1. The PA’s recurrent deficit for the first three quarters of 2015 was reduced when compared to the same period in 2014 and efforts to control certain expenditure categories are starting to show results, but the fiscal situation remains difficult due to lower than needed aid. Total revenues grew by 10 percent year-on-year as a result of an increase in clearance revenues and the collection of domestic tax arrears. According to MoF figures, expenditure growth was maintained at 3 percent and as a result, the recurrent deficit declined by 10 percent, year-on-year. Reforms to control hiring, net lending and the cost of health referrals to Israeli hospitals are starting to show results. Nevertheless, the fiscal situation remains difficult because aid received so far has been lower than needed and the PA has continued to accumulate additional arrears to the private sector and the pension fund.

2. After a sluggish performance earlier in the year, domestic tax revenues picked up in the third quarter of 2015 mainly due to collection of tax arrears. Domestic tax collections grew by 10 percent year-on-year mainly as a result of a jump in VAT receipts. VAT liabilities owed by some of the big corporations were collected in July and August causing this tax category to grow by 8 percent during the first nine months of 2015, year-on-year\(^1\). In addition to collection of tax arrears, the MoF has also focused efforts on widening the tax base through adding more than 6 thousand taxpayers to the system, as of October 2015. Nevertheless, receipts from income tax stagnated when compared to the previous year. 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. Some other tax items also performed worse than in 2014. For instance, receipts from excise on tobacco between January and September 2015 dropped by 24 percent, year-on-year, as customers have been shifting to imported cigarettes and rolled tobacco sold in the informal market due to the elimination of the tobacco subsidy. Receipts from property tax also dropped by 5 percent during the same period.

3. Clearance revenues performed well during the first three quarters of 2015. They grew by 9 percent when compared to the same period in 2014 mainly driven by a significant increase in customs, 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 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 Israel by products from other countries. Another factor that contributed to the growth of clearance revenues is an 11 percent increase in collections from petroleum excise due to growth in fuel consumption in the West Bank and much larger imports of Israeli fuel into Gaza. As a result, Gaza’s share of petroleum excise is now close to 27 percent.

4. The MoF figures show that expenditure growth was contained in the first three quarters of 2015 amounting to 3 percent, but it appears that these figures underestimate commitments - particularly on the wage bill. According to figures published on the MoF website, the wage bill grew by 1.8 percent in the first nine months of 2015 compared to the same period in 2014 -- well below the 3.8 percent assumed by the budget. This is partly because the PA has placed a tight leash on hiring in

\(^1\) Settlements were made with Paltel, Birzeit Pharmaceuticals, Jawwal and Jerusalem Pharmaceutical Company for the amounts of NIS37.5 million, NIS16.6 million, NIS35 million and NIS9.2 million, respectively.
The MoH has also been conducting efforts to control referral costs and results are starting to show. The MoH has already signed Memoranda of Understanding (MoU) with three Israeli hospitals to regulate contractual terms of the referral process, including pricing arrangements. As a result, the cost of referrals to Israeli hospitals was actually reduced by 19 percent, year-on-year. Nevertheless, the cost of referrals to Palestinian hospitals in the West Bank and East Jerusalem continues to rise. The MoH states that it plans to expand reforms it has already implemented to regulate its relationship with the Israeli hospitals to cover Palestinian hospitals as well. Furthermore, the MoH in cooperation with the World Bank has developed a referral master plan that identifies specific actions required to control referral costs.

Spending on the use of goods and services increased by 3 percent in the first three quarters of 2015 mainly due to an increase in the cost of medical referrals outside the public system. It is important to note, however, that the Ministry of Health (MoH) has been conducting efforts to control referral costs and results are starting to show. The MoH has already signed Memoranda of Understanding (MoU) with three Israeli hospitals to regulate contractual terms of the referral process, including pricing arrangements. As a result, the cost of referrals to Israeli hospitals was actually reduced by 19 percent, year-on-year. Nevertheless, the cost of referrals to Palestinian hospitals in the West Bank and East Jerusalem continues to rise. The MoH states that it plans to expand reforms it has already implemented to regulate its relationship with the Israeli hospitals to cover Palestinian hospitals as well. Furthermore, the MoH in cooperation with the World Bank has developed a referral master plan that identifies specific actions required to control referral costs.

Due to extraordinary deductions by the GoI from February clearance revenues, net lending grew by 16 percent in the first three quarters of 2015. If figures are adjusted to assume a standard deduction from the February revenues, net lending would have declined by 7 percent, which is a commendable achievement. The PA has recently taken some steps to control net lending including entering into MoUs with three Palestinian electricity providers including NEDCO, HEPCO and Tulkarem municipality. By signing the MoUs, the electricity providers commit themselves to paying 90 percent of what they collect from customers to the Israel Electric Corporation. The remaining 10 percent is used to cover operational costs. The Palestinian Energy and Natural Resources Authority (PENRA) states that two additional MoUs will soon be signed with JDECO and TEDCO. In addition, PENRA and the MoF have recently completed an exercise to specify debt obligations between the MoF and electricity providers and the results were published in a report. Future efforts will focus on further controlling net lending through implementing an action plan that is currently being developed by the Energy Authority and the MoF. The World Bank will also be providing technical assistance to the PA in this regard.

The PA continues to rely on arrears as a source of deficit financing. The PA’s total deficit amounted to USD996 million during the first three quarters of 2015. Aid received was USD593 million: USD530 million in budget support and USD63 million in development financing. Notably, budget support received was 12 percent lower than expected while development financing channeled through the

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2 518 employees departed from the labor force in Gaza while 334 were hired in the West Bank. The number of employees in the national fund and embassies increased by 98 employees. Net employment in the security and health sectors increased by 52 and 183, respectively, while it was reduced by 265 in the education sector.

3 Even though the CoLA and the increase for teachers have not yet been fully disbursed, the MoF should include them in the wage bill figure on commitment basis since they were committed through the budget.
treasury was a staggering 92 percent lower than budgeted. As a result, the PA ended up with a financing gap of USD403 million. In the first three quarters of 2015, the PA reduced its stock of private sector arrears from previous years by USD150 million. However, additional arrears were generated, and hence, net accumulation of arrears amounted to USD417 million in 2015—slightly more than what was needed to close the financing gap. Excess financing in addition to clearance revenue advances enabled the PA to reduce net domestic bank financing by USD139 million in the first three quarters of 2015, leading to a total stock of debt of USD1.17 billion as of September, 2015.

9. **Good progress was achieved in some areas of Public Financial Management (PFM).** For instance, there has been some improvement in the reporting and accounting of arrears. In particular, the MoF has implemented new functions of the Integrated Financial Management Information System (IFMIS) that require entering the due date for each payment, which enables the system to provide accurate data on the total stock of arrears. Also, the reporting on arrears has improved since a line on repayment from previous years was added to the monthly reports published on the MoF website. Furthermore, the MoF has recently issued an instruction mandating the implementation of a commitment system in a number of line ministries. This system ensures that a budget allocation is secured for any expense prior to its contracting. It has already been piloted at the MoF and the Ministry of Education and is now being rolled out in the Ministry of Health, Transportation, Interior, Public Works and Local Government. This system will provide information on all outstanding and newly incurred commitments that will be paid at a later stage. Eventually and once this system is developed into a full commitment control system aimed at monitoring and adjusting the flow of new commitments according to availability of financing, it will considerably reduce the possibility of generating new arrears.

10. **Efforts to finalize the procurement reform have recently been resumed, after having stalled for almost one year.** The Public Procurement Law has not yet come into effect and the Higher Council for Public Procurement Policy (HCPPP) is not yet functional. However, hiring of key staff that are necessary for HCPPP to assume its envisaged role in leading the development of the procurement system has just started following the allocation of necessary financial resources. The implementation of other pre-requisite components is expected to launch in December 2015, with World Bank support. Those include training of procurement practitioners on the key steps and procedures in the procurement process from planning through acquisition, finalizing and issuance of National Standard Bidding Documents for use by all procuring entities, and the establishment of the first phase of the single portal procurement website where all procurement information (plans, notices, etc.) will be posted. Other components, such as the establishment of a functioning dispute review mechanism will also follow.

11. **End of year fiscal projections indicate that the PA will face a financing gap of about USD0.5 billion in 2015, but a crisis scenario is unlikely in the short term.** According to Bank staff estimates, the PA’s recurrent deficit will amount to USD1.18 billion in 2015, which is close to the expected budget target. Development expenditure has been significantly underperforming mainly due to lower than expected donor financing, and is projected to total USD217 million, a fraction of the USD1.2 billion assumed by the budget. As a result, the end of year overall deficit is expected to reach USD1.4 billion. External financing is projected at USD898 million in 2015: USD814 in budget support and USD84 million in development financing. Based on the above figures, a financing gap of about USD0.5 billion would ensue. However, part of this gap has already been financed through accumulating domestic arrears in the amount of USD417 million between January and September 2015. The remainder of the

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4 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 44 percent of arrears accumulated in 2015 are to the private sector while the majority of the rest is to the pension fund.
gap can be financed through borrowing from local banks particularly since the current level of domestic
debt allows for additional borrowing before reaching the limit set by the Palestine Monetary Authority.
As a result, a crisis scenario is unlikely this year. However, the practice of accumulating arrears to the
private sector is damaging for the economy and it could affect revenue generation. Also, the Bank’s
estimates show that if the PA continues accumulating arrears to the pension fund, the system will
become insolvent in 5 to 6 years. Therefore, resorting to arrears as a source of deficit financing may
become more difficult in the coming years, and it is key that the PA accelerates efforts to enhance
revenues and further control spending in order to put its finances on a sustainable path.