1- The PA managed to reduce its recurrent deficit in 2014 mainly due to strong clearance revenues while domestic revenues performed worse than expected and expenditures increased by 9 percent compared to the previous year. The PA’s recurrent deficit was reduced by 0.8 percentage points of GDP in 2014, which is a good achievement given the economic and political downturn. Nevertheless, fiscal pressures continue to be high and this is particularly reflected in the growth of the wage bill and net lending as well as backing away from some previously planned revenue reforms. In 2015, the withholding of clearance revenues by the GoI have significantly worsened the fiscal difficulties.

2- The performance of clearance revenues was impressive in 2014. They grew by more than 20 percent and exceeded their budget target by 12 percent. This is mainly due to higher collections from customs, VAT and petroleum excise which grew by 22, 13 and 26 percent, respectively, in 2014 relative to the previous year. The increase in clearance revenues can be attributed to larger imports of Israeli fuel into Gaza as access to the cheaper Egyptian fuel was interrupted following the destruction of tunnels with Egypt in the summer of 2013. Another key contributor to the growth of clearance revenues is an increase in non-Israeli imports which grew by 19 percent in 2014 compared to the previous year as there has been a growing trend amongst Palestinian consumers, particularly since the 2014 Gaza war, to substitute products imported from Israel by others from other countries.

3- On the other hand, domestic revenues stagnated even though the economy of the West Bank - where the economy of these revenues are generated- expanded in 2014. Domestic tax collections in 2014 were very close to their 2013 level. Growth in VAT receipts was offset by a strong decline in collections from income tax and excise on tobacco by 4 and 38 percent, respectively. The unsatisfactory performance of domestic revenues is a strong indication that revenue reforms need to be intensified. Efforts should focus on widening the tax base, particularly the number of files in the LTU. According to the MoF, currently only 30 percent of the potential tax base is covered. Thus, it is important to strengthen tax enforcement and impose financial penalties on evaders. The MoF should also work on strengthening procedures and practices in audit as well as developing a simplified tax regime for SMEs. Notably, the recent decision by the MoF to cancel the capital gains tax and freeze the 10 percent dividend tax is discouraging, particularly as the latter was passed as part of the Revenue action Plan 2014-16 to mobilize previously untapped sources of revenue. In addition to the West Bank, efforts to enhance revenue collection from Gaza will need to be enhanced once governance arrangements over the territory are determined. Our estimates show that yearly revenues from Gaza, including domestic taxes and import duties, could amount to USD350-400 million, which will increase the share of PA revenues in the economy from about 22 percent of GDP to 25 percent.

4- Aided by lower oil prices, fuel subsidies provided as tax refunds also declined in 2014. The monthly average of these subsidies was reduced to about USD12 million down from USD17 million in 2013. Nevertheless, these subsidies remain a source of inefficiency in the PA’s budget and as mentioned in the World Bank’s previous reports, they should be fully eliminated. International experience shows that fuel subsidies not only have distortionary effects on economic activity, but they also disproportionately benefit better-off segments of the population. The Bank therefore recommends that funds currently spent

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1 Gaza’s revenue potential depends on several factors including inflows of aid into Gaza, ease of importing goods through official crossings with Israel and Egypt, and the tax collection regime that will be put in place to collect tax revenues on imports from Egypt and to collect revenues on economic transactions within Gaza. Hence, providing an exact estimate on potential revenues from Gaza would be difficult until these factors are determined.
on fuel subsidies be gradually shifted to the PA’s well-targeted cash transfer system which is a more effective mechanism to offset the impact of any cost of living increase on the living standards of the poor.

5- **Wage bill growth explains more than one third of expenditure growth in 2014.** The wage bill represents more than half of recurrent spending and increased by 6 percent in 2014, slightly exceeding its budget target -- despite a delay in allowances. While the 2014 budget included a 1.75 percent Cost of Living Allowance (CoLA), half of this amount was actually disbursed and only in some months of the year. Savings that resulted from lower than budgeted CoLA were offset by a breach in the zero net hiring policy that was assumed by the Budget. Figures provided by the MoF indicate that the number of PA employees increased by 1,296 on a net basis in 2014. The net increase took place in the West Bank and mostly in the military sector², which raises sustainability as well as efficiency concerns given that the sector is already large by international standards and suffers from significant grade inflation.

6- **In addition, spending on goods and services was significantly higher than expected in 2014 mostly due to overspending on outside health referrals.** This is partly due to the increase in the number of referrals from Gaza particularly as a large number of injured during the recent conflict were treated in East Jerusalem and Israeli hospitals. Nevertheless, the increase in the cost of health referrals has been a concern for years. Referral expenditures increased from USD8 million in 2000 to more than USD144 million in 2013. The rapid increase in referrals can be explained by the lack of resources within the MoH facilities, the increase in prevalence of non-communicable diseases and mostly by inefficiency of service delivery. The MoH has taken several measures to reduce referrals including the establishment of specialized committees in charge of reviewing and approving referral cases. In addition, a manual that sets clear guidelines for conditions that can be referred is currently being prepared and a consolidated Health Information System that covers referrals, billing and health insurance is being constructed with support from USAID. These efforts are commendable; however, reforming the extremely generous Health Insurance System, which is the primary source of hemorrhage, should 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.

7- **Net lending continues to form a major drag on the PA’s budget.** In 2014, it was 35 percent higher than the previous year and ran 70 percent above its budget target. The major cause of net lending is that funds collected from consumers through electricity bills are used by Local Government Units to finance expenditures rather than pay bills to the Israeli electricity company (IEC) -- the main electricity supplier. A share of the unpaid amount is deducted by Israel from the PA’s clearance revenues, and is called net lending. The rest accumulates as debt which, according to IEC, stood at more than USD0.5 billion, as of February 2015. Net lending is in fact being used as an indirect intergovernmental fiscal transfer, and while transfers from the PA to local governments are needed, they should be direct, equitable and transparent. It is therefore important that (in addition to efforts to improve bill collections and reduce significant electricity losses stemming from underinvestment in the power grid) the PA reforms the currently distorted intergovernmental fiscal transfers system in order to reduce and ultimately eliminate net lending. The PA has already taken some steps to address this issue including passing a resolution in late 2014 on the reconciliation of debt between the Palestinian MoF and some of the electricity providers, including distribution companies and village councils³. Other actions were also

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² 898 employees departed from the public labor force in Gaza while 2,170 were hired in the West Bank. Employment in the national fund and embassies was also reduced by 24 employees. Employment in the security, health and education sectors increased by 454, 362, and 391, respectively.

³ The major contributors to net lending, as identified in the World Bank Net Lending report are the Jerusalem District Electricity Company, Northern Electricity Distribution Company, Hebron Electricity Distribution Company,
taken to increase the collection rate. For example, the Council passed a resolution in 2014 allowing electricity suppliers to cut off electricity supply if a consumer has 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.

8- **The PA continues to rely on arrears as a major source of financing.** In 2014, the PA’s total deficit amounted to USD1.59 billion while aid received was USD1.23 billion, resulting in a financing gap of USD357 million. Net accumulation of arrears amounted to USD497 million – more than what was needed to close the financing gap. Around USD106 million of these arrears are to the private sector while the majority of the rest is to the pension fund. Excess financing enabled the PA to reduce its net domestic bank financing by more than USD140 million, yielding a stock of local debt of USD1.25 billion as of December 2014.

9- **The GoI’s decision to withhold clearance revenues pushed the PA into a crisis management mode.** These revenues represent 70 percent of total revenues and they cover about 50 percent of spending. The GoI has so far withheld revenues for December, January and February and the general assumption is that the transfer of these revenues will not be resumed until the new Israeli Cabinet is formed. Due to the liquidity strain, the Palestinian Authority has been paying only 60 percent of staff salaries (with a minimum of NIS2000), while delaying most other expenditures. Partial salaries are paid with local revenues, aid and credit from local banks. Our analysis of the PA’s cash flow indicates that expected budget support and additional borrowing will enable the PA to continue making partial salary payments until June when the PMA’s limit on local borrowing will be reached. After that, additional borrowing from local banks will probably not be possible. Furthermore, by then, the PA would have accumulated more than NIS2.5 billion in arrears on its nonwage spending.

**Progress in achieving DPG VI targets**

10- **DPG VI** was disbursed in July 2014 after the PA has taken 8 prior actions aimed at strengthening its fiscal stance, improving PFM and improving the investment climate. The following is an assessment of results that were included in the DPG’s policy matrix.

**Domestic revenue**

11- **Prior action 1**: The Cabinet of Ministers has approved draft amendments to the Investment Promotion Law aimed at broadening the tax base by reducing the scope of tax incentives for new investments and limiting their duration.

**Comments**: The action was taken and tax incentives granted to new investments were reduced along with their duration.

12- **Prior action 2**: The Cabinet of Ministers has approved draft amendments to the Income Tax Law introducing 10 percent tax on distributed dividends.

**Comments**: These amendments were frozen and dividend tax will not be collected on 2014 dividends distributed in March 2015.

13- **Expected results**: Gross domestic tax revenues have increased in nominal NIS terms by 8 percent and by at least 0.1 percentage point of GDP between 2013 and 2014.
Comments: The expected results were not achieved. Gross domestic tax revenues decreased in nominal terms by 0.4 percent and they also slightly declined as a percentage of GDP.

**Wage bill**

14- **Prior action 3:** No increase in the number of civil and security personnel of the Palestinian Authority has been provided for in the 2014 Budget of the Palestinian Authority for the calendar year of 2014.  
**Comments:** Action *de jure* taken but not implemented.

15- **Prior action 4:** The Recipient has discontinued the practice of paying transportation and supervision allowances for stay-at-home staff of the Palestinian Authority.  
**Comments:** Transportation and supervision allowances were discontinued.

16- **Expected results:** The 2014 central government nominal wage bill growth has not exceeded 4.9 percent (in NIS terms) and is at least 0.2 percentage points of GDP lower in 2014 compared with 2013.  
**Comments:** The expected results were not achieved. The PA’s wage bill grew by 5.9 percent in nominal terms in 2014, and increased by 0.9 percentage points of GDP.

**Public procurement**

17- **Prior action 5:** The Public Procurement Law of the Recipient has been amended in order to refine, fill gaps, eliminate inconsistencies and further elaborate the provisions of the Law on institutional and procedural matters, and the Cabinet of Ministers has adopted the Regulations for the implementation of the amended Law.  
**Comments:** The law was amended and the regulation was adopted.

18- **Expected results:** The use of National Standard Bidding Documents in public procurement has started. And, posting of procurement plans, notices and award decisions by all procuring entities on a single portal procurement website has started.  
**Comments:** The expected results were not fully achieved. The Standard Bidding Documents were prepared but are pending final clearance by three reviewing committees (works, goods, consultants services) designated by the cabinet. Furthermore, the design of the single procurement portal was completed, with USAID financing, but the launch of the bidding process for the development of the portal is still pending the allocation of the necessary financing.

**Public Finance Management**

19- **Prior action 6:** The practice of the adjustment and implementation of the Annual Cash Plan on a monthly basis has been established based on the template developed with the World Bank technical assistance.  
**Comments:** The MoF has been producing an annual cash plan that is adjusted on a monthly basis.

20- **Prior action 7:** The Ministry of Finance has issued an instruction to implement new functions of the Integrated Financial Management Information System to strengthen arrears management by introducing: (i) automatic carryover of arrears; (ii) age profile of all arrears; and (iii) reporting separately the total stock of arrears, arrears accumulation and arrears repayments in monthly budget execution reports.  
**Comments:** Even though the instruction was issued, the required actions were not implemented in 2014. Encouragingly, the new IFMIS functions were developed in early 2015 and are expected to become operational in March 2015.
21- **Expected Results:** PEFA score on cash flow planning and monitoring has improved in 2014 as compared to 2013. And, PEFA score on access to reliable information on arrears has improved in 2014 as compared to 2013.

**Comments:** The expected results were not fully achieved. Even though the PEFA score on cash flow was upgraded from D to C, the score on access to reliable information on arrears continues to be D due to delays in developing the abovementioned IFMIS functions. Once this is implemented, the score would improve to B.

**Improving the business climate**

22- **Prior action 8:** The Law on Leasing has been enacted by the President.

**Comments:** The leasing law was enacted by the President and published on May 28 2014.

23- **Expected result:** Total real value of leasing contracts is higher at the end of 2014 compared to end 2013.

**Comments:** the expected result was achieved.