Palestinian National Authority

Ministry of Finance

Fiscal Developments

Third Quarter, 2009

November 22, 2009

1. Summary and overview

The recurrent fiscal deficit in the Palestinian National Authority budget in Q3 09 of $ 376 million was lower than the recurrent deficits in the previous two quarters (table 1). PNA revenues benefited from $ 100 million in license fees, but expenditures continued to bear the costs of the Gaza offensive on the Gaza population. The need for alleviating the acute hardships suffered by the population and the damage sustained by Gaza's infrastructure, has raised both PNA transfers and operational expenditures to Gaza well beyond their budget trajectory. This has prompted the Ministry of Finance (MoF) to request a supplementary appropriation to the budget of $ 300 million, and a plea with the donor community to finance this appropriation since the Palestinian Treasury does not have the resources to meet this unforeseen emergency.

The $ 300 million appropriation request was approved by the Council of Ministers on September 29, 2009 and has been incorporated in the budget column of the attached tables. It raises the recurrent deficit Budget projection for 2009 from $ 1.15 billion to $ 1.45 billion.

Based on the most recent data, net revenue projections for 2009 on a commitment basis, are at $ 1.59 billion, about $ 40 million short of budgetary projections of $ 1.63 billion (table 5). Revenue performance has actually been very good, despite the sharp fall in revenues from Gaza in the aftermath of the Israeli offensive, and is an indication of vigorous economic growth in the West Bank. The shortfall mostly resulted from an ambitious budgetary projection of $ 100 million in PNA dividends, none of which materialized. While the PNA did receive $ 100 million in license fees, about $ 50 million were budgeted, resulting in a revenue shortfall for these two categories combined of $ 50 million

Recurrent expenditures on a commitment basis in Q3 09, at $901 million (Tables 1 and 2), exceeded the expenditures in the previous two quarters due to two factors: wage expenditures were higher by about $ 30 million because of compensation provided for PNA employees who had to pay interest on bank loans they took in 2006 due to the financial boycott on the PNA which prevented it from paying salaries. The second factor pertains to the continuous rise in both operational and transfer expenditures benefiting Gaza.

Most recent expenditures data indicate that total PNA spending and net lending in 2009 may reach $ 3.19 billion, about $ 110 million above the amended budget projection of $ $ 3.08 billion.

This expenditure overrun, coupled with the $ 40 million shortfall in revenues, suggest that the recurrent fiscal deficit, on a commitment basis, may reach $ 1.6 billion or $ 150 million over the amended budget projection of $ 1.45 billion.

Development expenditures accelerated, due to higher implementation levels, and the shift of some donor financing to community projects. During Q3 09 spending on development projects reached $ 127 million, more than double the level during the previous quarter. During the first nine months of the year these expenditures totaled $ 219 million, but recorded external financing with MoF, only amounted to $ 37 million (table 7). Development expenditures for 2009 are unlikely to exceed $ 300 million.

External budget support in Q3 09 at $ 663 million was very strong, due to transfers of $ 200 million each from Saudi Arabia and the United States (table 7). By end October 2009, budget support amounted to $ 1.04billion. For the rest of the year $ 400 million are needed from the donor community to fully finance the amended budget. At the same time, the PNA will attempt to restrain its expenditures to limit any overruns and avoid incurring private sector arrears.

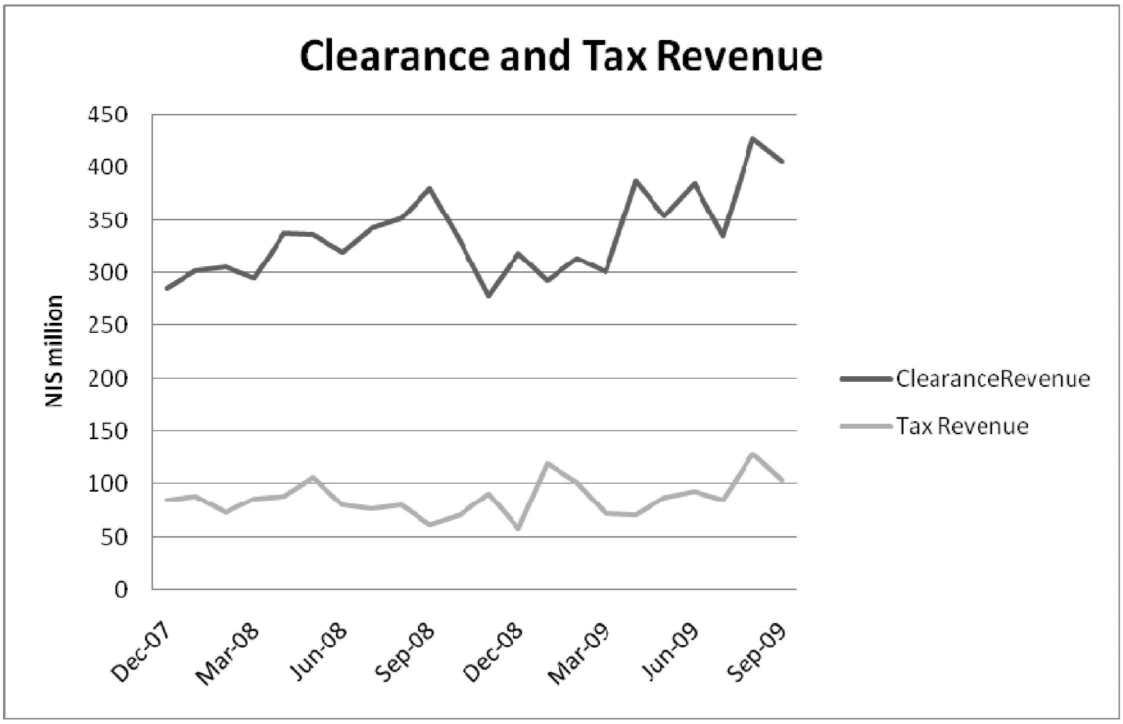
2. Revenues

Gross PNA revenue at $ 542 million during Q3 09 (table 1 and 5), was substantially higher than the previous two quarters on the strength of higher domestic tax revenue and a rebound in clearance revenue. Higher than expected economic growth in the West Bank was the main factor behind this strong performance. Estimates detailed below, for various revenue categories, indicate that total net revenues for 2009 would reach about $ 1.59 billion by end 2009, slightly below the budget target for 2009 of $ 1.63 billion. However, should the PNA receive any additional license fees or dividends during the last quarter of the year, the budget target might be exceeded.

Gross domestic revenues in Q3 09 amounted to $ 238 million and increased by 46% in NIS terms over Q3 08, when license fees in Q3 are excluded, thanks to strong performance in both tax and non tax revenues. Comparing the January-September period in 2009 to the same period in 2008, gross domestic revenues increased by 19% in NIS terms. Despite these strong results, domestic revenues during the first nine months of this year ($ 450 million) may fall short of the budget target for 2009 ($ 625 million) by about $ 40 million, assuming that revenues in Q4 09 are similar to those in Q3 04 (excluding license fees). This is a case where the budget target for 2009 may have been overly ambitious with respect to dividends revenues which were set at about $100 million for 2009.While by the end of Q3 09, $ 100 million were accrued in license fees, no dividend revenue materialized and it is unlikely that $ 40 million will be forthcoming during the rest of the year in either license fees or dividends.

Domestic tax revenues in Q3 09, at $ 83 million, exceeded tax revenues in both the first and second quarter of 2009, on the strength of domestic VAT revenue collection. Compared to Q3 08, they increased by 46% in NIS terms, while the January-September revenues rose by 16% relative to the same period in 2008. Should Q4 09 tax revenues amount to their average yield in 2009, domestic tax revenues would exceed their 2009 budget target ($ 273 million), by $ 17 million.

Revenues from income taxes, during the January-September 2009 period, declined by 7% in NIS terms compared to the same period in 2008, because of the higher deductible which became effective in January 2009 with the amendments to the income tax law. To strengthen its collection efforts and administrative capacity, the income tax department is receiving external technical assistance. On the other hand, domestic VAT revenues increased by 30% in NIS terms, while excises on tobacco increased by 45 %, pointing to a stronger tax collection as well as substantial growth in consumption and income.



Clearance revenue in Q3 09 at $ 304 million (table 5) exceeded revenues obtained in each of the previous two quarters. Comparing Q3 09 to Q3 08, clearance revenues increased by 9% in NIS terms, despite much lower revenues from Gaza, due to the siege, which limits imports of fuel and other goods into Gaza. Looking at the January-September period in 2009, relative to the same period in 2008, clearance revenues increased by 6% in NIS terms, even though Q1 09, marked by the Israeli Gaza offensive, yielded very low revenues[1]. These results are consistent with domestic tax revenue performance and are a further indication of a substantial increase in consumption and income during the first three quarters of 2009, in comparison with the same period in 2008.

[1] See First and Second Quarter fiscal developments reports at www.pmof.ps

Assuming, that clearance revenues during Q4 09 will match the average obtained in Q2 and Q3 09, i.e. about $ 285 million, total revenues for the full year will amount to $ 1.1 billion, or slightly below their budget target of $ 1.12 billion.

Deductions from clearance revenues averaged $ 27 million per month during Q3 04 mostly for electricity and water but also including $ 4.7 million in court order withholding of NIS 18 per month on behalf of US citizens claims.

Tax refunds, at $ 17 million during Q3 09, are slightly below their quarterly average for this year ($ 18 million) and substantially below the quarterly average in 2008 ($ 29 million). Should tax refunds remain at about $ 18 million during Q4 09 total refunds for the year ($ 74 million) would be lower than the budget target by $ 44 million. This is an indication that tax refund arrears are likely to accumulate in 2009.

3. Expenditures and net lending

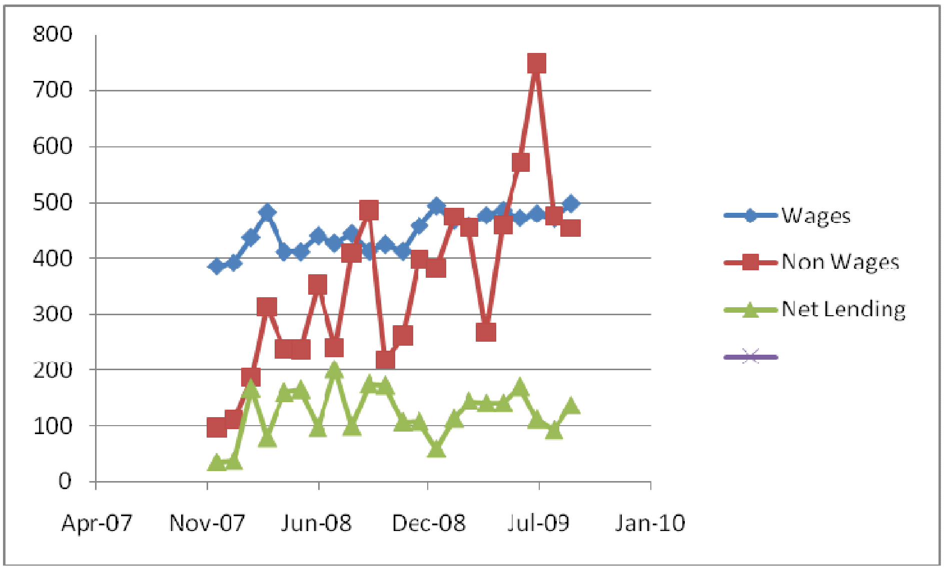
Total PNA expenditures in Q3 04, on a commitment basis amounted to $ 901 million, exceeded levels attained during the previous two quarters. This was due to a one off wage compensation to PNA employees (see below) and higher spending in transfers and operational spending, as a result of higher allocations to alleviate the plight of the Gaza population. By contrast, expenditure on "Net Lending" has declined during Q3 04, indicating some progress in the collection of electricity bills.

Wage expenditures, on a commitment basis, of $ 377 million in Q3 09, have risen by about $ 30 million over their average level during the first two quarters of the year (tables 1 and 2). To some extent this increase is due to a rise in PNA net employment between June and September by 1426; this would raise the payroll by about $ 4 million per quarter. However, the main reason for the increase in the wage bill in Q3 09 stems from the inclusion of NIS 600 to each entitled employee in the second salary payments disbursed on September 17. This one off payment is compensation to those PNA employees, who had to obtain bank loans in 2006 and pay interest on them, because the PNA was unable to disburse salaries, under the Israeli and OECD financial boycott which took place following the January 2006 elections.

During Q4 09, the wage bill would revert to its normal trend, and assuming tight controls on employment, should not exceed $ 400 million. This would bring it roughly to $ 1.47 billion for the full 2009 year, or about $ 60 million over the budgetary appropriation of $ 1.41 billion.

Major Expenditure Categories

(in millions of NIS)



The wage bill on a cash basis in September was much higher than commitments (Table 4). Because of the Eid holidays beginning September 21, it was decided to make two payments to PNA employees: $ 131.4 million on September 5, and another ($ 148.5 million), which would have been normally due at the beginning of October, on September 17, just before the Eid. In October, cash expenditures on wages would be minimal.

Total PNA employment reached 147,143 by end September, well within the 153,000 benchmark limit for 2009, set with the World Bank's Development Grant. The civil service in the PNA increased by 520 employees during Q3 09, while security personnel increased by 906. During the first nine months of 2009, PNA employment rose by 4216, of which, civilians accounted for 1965, while security personnel rose by 2231. It should be recalled that a number of employees who were hired in 2006, 2007 and 2008 were only confirmed in 2009. Some security personnel who were taken out of the payroll in 2007 on suspicion of having been illegitimately hired in 2006 and 2007, have been reinstated following positive results from reviewing their file.

On the security side, given the successful deployment of security personnel in West Bank areas under Palestinian sovereignty, there was a need to build upon these achievements by hiring additional personnel. As for civilians, the bulk of new hiring was for social services (1900 out of 1965). Comparing September 09 to end December 08, there was an increase of 1258 teachers, 461 health workers and 181 additional staff in the Ministry of Social Affairs.

Non wage expenditures have been adversely affected by the humanitarian and material consequences of the Israeli Gaza offensive in December 08/January 09. Both transfers and operational expenditures increased substantially to compensate people who have lost their homes, to broaden social allowances, and to repair damages sustained by the electricity, water and road networks. The request for a supplementary budget appropriation to deal with these unforeseen expenses was approved by the Council of Ministers. Operational expenditures were allocated an additional $ 100 million while transfers were increased by $ 200 million (Table 2, budget column)

Overall, non wage expenditures in Q3 04, on a commitment basis, reached $ 436 million, including large commitments for medicines and medical supplies. There were also some repayments of arrears, such as the NIS 30 million in telephone bills incurred prior to June 2007 and left unpaid. Non wage expenditures in cash were $ 360 million, indicating that $ 76 million were due but not yet paid (table 4)

Operational expenditures, (table 2) at $ 178 million, marked a large increase over Q2 09 ($ 122 million) but total operational expenditures during the first nine months of this year ($ 410 million) remained within the amended budgetary appropriation of $ 500 million. The major reason for the rise in operational expenditures in Q3 04 was a spike in commitments for medicines and treatment abroad in July, mostly in response to the Gaza casualties, which together exceeded $ 50 million, and raised operational expenditures for that month to $ 96.3 million, from the relatively high June level of $ 69.8 million. Subsequently these expenditures declined in August (to $ 53 million) and in September (to $ 28 million).

Transfer expenditures also increased from $ 165 million in Q2 09 to $ 238 million in Q3 09. There was a large increase in Transfers in both July (from $ 61 million in June to $ 81 million in July) and September (from $ 66 million in August to $ 91 million in September). Again, these increases are mostly due to the consequences of the Gaza offensive on the population, which prompted the PNA to raise the level of allowances, including compensation for lost housing and provision of temporary shelter. Thus, while total social allowances in January 2009, amounted to $ 1.7 million, by September 2009 these allowances had risen to $ 17.7 million. Payments of pensions to both civilian and security personnel also increased from $ 12 million in January to $ 16 million in September 2009, following the retirement of a number of security personnel.

During the first nine months of this year, transfer expenditures amounted to $ 580 million. To remain within the amended budget appropriation of $ 758 million by year end, transfer expenditures during Q4 09 should not exceed $ 178 million. This tightening of transfers appears to be on track as indicated by preliminary data for October spending and the amended budget target may be respected.

Minor Capital expenditures fell sharply to $ 19 million in Q3 04, after having exceeded its budget appropriation in Q2 09 by a large amount due to the payment of 2008 arrears. Firm instructions were sent to ministries to limit expenditures on durable goods. Thus, these expenditures declined from $ 14.6 million in July to $ 4 million in August and only $ 0.9 million in September.

Net Lending amounted to $ 89 million in Q3 09, a substantial decline from the $ 109 million spent during the previous quarter. Progress was made in collecting electricity bills from municipalities. Electricity bills deductions from clearance revenues in Q3 04 averaged $ 16.2 million per month while during the previous quarter they were $ 22.1 million per month. This decline should be viewed in the context of rising electricity consumption during the last nine months, consistent with substantial economic growth estimates. If this trend is maintained during the last quarter, net lending should remain within the budget appropriation of $ 380 million by year end.

Development expenditures, on a commitment basis**,** accelerated during the year, as there was better project execution, and a broader coverage of donor financed development. During Q1 09 only $ 5.6 million were spent, rising to $ 57 million in Q2 09 and $ 127 million in Q3 09. Of the $ 190 million spent during the first nine months of the year, $ 37 million were disbursed by donors while the rest was financed from the Treasury, mostly for Community Development Projects.

Since December 2007, 1452 community projects, valued at 1.45 billion were launched, of which 850 have been completed ($ 122 million) and 263 are being executed ($ 168 million). 339 projects have been planned but have not started yet, as the capacity for execution has run into implementation constraints. Most of these projects have focused on building schools, municipal facilities, rural roads, and infrastructure for electricity distribution and connecting villages to the electrical network.

While external financing for these projects was timid at first, a number of donors have contributed financing, including the European Union ($ 79 million), the USA ($ 31 million), Japan ($ 10 million) the Netherlands ($ 8 million) and others. Recently, the Abu Dhabi Fund for Development, pledged $ 45 million for community projects, of which $ 5 million have been disbursed.

4. Financing

External budget support in Q3 09 amounted to $ 663 million (table 7), a major increase over the previous quarter ($ 148 million). This sharp rise in financing was due to a large transfer ($ 203 million) by Saudi Arabia in August 2009 and an equally large transfer by the United States in July ($ 198 million). The US grant enabled the PNA to pay the Petroleum Authority, accumulated tax refunds on petroleum products in arrears, amounting to $ 90 million (table 4).

The European Union contributed $ 164 million, an exceptionally high amount, due to two salary payments in September, coinciding with the Eid. With no PNA salaries in October, the contribution by the EU budget support mechanism (PEGASE) would also be much lower.

In August 2009, the World Bank provided $ 69 million, including $ 40 million as a Development Grant and $ 29 million from its Trust Fund. During that month, Turkey also provided $ 10 million in budget support.

By end October 2009, external budget support to the PNA amounted to $ 1.04billion. For the rest of the year $ 400 million are needed from the donor community to fully finance the amended budget.

Domestic Financing mostly relied on borrowing from commercial banks. Because of the accumulation of domestic bank debt during Q1 09 and Q2 09 ($ 287 million), the large external assistance in July and August 2009 enabled the PNA to repay banks $ 345 million during these two months, and borrow again in September ($ 211 million), to finance disbursement of two salary payments, and to make up for much lower external financing ($ 80 million) than the average monthly requirement ($ 120 million). All in all, in Q3 09, there was $ 133 million in net repayments to the banks, and $ 90 million in tax refunds to the Petroleum Authority. On the other hand, $ 75 million of outstanding bills were accumulated, partly to the Pension Fund and partly to the private sector.

Public debt. Domestic debt to commercial banks increased by $ 154 million, (table 1) between end December 2008 and end September 2009, raising the stock of debt to commercial banks to $ 522 million. External debt was reduced by $ 3.6 million during the first nine months of the year, which lowered the stock of external debt to $ 364 million[2]. Total public debt in Palestine amounts to 14 % of GDP, much lower than debt levels in both OECD and developing countries.

[2] Mostly IDA long term concessional loans ($ 312 million).