Palestinian National Authority

Ministry of Finance

Fiscal Developments: Fourth Quarter, 2008 and 2008 Budget Performance

March ١٩, 2009

The fourth quarter (Q4) of 2008

A. Budgetary Operations and Financing

١. Summary and overview[١]

The recurrent deficit for the Palestinian National Authority (PNA) on a commitment basis during Q4 of 2008 of $ 337 million was marginally lower than the deficit during Q3. (Table 1)

This retrenchment can be fully attributed to a tightening of expenditure policy to remain within the annual budgetary appropriation. Non wage expenditures declined by about $ 90 million from the previous quarter (Table 2). Wage expenditure was marginally higher in NIS terms, consistent with new teacher hiring at the beginning of the school year. On the other hand, net lending to municipalities reflecting PNA payment of their utility bills declined, due to higher bill collection rates and lower fuel prices.

External budget support of $ 351 million fully financed this deficit, and allowed for the repayment of the remaining wage arrears in November ($ 36 million, Tables 4 and 7)

[١] For analytical purposes, all revenue data mentioned in this report exclude one off items-- the exceptional dividend of $ 197 million received from the Palestinian Investment Fund (PIF) in May 2008 and used to repay PNA debt to the PIF, and $ 21 million received in February as an initial interest payment on frozen clearance revenues.

2. Budget execution in 2008.

Budget performance in 2008 achieved substantial progress towards attaining fiscal sustainability.

Budget execution in 2008 has been strong with respect to both PNA revenue and expenditure. Gross budget revenues have exceeded budget targets by $ 41 million (Tables 1 and 5). Wage expenditures have been below the budget appropriation and declined in real terms. Operational expenditures and transfers in 2008 have been virtually in line with budget appropriations, despite a rate of inflation (7%) almost double what was foreseen in the budget.

Net Lending, mostly dedicated for utility bill payments on behalf of municipalities, exceeded appropriations by $ 47 million (12% of appropriation, Table1). This overspending was due to a spike in energy prices; actual spending declined in real terms. While expenditure controls were firmly in place on all ministries, it should be stressed that "net lending" is not under the control of the Ministry of Finance. Unpaid electricity bills are deducted by the Israeli authorities during the monthly clearance sessions, and payment of bills is at the discretion of local governments.

This large fiscal subsidy to municipalities has not been the outcome of deliberate PNA economic policy but has been imposed on the PNA by municipality payment delinquencies and virtually automatic deductions by the Israeli authorities of claims by the wholesale supplier of electricity to the West Bank and Gaza, (Israel Electric Company), without having a bill review mechanism, mutually agreed upon.

The recurrent deficit in 2008, on a commitment basis, (NIS 3.27 billion) was kept below budget estimates (NIS 4.90 billion). At 20 % of GDP, this deficit reflects a fiscal retrenchment from the 2007 recurrent budget deficit by 5 percentage points of GDP, a solid performance by international standards.

This robust budgetary performance in 2008, coupled with comprehensive transparency in government operations, regained donor countries confidence in PNA financial management and contributed to the mobilization of a record level of external budget support ($ 1.763 billion). The additionallity in external budget support, over the recurrent deficit financing needs, went entirely to the repayment of all remaining wage arrears ($ 317 million) and private sector arrears ($ 70 million), rather than into new spending commitments (Table 4). There were also net repayments to commercial banks in 2008 of $ 29 million, reducing outstanding PNA debt to commercial banks from $ 422.5 million (end 2007) to $ 395.5 million (end 2008).

Development expenditures in 2008 on large infrastructure projects financed by donor countries, estimated at about $ 190 million on a disbursement basis, were less than half the $ 492 million donor commitment listed in the Palestinian Reform and Development Plan (PRDP) and the 2008 budget. Various permitting and movement restrictions imposed by Israel resulted over the last several years in numerous delays and a low ratio of project execution.

By contrast, small community projects responding to community needs and their own priorities are less vulnerable to these restrictions and have gained momentum during the second half of 2008. By end 2008 over 1100 of these projects have been vetted and approved, 314 projects have been completed and 509 were being executed.

Expenditures on these projects (and small capital expenditures) in 2008 amounted to $ 59 million (Table 2). While this exceeded the budget target of $ 50 million, external financing from the European Commission and USAID has more than covered the additional spending. PNA expenditures on these projects are expected to reach $ 300 million in 2009, within the 30 programs delineated in the PRDP.
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3. Revenue

a) Fourth Quarter 2008

Gross domestic revenues of NIS 441 million during Q4 of 2008 were marginally higher than revenues in Q3[2] . These results would have been stronger, were it not for some weakness in domestic VAT tax collection in December.

[2] When excluding license fees from Wataniah, the new telecommunication company.

Clearance revenues in Q4 (NIS 928 million) weakened relative to Q3 mostly due to lower petroleum excises and VAT receipts. The tightening of the siege on Gaza and the Israeli offensive at the end of the year resulted in lower shipments of petroleum products and other imports to Gaza. The decline in oil prices in November and December also reduced tax receipts.

b) PNA Revenues in 2008

Gross revenues in 2008 of NIS 6 billion, excluding one off receipts, increased by 13 % over 2007 revenues, consistent with evidence of an economic recovery in 2008 (Table 1). Gross revenues exceeded the 2008 budget target of NIS 5.9 billion.

Net revenues of NIS 5.55 billion, also exceeded the budget target of NIS 5.35 billion, albeit by a lower amount, considering that actual tax refunds ($ 116 million) were much higher than budgeted ($ 20 million)

Regular clearance receipts, on a commitment basis (NIS 4 billion), increased by 6.2 % over 2007 receipts, but this average conceals a much higher increase in the West Bank. (20 % increase in VAT receipts and 10 % increase in petroleum excises), and a sharp decline in receipts from Gaza (-65% in VAT receipts and -7 % in petroleum excises), due to the virtual closure of its border crossings. While gross clearance revenues on a cash basis amounted to NIS 4.0 billion in 2008, there were NIS 1.3 billion in deductions, of which NIS 878 million for electricity bills (on behalf of Palestinian municipalities), NIS 160 million for water consumption and NIS 72 million in revenue withholding under court orders.

Taxes levied directly by the PNA amounted to NIS 966 million in 2008, a 17 % increase over 2007, despite a blanket waiver of tax payments to Gaza residents and the aforementioned amendment to the income tax law. This increase was partly due to the economic recovery in the West Bank but also to the administrative reforms, particularly in the collection of the domestic VAT.

Non tax revenues of NIS 1 billion were double the amount obtained in 2007, partly on the strength of the $ 80 million license fee by Wataniah, the new telecommunication company, received for the first time in August 2008.

4. Expenditures

a) The fourth quarter of 2008

PNA recurrent expenditures, on a commitment basis, amounted to NIS 2.5 billion in Q4 of 2008, as compared to NIS 3.0 billion during the previous quarter (Tables 1 and 2). This decline was mostly due to expenditure controls on operational expenditures and transfers, which declined by 24 % from the high Q3 level, bringing them back within budgetary appropriations.

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Wage expenditures of NIS 1.29 billion during Q4 increased only slightly, compared to Q3 (NIS 1.28 billion) with the hiring of additional teachers for the school year. There has been a rigorous control over PNA employment and there was no general wage increase.

PNA permanent employment increased from 141,267in September 2008 to 142,937 by end December 2008, of which 64,213 (45%) were employed in Gaza. This PNA employment level is nevertheless lower than in December 2007 (144,380). Most of the decline has affected security personnel.

Non wage expenditures declined from NIS 1.15 billion in Q3 to NIS 0.87 billion in Q4. Most of this decline was on account of transfers, falling from NIS 0.75 billion in Q3 to NIS 0.48 billion in Q4. Transfers include payments to retired PNA employees, the government's share in pension contributions and transfers to the Ministry of Social Affairs (MOSA). Some of these payments are lumpy and depend on availability of cash or payments from abroad. For instance, the European Commission transferred $ 12 million to MOSA in December under its PEGASE facility, while there were no transfers in November. This lumpiness accounts for the volatility in transfer payments from month to month.

Operational expenditures also fell by 23% to NIS 273 million. Q3 non wage expenditures were particularly high, which explains the decline in Q4, in an effort to remain within budgetary appropriations.

Net lending also declined in Q4 by 20% (to NIS 388 million) due to the decline in petroleum products prices, much lower shipments of fuel to Gaza and higher rates of electricity bill collections by various municipalities. In particular, the collection rate in Hebron municipality increased from 65% during the first half of the year to 73% by end November 2008 while collections in Nablus increased from 66% to 77%. On the other hand, Gaza collection rates declined from 34 % to 31 %

b) Performance in 2008

There was a major improvement in the quality of expenditures in 2008, as compared with 2007. The PNA wage bill declined from 25 % of GDP in 2007 to 23 % of GDP in 2008 and the share of wages in total expenditures declined from 56 % in 2007 to 50 % in 2008. Likewise, the share of implemented development expenditures rose from 5 % of total expenditures in 2007 to 8 % in 2008.

At NIS 10.2 billion, recurrent expenditures in 2008, on a commitment basis, were about NIS 30 million below budgetary appropriations. If the overspending on net lending, on which MoF has no control, were to be excluded, budgetary performance in 2008, would have been lower than budgetary appropriations by $ 55 million. The savings were mostly achieved in the wage bill.

Total recurrent expenditures in 2008 (NIS 10.215 billion) were higher than in 2007 (NIS 9.34 billion). However, the wage bill in 2008 (NIS 5.15 billion) was lower than in 2007 (NIS 5.26 billion). The average monthly wage per employee declined from NIS 3036 in December 2007 to 3000 in December 2008. While there was a substantial decline in real PNA wages in 2008, disposable income of PNA employees rose in 2008 by an estimated 7 % in real terms due to three factors. i) payment of NIS 1.124 billion in wage arrears, ii) the lowering of income taxes, by raising the individual exemption and iii) the doubling of the transportation allowance in April 2008 in response to the spike in fuel costs.

As mentioned earlier, non wage expenditures were virtually in line with the 2008 budget, while allowing for an increase in transfer payments by 86 % over their 2007 level, with the sharp deterioration of the economic situation of Gaza and the rise in unemployment and poverty. Operational expenditures increased by 51% over their 2007 level, bringing a better balance between services rendered by PNA employees and the material and supplies needed to perform these services efficiently.

There was substantial progress towards reducing net lending, with PNA payments declining from $ 535 million in 2007 to $ 447 million in 2008. In addition to improved collection ratios mentioned above, the PNA is promoting a culture of payment for electricity bills by enforcing certificates of payment, encouraging municipalities to pay Israel Electric Company directly and providing monetary incentives to municipalities remitting their old bills. However, two critical steps are necessary to attain a sustainable solution: putting electricity distribution companies in charge of collecting electricity bills and compensating municipalities for loss of revenue by a reform of local government finance.

5. Financing

External budget support in Q4 of $ 351 million (Table 7) was lower than the levels attained in the previous three quarters. Nevertheless, it was sufficient to cover the recurrent budget deficit, yielding a surplus of $ 14 million, which contributed in liquidating wage arrears in November 2008, with a last payment of $ 36 million.

The United States was the largest contributor to the PNA's budget support ($ 150 million), followed by the EC's PEGASE ($ 115 million) and Saudi Arabia ($ 56 million).

Total budget support for 2008 reached a record of ($ 1.76 billion), covering the recurrent deficit for the year ($ 1.12 billion), and thereby ensuring regular and timely payments of salaries to PNA employees as mentioned earlier. It also allowed for the repayment of all wage arrears ($ 317 million), private sector arrears ($ 70 million) and about $ 29 million to commercial banks.

Arab countries provided $ 526 million (30 % of all budget support, including Kuwait's contribution to the Trust Fund) while the EC provided $ 651 million (37 %), through its various financing instruments. The World Bank provided, $ 283 million, including Kuwait's contribution) through its Trust Fund, Development Grant and ESSP.

The single largest bilateral donor in 2008 was the USA ($ 300 million), followed by Saudi Arabia, $ 234 million.

B. Institutional developments in the Ministry of Finance

a) The 2009 draft budget was approved by the Council of Ministers on January 19, 2009 and has been signed into law on February 28, 2009.

The 2009 budget has been built from the ground up. For the first time in Palestinian public finance, this is a unified budget, combining recurrent and development expenditures. Following the instructions of the budget circular, issued on July 6, 2008, each ministry and agency provided information on their policy priorities, strategic plans, objectives and targets. In this budget, a summary of strategic objectives and programs are shown for each ministry and their linkage to the PRDP is clearly stated.

The 2009 budget has been framed to achieve substantial progress towards fiscal sustainability, under the Medium Term Fiscal Framework as outlined in the updated Palestinian Reform and Development Plan (PRDP) 2009-11. It incorporates an ambitious policy agenda and seeks a fiscal retrenchment of 2 percentage points of GDP on top of the 5 percentage points achieved in 2008.

b) The Budget Department, which was largely moved from Gaza to the West Bank, has gone through a transitional period in 2008 with capacity building, drafting a unified budget and increasing responsibility for budget execution. Beginning in January 2009 it will have full responsibility for supervising budget execution by line ministries and enforcing budgeted expenditure ceilings.

c) The Financial Management Information System (FMIS) reconciles banking transactions with revenue and expenditure flows. According to IMF experts, "within only a few months of its acquisition, production of key financial reports from the system was successfully undertaken, a process which would take years in most developing countries."[٣] Between March 2008, when it was established, and end December 2008, it has acquired greater automaticity, covering 95 % of budget transactions from the accounting system, making it possible to issue on

[٣] Mark Sillins, IMF technical assistance, November 2008 the 15th of every month MoF reports on budget execution and quarterly analysis on public revenue and expenditure flows on the MoF web site.

d) During Q4, the MoF internal audit department has focused on auditing the Ministry of Finance. It has completed the auditing of the Petroleum Authority, and the Property Tax. It is now working on other tax departments of the Ministry.

   In addition to the two audits mentioned above, the Internal Audit Department has prepared audit reports for the ministries of Labor, Public works, Telecommunications and Prisoners Affairs