Gaza operations has also affected VAT receipts. Furthermore, the Israeli decision to withhold clearance revenues in early 2015 caused a liquidity squeeze in the economy that has affected consumer spending and hence, tax collection. Even though the Ministry of Finance (MoF) has so far in 2015 added about 5 thousand new taxpayers to its tax base, collections from income tax slightly declined in the first half of the year compared to the same period in 2014. The PA’s decision to reduce the income tax rate from 20 to 15 percent and also to widen the exempted bracket from NIS30 thousand to NIS36 thousand per year, effective since May 2015, has negatively affected income tax collections. The Minister has explained that the measure is intended to encourage more people to pay tax but this has yet to transpire. Excise on tobacco dropped by 33 percent as customers have been shifting to imported cigarettes and rolled tobacco sold in the informal market due to the elimination of the tobacco subsidy. Efforts so far conducted by the MoF to strengthen revenue performance and increase the number of taxpayers are commendable, but more needs to be done. Widening the tax base should be done in a more targeted manner that focuses on increasing the number of filers in the Large Taxpayers Unit (LTU). The MoF should also aim to strengthen tax enforcement and impose strict financial penalties on evaders. In addition to the West Bank, efforts to enhance revenue collection from Gaza will need to be pursued once governance arrangements over the territory are clarified.

5. Despite being withheld earlier in the year, clearance revenues performed well in the first half of 2015. The GoI withheld clearance revenues for the months of December 2014, January, February and March 2015 and finally released them on April 20 after making an extraordinary deduction of NIS237 million to clear electricity debt owed by the PA, on top of the usual monthly deductions. Since then, the GoI has resumed the monthly transfer of these revenues, and between January-June 2015 they grew by 6 percent year-on-year on a commitment basis and reached their half year budget target. This growth was mainly driven by a significant increase in customs receipts, which are only collected on non-Israeli imports according to the Paris protocol, and which grew by 17 percent year-on-year. Growth in customs receipts is attributed to an increase in the number of Palestinian consumers that have been substituting domestically produced cigarettes - that are no longer subsidized - with imported brands. In addition, there has been a general trend among Palestinian consumers, since the 2014 Gaza war, to substitute products imported from

---

1 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.
Israel by products from other countries. Even though trade data for June 2015 is not available yet, data for January - May shows that non-Israeli imports grew by 21 percent relative to the same period in 2014. Another factor that contributed to the growth of clearance revenues is a 6 percent increase in collections from petroleum excise mainly due to larger imports of Israeli fuel into Gaza. Notably, part of the growth in clearance revenues may not be due to a real increase in the volume of imports, but due to the PA’s efforts in combating under invoicing through tax cooperation with the GoI.

6. **Expenditure growth in the first half of 2015 was high amounting to 8 percent and it was mainly driven by an increase in transfers which grew by 15 percent.** This is mainly due to an increase in social spending provided to poor households through the National Cash Transfer Program (NCTP), particularly in Gaza. The humanitarian situation in Gaza following the 2014 war got increasingly acute and the need for social assistance grew. As a result, 6809 new Gaza beneficiaries were added to the NCTP in 2015.

7. **The MoF figures indicate that the wage bill was kept below its prorated budget target for the first six months of 2015, but the PA has slightly underestimated its wage bill commitments.** According to the MoF, the wage bill grew by 3.4 percent—lower than the 3.8 percent assumed by the budget. Figures reported by the MoF on the wage bill do not include the planned CoLA adjustment and the 5 percent increase for teachers which has so far only been paid for one month. If those were added, the increase in the wage bill would exceed 5 percent. Despite some delay, the PA has recently made retroactive payments to cover the 1.25 percent annual increase for the first six months of 2015, which contributed to the growth of the wage bill. In addition, there was a net increase in the number of PA employees by 219 as of June 2015 even though the budget assumes a zero net hiring policy. 432 employees departed from the public labor force in Gaza while 643 were hired in the West Bank, while net employment in the national fund and embassies increased by 8 employees. Despite the increase in staffing, the PA has restated its commitment to the zero net hiring policy for 2015 and it states that the net increase is temporary and is caused by the fact that hiring usually happens earlier in the year while retirements and exits take place towards the end.

8. **According to the MoF, spending on the use of goods and services also increased by 11 percent in the first half of 2015.** The majority of the increase in spending was at the Ministry of Health (MoH) due to an increase in the cost of medical referrals outside the public system. 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. In fact, full year data for 2014 shows that the MoH has successfully managed to reduce the cost of this category of referrals by 19 percent when compared to 2013. Nevertheless, the overall cost of referrals continued to rise in 2014 due to an increase in the number and cost of cases referred to Palestinian hospitals in the West Bank and East Jerusalem. Hence, there is an urgent need for a comprehensive strategy that sets clear guidelines and procedures for the overall referral process. In addition, reforming the extremely generous Health Insurance System (HIS), which is the primary source of hemorrhage, should be a priority.

---

2 Employment in the security, health and education sectors increased by 57, 51, and 110 employees, respectively.
3 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.
9. Net lending also increased by 34 percent in the first half of 2015 compared to the same period in 2014 but 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 declined by 16 percent, which is a commendable achievement. The PA has recently taken some steps to control net lending including entering into Memorandum of Understanding with Palestinian electricity providers to ensure that fees collected are used to cover bills to the Israeli Electricity Company (IEC) and not to finance non-electricity related expenditures. In addition, the MoF has recently been working with the municipalities and village councils to reconcile the amount of electricity debt owed by/to them. 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. The MoF in cooperation with the Energy Authority currently aims to build upon these actions and produce a comprehensive action plan that aims to gradually reduce net lending until it is fully eliminated.

10. The PA continues to rely on arrears as a source of deficit financing. The PA’s total deficit amounted to USD679 million in the first half of 2015. Aid received was USD453 million: USD425 million in budget support and USD28 million in development financing. Notably, budget support received was 7 percent higher than expected while development financing channeled through the treasury was a staggering 95 percent lower than its half year budget. As a result, the PA ended up with a financing gap of USD226 million. In the first half of 2015, the PA reduced its stock of private sector arrears from previous years by USD109 million. However, additional arrears were generated, and hence, net accumulation of arrears amounted to USD306 million in 2015– more than what was needed to close the financing gap. Excess financing enabled the PA to reduce its net domestic bank financing by USD49 million in the first half of 2015, leading to a total stock of debt of USD1.27 billion as of June 2015.

11. Despite some recent measures, Public Financial Management (PFM) reforms have not been advancing as hoped. The Bank-financed sixth Development Policy Grant (DPG VI) included a prior action of MoF issuing an instruction to implement new functions of the Integrated Financial Management Information System aimed at improving the accounting and reporting of arrears. The new functions were installed but the reporting of arrears in the monthly fiscal tables remains incomplete; even though a line to report on arrears repayment from previous years was added, data on the total stock of arrears is still unavailable. Public procurement reform has also not progressed as planned. Even though the Higher Council for Public Procurement Policy has finally received a budget allocation, it continues to face difficulties in exercising its role due to internal disagreement within the PA on its level of authority. The situation has reflected negatively on the overall procurement reform and threatens to undermine achievements made so far.

---

4 It is important to note that even though development assistance channeled through the treasury was lower than expected, additional funds were disbursed for Gaza reconstruction through other channels such as UNRWA and other implementing agencies in Gaza.

5 About 35 percent of arrears accumulated in 2015 are to the private sector while the majority of the rest is to the pension fund.