Palestinian National Authority

Ministry of Finance

Fiscal Developments:

Fourth Quarter Report

and

Review of 2009 Performance

March 23, 2010

1. Summary and overview

The recurrent deficit in Q4 09 on a commitment basis, at $ 434 million, was higher than the deficit in Q3 09 of $ 397 million[1], mostly due to a 7% increase in the wage bill partly reflecting a 2% depreciation in the US dollar (Table 1). Clearance and domestic tax revenues were roughly the same level as in Q3 09, while non wage expenditures were marginally lower. Net lending declined from $ 115 million in Q3 09 to $ 101 million in Q4 09.

External budget support received during the first nine months of the year, averaged $ 361 million per quarter, which is the quarterly level of external budget support required to meet the budget deficit in 2009 of $ 1.45 billion. In Q4 09, external budget support received of $ 284 million fell short of this requirement and the shortfall was partly met by higher bank borrowing ($ 35 million) and some accumulation of arrears[2] (Tables 1 and 7).

Looking at the second half of 2009, which did not bear the full brunt of the financial consequences of the Gaza offensive, the recurrent deficit at $ 731 million was substantially lower than the deficit incurred during the first half ($ 862 million). Particularly significant was the 15% increase in clearance revenues during the second half of the year over the first half (in NIS terms) and by 16% over the second half of 2008. This result confirms the substantial economic growth which has taken place in the West Bank during the second half of 2009. PCBS preliminary estimate for real growth in 2009 was put at 6.1%

Budget execution in 2009 was confronted with the humanitarian hardship and physical destruction resulting from the Israeli offensive on Gaza.

[1] Excluding $ 100 million of exceptional license fees revenues in Q3 09 which brought the recurrent deficit down to $ 297 million in that quarter.

[2] It should be recalled that two salary payments were made in November to coincide before the Eid and no salary payments were made in December. This resulted in large wage arrears incurred, on a commitment basis, in December.

Emergency expenditures were immediately required after the offensive to repair the damage sustained by the electricity, water and sanitation networks, as well as to the essential transportation infrastructure. Medical treatment, provision of social allowances to the families of over 6,500 casualties, and to those who lost their housing and jobs, were also provided.

The loss of revenue and additional expenditures resulting from the Israeli offensive prompted the government to request a supplementary budget appropriation of $ 300 million, which was approved by the Council of Ministers on August 24, 2009. However the refusal by the Israeli authorities, till this day, to allow for importation of most building material into Gaza, severely limited reconstruction, new job creation and economic recovery, perpetuating welfare and humanitarian assistance as the major underpinnings of Gaza's economic survival. In particular, it lengthened PNA allowances provided for rental of temporary housing and perpetuated the much higher social allowances for unemployment and poverty. This has caused an upward structural shift in budgetary transfers, in favor of the Gaza population, and it is estimated that out of the $ 300 million emergency spending request, about $ 100 million have now become embedded in budgetary transfers.

Despite the challenges faced by the PNA in Gaza, budget execution in 2009 remained strong, as was the case in 2008. Gross revenue in 2009, amounting to $ 1.7 billion, increased by 14% in NIS terms over 2008[3], despite the weakness of clearance revenue during the first quarter of the year, due to the Gaza offensive.

Total recurrent expenditures in 2009, at $ 3.2 billion, included $ 142 million of arrears carried over from 2008 (Table 1). Excluding these arrears, 2009 expenditures of $ 3.05 billion were kept below the amended budget appropriation ($ 3.08 billion) on the strength of expenditure control, particularly with respect to employment and wage increases

The PNA recurrent deficit on a commitment basis in 2009, (excluding the 2008 arrears) amounted to $ 1.45 billion, substantially higher than the $ 1.26 billion

[3] Excluding dividends and license fees for telecommunication companies

recorded in 2008 (Table 1). However, if emergency expenditures on Gaza were to be excluded, the recurrent deficit in 2009 would have fallen to $ 1.15 billion, two percentage points of GDP lower than the expenditure level in 2008. This only underscores the steady progress the PNA is achieving in attaining fiscal sustainability and in reducing its dependence on external budget support. The recurrent deficit on a cash basis at $ 1.37 billion was below the budget ceiling (Table 4).

Financial support from donors for the recurrent budget amounted to $ 1.35 billion, somewhat short of the amended budget deficit ($ 1.45 billion) but substantially higher than the original budget deficit estimate ($ 1.15 billion, tables 1 and 7)

Development expenditures gathered momentum in 2009 by reaching an estimated $ 400 million. Of these, $ 215 million were channeled through the Treasury, mostly for community development projects[4] which were financed by donors, except for $ 10 million which was covered by the Treasury. Project execution was high with the completion of some major roads in the West Bank and water sanitation projects in Gaza.

2. Revenue

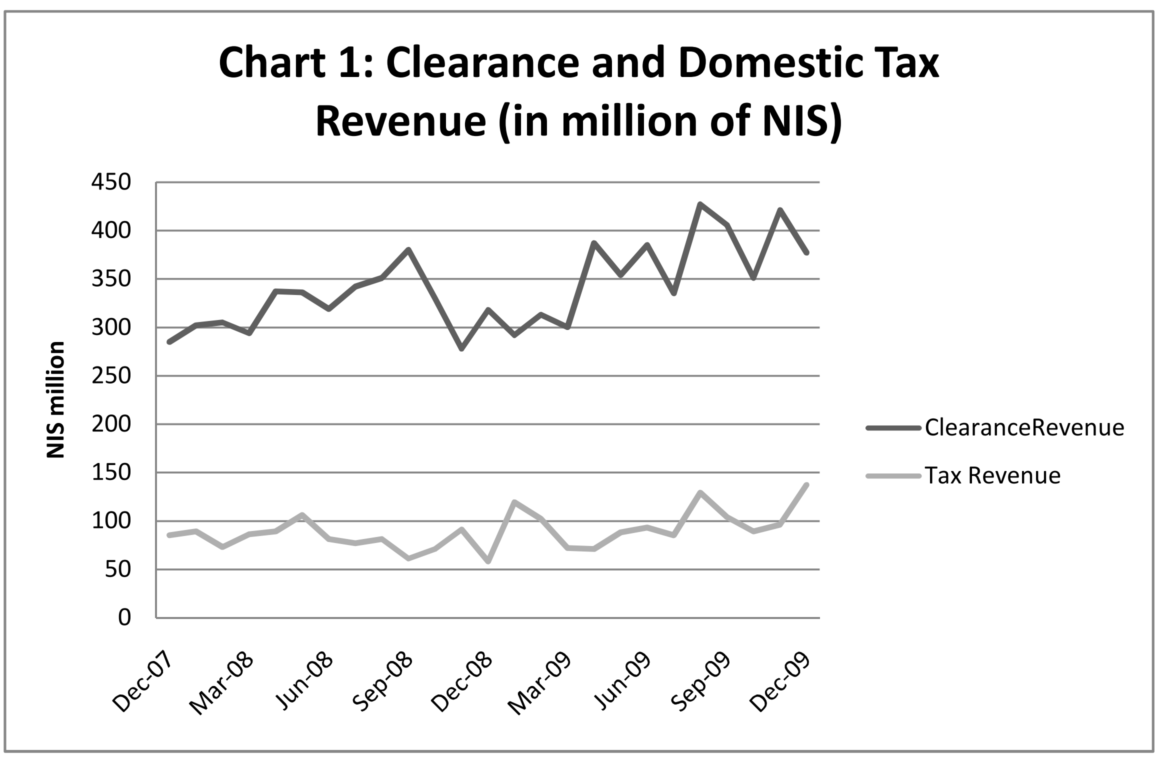
Gross PNA revenue of $ 437 million during the Q4 09 increased by 20% over Q4 08 in NIS terms. For the year 2009 as a whole, with PNA gross revenue reaching $ 1.7 billion, there was a 14% rise over 2008 revenue, due to reforms in domestic tax administration and robust economic growth. The economic growth momentum achieved in 2009 appears to be continuing in 2010 and, if sustained, PNA gross revenues are expected to exceed $ 2 billion for the first time.

Domestic tax receipts have been particularly strong since August 2009, with administrative reforms, benefiting the income and value added taxes as well as

[4] Actual development expenditures are substantially higher, since this amount only covers projects financed through the central budget accounts. Additional projects are financed directly by donors

excises (see chart 1). The objective of the Palestinian tax administration is to raise income tax receipts from their 1.5% GDP ratio to the 5-6% GDP ratio prevailing in neighboring countries. The low income tax proceeds in Palestine, relative to neighboring countries, resulted from the economic restrictions which the GoI has imposed on the Palestinian territory and which has been suppressing economic activity and investment. Efforts at raising income tax revenues have focused on enlarging the tax base and on tightening controls over tax incentives benefiting foreign investment.

Some of these measures, implemented since mid 2009 are already producing results. Income tax receipts in the second half of 2009 of NIS 147 million increased by 58% over the same period in 2008. VAT receipts at NIS 313 million increased by 35% over 2008. Excises on tobacco which are yielding receipts in the same range as the income tax (NIS 145 million during the second half of 2009) also recorded a 73% increase.



Clearance revenue on a commitment basis, which accounts for two thirds of PNA receipts, at $ 306 million in Q4 09, registered a 24% increase over Q4 08, reflecting some weakness in December 2008, with the onset of the Israeli offensive on Gaza[5]. Still, clearance revenues in the second half of 2009 have been very strong, with a 16% increase over the same period in 2008. Comparing Q4 09 to the same quarter in 2008, the strongest gains were achieved by petroleum excises (34% increases to NIS 402 million) which for the first time, exceeded revenues from both customs and VAT, each of which registered a 18% increase. The strong performance in petroleum excises can be attributed to the MoF taking over the Petroleum Authority, and the tightening of the Authority's management. Further progress is expected in this regard.

Deductions from clearance revenue averaged $ 26 million per month during Q4 09, mostly for paying municipal electricity and water bills to Israeli providers. For the year as a whole, accrued clearance revenue were $ 1.1 billion, while what was received in cash was 782million, after deductions (Table 4). Part of the deductions pertained to the withholding, by court order, of NIS 18 million per month, amounting to $ 55 million for the year, to defray possible litigation payments. On the positive side, NIS 10 million in income tax collections from Palestinian workers working in Israel was remitted to the PNA in December 2009, bringing the total for the year to NIS 74.2 million ($19 million, table 5). This is the first time, since 2000, that the GoI has remitted income tax proceeds to the PNA, in response to MoF requests in this regard. On the other hand, the monthly deductions by the GoI are not fully vetted and documented with PNA officials, and often appear arbitrary. Full sharing of information and a more collaborative approach would benefit the clearance process, as well as transparency and accountability.

Non tax revenues are mostly divided in fees and charges and license fees, neither of which is particularly sensitive to economic activity. Fees and charges during Q4 09 of $ 26 million were lower than those obtained in Q3 09 ($ 34 million), but

[5] See Fiscal Developments, Fourth Quarter 2008, March 20, 2009 www.pmof.ps

receipts for the whole year ($ 118 million) were higher than those collected in 2008 ($ 106 million, table 5).

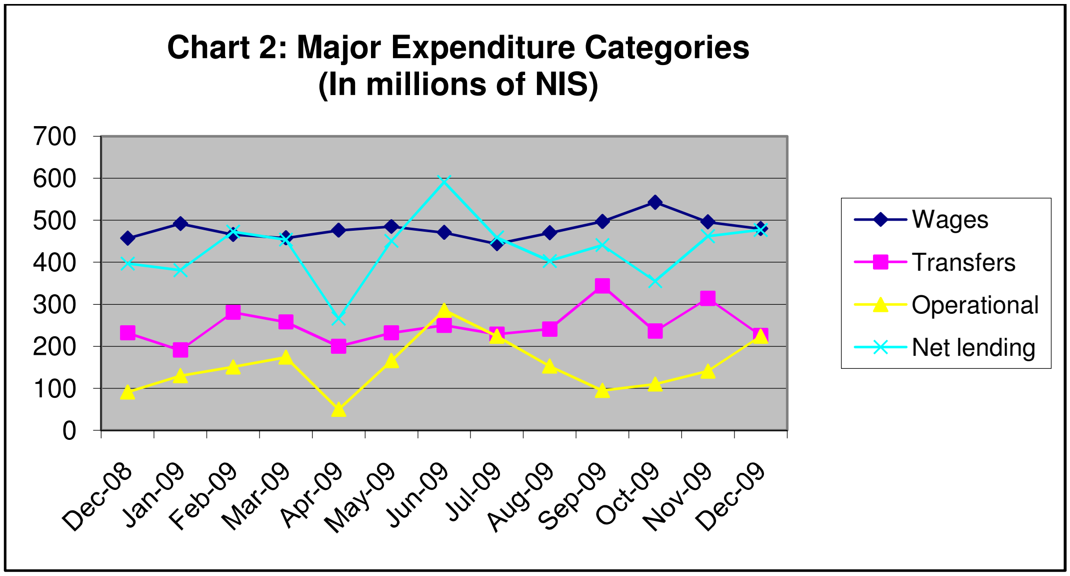
License fees amounted to $ 19 million in Q4 09 and $ 165 million for the year 2009. This included $ 60 million from Jawal and $ 40 million from Zein telecommunication companies. In 2008 license fees amounted to $ 128 million. On the other hand, there was no investment income in 2009, as opposed to a $ 100 million 2009 budget projection and $ 55 million in dividends received in 2008. Lack of dividends in 2009 mostly reflects the fall in PIF portfolio value, following the financial crisis of 2008/09.

Tax refunds in Q4 09 amounted to $ 22.5 million, in line with the quarterly average of $ 22.7 million per quarter. The monthly refunds are divided between the VAT (52%) and refunds of some petroleum excises (48%). For the year 2009, tax refunds were $126 million, well above refund commitments in the budget, which were $ 90 million.

3. Current Expenditures

Total recurrent expenditures in Q4 09 amounted to $ 848 million, on a commitment basis, at about the same level as in Q3 09, when measured in NIS. The major increase over Q3 09 occurred in the wage bill which rose by about 7% over Q3 09. Both non wage expenditures and net lending declined, relative to Q3 09 (Table 1).

For the year 2009 as a whole, total recurrent expenditures amounted to $ 3.19 billon, but included repayment of $ 141 million in 2008 arrears. Excluding these repayments, recurrent expenditures drawn on 2009 budgetary appropriations of $ 3.08 billion, amounted to $ 3.05 billion. The wage bill of $ 1.467 billion exceeded the budget appropriation of $ 1.41billion, but this was entirely due to the compensation provided to PNA employees in September and October 2009 for the interest paid on loans they had incurred in 2006, when the PNA was not able to pay salaries because of the financial boycott imposed on it. This expenditure was not originally budgeted, and was financed in 2009 by savings in other areas.



Non wage expenditures which bore the brunt of emergency spending in Gaza, fell within the amended budget appropriation of $ 1.29 billion

The wage bill in Q4 09 rose from $ 368 million in Q3 09 to $ 403 million in Q4 09. The increase was concentrated in October 2009 ($ 144 million, as opposed to an average monthly payment of $ 122 million in Q3 09), due to the entrance of additional teachers into the payroll, with the onset of the school year, and some spillover of the Interest compensation paid to PNA employees in Q3 09[6]. By December 2009, the wage bill declined to $ 127 million (chart 2).

PNA employment increased from 147,153 at end September 09 to 147,726 by end December 09. The civil service increased by 595 positions, but Gaza employment of 28,717 in December 09, declined by 61 positions since end September 09. Security personnel remained stable at about 63,000.

For the year 2009 as a whole, PNA employment increased by 4789. However, this included 3830 teachers hired between 2006 and 2008 and confirmed into the payroll in 2009. It also included 567 new health employees.

[6] See Fiscal Developments, Third Quarter 2009, P7. www.pmof.psyments

Non wage expenditure in Q4 09 at $ 343 million declined slightly from Q3 09 in NIS terms. For the year 2009, total expenditures of $ 1.349 billion included repayment of $ 141 million in 2008 arrears: $ 53 million for operational spending, $ 66 million for transfers and $ 22 million for small capital expenditures. Actual spending in line with 2009 budgetary appropriations amounted to $ 1.2 billon (Table 2).

Operational expenditures were stable at about $ 126 million in Q4 09. They had peaked in June at about NIS 280 million (Chart 2), with large commitments for medicine and health care after stocks were depleted by the Gaza emergency, and subsequently declined to a monthly average of NIS 158 million in Q4 09 (Table 2).

Transfer expenditures declined from $ 212 million in Q3 09 to $ 206 million in Q4 09. They had peaked in September 09 at NIS 344 million, but declined during Q4 09 to a monthly average of NIS 259 million as some of the early support provided for the Gaza emergency ran its course (chart 2 and table 2).

Net lending declined from $ 115 million in Q3 09 to $ 101 million in Q4 09. Payments by municipalities for electricity bills had risen and the Gaza Electricity Distribution Company has increased its collections (Chart 2).

Development expenditures channeled through the PNA Treasury during Q4 09, were roughly at the same level as in Q3 09 ($ 72 million). This brings the total for the year to $ 215 million, mostly on community projects. Larger infrastructure projects financed directly by donors are estimated at $ 185 million bringing total development spending in 2009 to about $ 400 million. This is a substantial increase over 2008 development expenditures estimated at $ 250 million, and marks a qualitative shift away from government consumption (recurrent spending), towards investment.

The focus on community development projects, in line with the PNA strategy of generating development from the ground up, with the full participation of local residents, has gained traction, both in the pace of execution and in donor financing. While these projects amounted to $ 59 million in 2008 with little donor financing, they reached $ 215 million in 2009, of which $ 205 million were financed by donors[7]. The EU was the largest contributor, at $ 87 million, followed by the UAE ($ 47 million) and the US ($ 31 million)

4. Financing

External budget support received during Q4 09 of $ 284 million, was short of the quarterly requirement for financing the recurrent deficit ($ 362 million). The largest donor was the UAE ($ 149 million) followed by the US ($74.7 million) which disbursed its contribution in December 2009 (Table 7). This was both a timely and substantive transfer, since donor contributions to budget support were falling short of the amended budget deficit ($ 1.45 billion). By end December 2009, $ 1.355 billion were received. The shortfall was financed by raising the PNA indebtedness with commercial banks by $ 176 million.

Budget deficit financing brings the total PNA domestic debt stock by end 2009, to $ 561 million. In addition, the Petroleum Authority's debt with commercial banks at end December 2009 amounted to $ 78 million, bringing total PNA domestic debt to $ 639 million, or 9.6 % of GDP. External debt, which is long term and highly concessional, amounted to $ 359 million at end 2009. Thus, total public debt amounts to 15% of GDP, which is much lower than public debt in neighboring countries and among the broader category of emerging economies.

Payment arrears in 2009 reached about $ 300 million, including those carried over from 2008 ($ 141million). Since the PNA spent more on tax refunds than was committed in the budget and was owed clearance revenues from GoI, net arrears amounted to $ 221 million. The $ 159 million of arrears incurred in 2009 included $ 65 million in non wage arrears, $ 44 million in wage arrears, mostly to the Pension Fund, $ 20 million in net lending arrears and $ 29 million in development expenditure arrears.

It should be mentioned that the average exchange rate for the year at US $ 1 = NIS 3.94 ended up very close to the budget forecast of US S 1 = NIS 4

[7] The remaining $ 10 million were financed by the Treasury.

5. Institutional Developments and Progress in Reforms

1. The 2010 PNA draft budget has been presented to the Council of Ministers on March 8, 2010. It projected a lowering of the fiscal deficit by the equivalent of 4 percentage points of GDP, on a cash basis, and a major reduction in PNA reliance on external budget support.

2. The closed budgetary accounts for 2008 have been submitted to external auditors at the beginning of January 2010. This is the first time that closed budgetary accounts, which have been prepared in line with international auditing standards, have been submitted to independent inspection.

3. MoF is continuing to implement its electronic financial management system, by linking all ministries and agencies accounting networks with the Accounting Department at MoF. With all public procurement electronically linked to MoF, there should be greater control over ministries' commitments and lower accumulation of arrears.
   MoF is also recasting its budget classification to conform to the IMF's Government Financial Statistics (GFS)

4. In January 2010 in a document entitled "Palestine: Moving Forward", the Ministry of Planning has articulated priority interventions in institution building and development for 2010. This is the last year of the PRDP and will serve as a transition to the second Palestinian three year plan for 2011-13, consistent with the two year program outlined in Palestine: Ending the occupation, establishing the State.

5. The implementing regulations of the Electricity Law have been approved by the Council of Ministers (December 2009) and by the President (Jan 2010).

The Palestinian Energy and Regulatory Commission will be chaired by the head of the Energy Authority for a period of one year. A new electricity tariff scale is being designed by the Energy Authority, with the objective of protecting vulnerable groups, while aiming towards overall profitability. Electricity distribution companies are being licensed to operate on a commercial basis in electricity distribution and sales. The Northern Electricity Distribution Company is being established and will begin distributing electricity during the second half of 2010. The Energy Authority has also installed 156,000 prepaid meters and has tendered to procure 130,000 more.

6. An Action Plan for initial steps in public pension reform has been submitted to the Prime Minister's Office. The Plan aims at reducing short term pension liabilities while moving towards long term sustainability. It is expected to be discussed with various stakeholders over the next few months, pending approval.

7. The Ministry of Social Affairs together with the World Bank and the European Commission have been integrating their data bases and unifying their targeting criteria for social safety net eligibility. The cash assistance programs s merged and widened, and are expected to cost $ 15 million more for the broader coverage of vulnerable people.