Palestinian National Authority

Ministry of Finance

Fiscal Developments

Third Quarter 2010 Report (Final Draft)

November 3, 2010

Fiscal Developments during the third quarter, 2010(Q3 10).

Budget execution highlights:

- The current budget deficit at the end of Q3 10 is slightly above the budget target, but projections for the full year indicate that budgetary operations can remain within the budget ceilings.

- Domestic tax collection efforts continue to be on track to meet budget target. The shortfall in clearance revenue remains; however non tax revenue has shown a significant increase but still remains below budget target.

- The wage bill is largely on track with budget targets, except for a $ 30 million overage (1.9% of the wage bill) due to allowances not foreseen in the budget and exchange rate depreciation.

- Non wage expenditures remain below pro-rata budgetary appropriations. Provided transfers and operational expenditures during the last quarter of the year do not exceed an 11% increase over their spending level in the current quarter, savings obtained would offset revenue shortfalls and keep the budget on track.

- “Net lending” continues to reduce and is expected to meet the budget target. Electricity services provided by Nablus and Jenin governorates switching to the new electricity provider NEDCO will enhance the collecting process of bills and therefore decrease the net lending expenditure.

- Payment arrears to the private sector have continued to accumulate to $ 88 million during Q3 10, due to a large external financing shortfall. This remains of concern, as arrears to the private sector undermine PNA credibility and budget execution control, an issue which needs to be addressed.

- The external budget support at the end of Q3 10 is only 56% of annual budget requirement, representing a significant shortfall. This can mostly be attributed to a drop in regional budget support. Unless there is a strong pick up, the external financing gap could reach $ 300 million at year end.

1. Revenue

Gross PNA revenue, amounting to $ 526 million in Q3 10, represents a 13.6% increase over Q2 10 collections ~~($ 463 million,~~ tables 1 and 5). The first half of the year is usually marked by large income tax payments which benefit from a discount when paid early. Moreover, it also benefited from the administrative reform effort deployed during that quarter and the second half of 2009 in collecting domestic taxes[1].When measured against Q3 09, gross PNA revenues decreased during Q3 10 by 4.1%.[2].

While domestic tax revenue continues to exceed budget expectations, overall revenue may incur about a $ 45 million shortfall due to a continuing shortfall in non tax revenue ($ 70 million). However, this shortfall maybe reduced if the flow of commercial goods to Gaza increases significantly, following the partial lifting of the siege (shift to a negative list) and, if the MoF revenue department succeeds in collecting invoices for these goods, allowing for documented claims of indirect tax receipts at the monthly clearance sessions.

- **Domestic tax revenue** in Q3 10 rebounded to $ 116 million, to near the peak it had reached in Q1 10 of $ 117 million[3] and also showed an increase of 38% over Q3 09 (table 5). The income tax payments normally accrue early in the year. In 2010, income taxes amounted to $45 million in Q1 10(the highest level attained on record) and fell to $ 22 million in Q2 10, but have surged to $ 38 million in Q3 10 due to timing of payments. Domestic VAT also increased slightly (from $40 million in Q2 10 to $ 42 million in Q3 10) and excises on tobacco have also increased from $ 21 million in Q2 10 to $ 22 million in Q3 10.Customs duties have declined marginally.

[1] .See Fiscal Developments, First Quarter 2010, May 9, 2010. See www.pmof.ps

[2]. All changes over time are measured in NIS terms

[3] .Q2 10 the domestic tax revenue was $102 millions.

Domestic tax revenue could exceed the budget target of $ 377 million for 2010 by about $ 68 million if the current trends continue in Q4 10.

- **Non tax revenue.** Domestic fees and charges fell to $ 51.0 million in Q3 10, a 15 % decrease from Q2 10. The decrease reflected non recurrence of one off receipts in June 2010 of $ 10.0 million in license fees from a telecommunication company and $ 7.3 million, from exit taxes paid by Palestinians at the Allenby Bridge[4] (table 5).

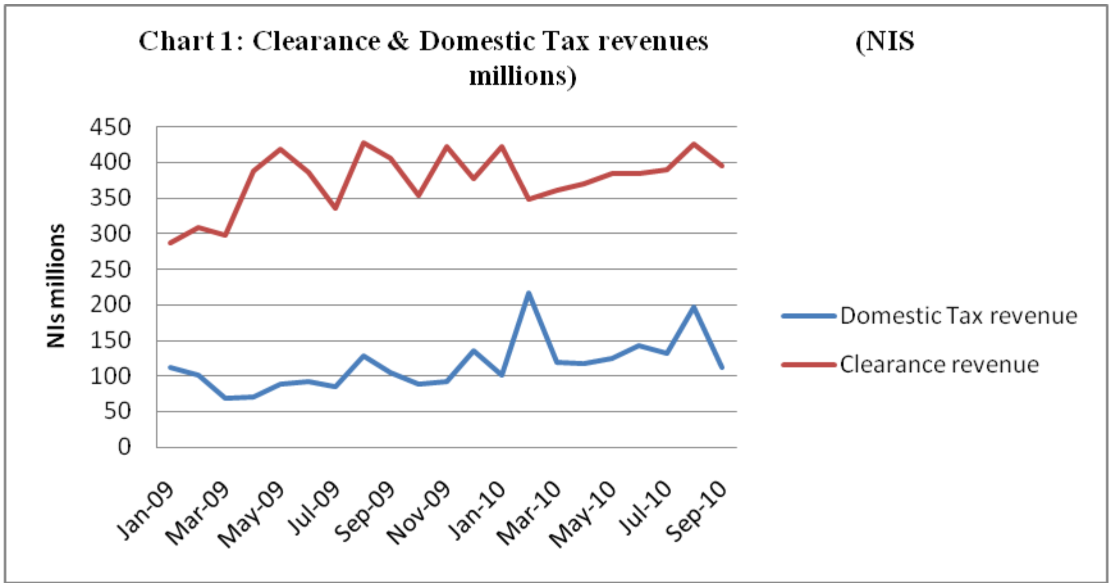
  In August 2010, $ 40 million were transferred to the PNA as dividends from the PIF. Overall, there may be a $ 45 million shortfall in non tax receipts relative to the budget target. Moreover, due to the cancellation of the communication agreement between Jawwal and Zein a refund of the advance payment of the amount $ 100 million must be done by the PNA which will decrease the expectations of the non-tax revenues.

- **Tax refunds** have been running at about $ 5 million per month during Q3 10 ($ 16 million), a slight increase from the previous quarter ($ 12.5 million). While tax refunds may not fully recover by year end, unless a sharp increase in external financing takes place. Any shortfall in tax refunds in 2010 will only be translated into higher tax refunds arrears in 2011.

- **Clearance revenue.** This revenue increased by 6% in Q3 10, over the Q2 10 figure (tables 1 and 5). Monthly monitoring of clearance revenue from the three major tax components, reveal some pickup in total revenues over the last three months and may indicate a strengthening in economic activity during Q3 10[5].Compared to Q3 09, the clearance revenue increased by 6.3%

[4]. These exit taxes are collected by the Israeli authorities and shared (by half) with the PNA. However, they are not remitted on a systematic basis and a transfer mechanism needs to be established. The previous (and only payment since the Intifada) of $ 5.3 million was received in April 2009 for 2008.

[5]. Monthly Clearance session rethports, MoF.



Expenditures and net lending

Total PNA expenditure and net lending of $ 790 million (on a commitment basis) during Q3 10 were effectively the same as Q2 10 ($ 796 million). When projected on an annual basis ($ 3.11 billion), total recurrent expenditures and net lending would fall slightly below the budgetary target ($ 3.17billion)

- **The PNA wage bill** on a commitment basis in Q3 10 of $ 401 million was slightly higher than during the previous quarter ($ 390 million). At the beginning of 2010, there was a change in budget classification in line with the IMF's Government Financial Statistics[6] which reduces the wage bill by about $ 9 million on an annual basis. Comparing Q3 10 to Q3 09, after adjusting for the change in budget classification, there was a 5.1% increase. This was in line with what was programmed in the budget, which was predicated on a 6% salary increase, including the 4% cost of living allowance granted for 2010, and a 2% increase in employment.

[6]This entailed taking out the transportation allowance from the wage bill ($ 43.5 million in 2009) and reclassifying it under operational expenditures. At the same time, contractual employees ($ 34.7 million) were taken out of transfer expenditures and reclassified under wages.

Projecting the wage bill for the full year 2010, results in a$ 1.58 billion wage bill, exceeding the budget target by 1.9% ($ 32 million).There are several reasons for this overage detailed in the Q2 10 report.

Wage expenditure in cash (tables 3 and 4) in Q3 10 of $ 376 million falls short of commitments by about $ 25 million. Wage arrears do not affect disbursements of monthly salaries to PNA employees. Instead, they essentially impact on the transfer of pension deductions (the employee share) to the Pension Fund and deductions owed to third parties. Substantial arrears to the Pension Fund were carried forward from 2009.

Overall **Employment in the PNA** remained static in Q3 10, consistent with the PRDP fiscal retrenchment guidelines.

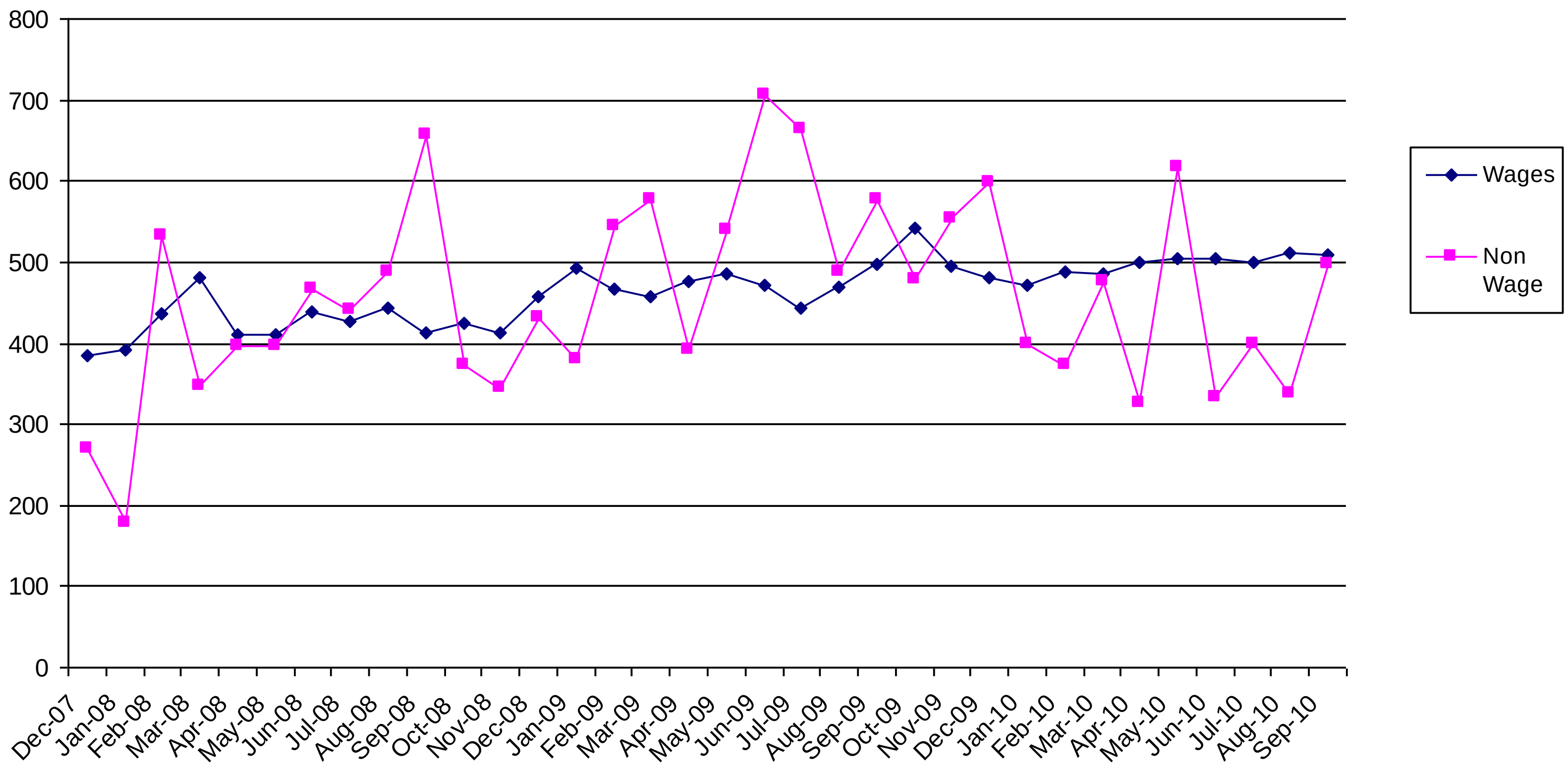
- **Non wage expenditures** of $ 326 million in Q3 10, on a commitment basis, show a decrease of 3.5%on Q2 10, with a decrease of $ 13 million occurring under "transfers" (tables 1 and 2)[7].

Projections of non wage expenditure for the full year, based on current trends, would indicate that this spending may fall below the budget target of $ 1.37 billion by about $ 100 million. It is essential that this spending restraint takes place so as to make up for the projected shortfalls in revenue.

Non wage expenditure in cash (tables 3 and 4) in Q3 10 of $ 237 million was lower than commitments by $ 88 million, with payment arrears mostly affecting the government contribution to the Pension Fund, as well as some arrears to private sector suppliers.

[7] The change in budget classification raised non wage expenditures by $ 9 million on an annual basis

Chart 2: Wage and Other Current Expenditure 2008-10
(In millions of NIS)



- **Operational expenditures** of $ 125 million in Q3 10 (table 2) increased marginally relative to Q2 10 ($ 121 million) but relative to Q3 09[8]showed a substantial decrease of 30%.

  The PNA has adopted a policy to continue decreasing operational expenditure over the remainder of the budget year by measures such as withdrawing car privileges. Following implementation of these measures, projected operational expenditures on an annual basis would result in savings of about $ 40 million relative to the budget appropriation.

- **Transfers** in Q3 10 of $ 196 million were slightly lower than in Q2 10($ 209 million, table 2) and 17.6% lower than Q3 09 ($ 238 million). The largest item in this category in Q3 10 is the PNA pension payments ($ 46 million) followed by pension obligations to the Pension Fund ($ 38 million), social allowances ($ 16 million). This decline is due to some expenditures that are not presented in the commitment reports which only can be measured when paid (such as the road tickets paid by the public, in which 50% of these revenues is paid to the municipalities support). Moreover, the amount of arrears signed to be paid to the pension fund.

  Projections for the second half of 2010 are $400 million based on maintaining the third quarter expenditure level without any increase. For the full year 2010, transfers are projected at about $ 780 million, a $ 33 million saving from the budget target.

- **Minor capital** expenditure dropped back to about $ 5 million in Q3 10 from the level in Q2 10 ($ 8 million). This was the result of PNA decision to cut back on this spending category, given the shortfall in external budget support. It is not expected that this spending will exceed $ 5 million in Q4 10. This may result in a $ 23 million saving with respect to the budget, but also a pent up demand for items under this category in 2011.

- **Net Lending** expenditure of $ 62 million in Q3 10 continues to decline from the previous quarter ($ 68 million). Compared to Q3 09, there was a $ 27 million, or 22%, reduction. Considering that a declining trend in "net

[8] After adjustment for change in budget classification

lending" has been firmly established, MoF expects that its budget appropriation of $ 250 million for 2010 will be met; as a practical step **starting October 1, 2010 the PNA has stopped the fuel supply to Gaza Power Station after all its' Fuel bills were paid by the distribution companies.**

Substantial progress continues in reducing utility subsidies to municipalities and delinquent consumers. These measures were described in the Q2 10 Report.

- **Development expenditure financing** channeled through the PNA treasury increased substantially to $ 134 million in Q3 10, a 94 % increase on Q2 ($ 69 million). This increase reflects realization in cash of commitments previously made in the first half of the year. Much of this spending ($ 43 million, table 6b) went to security infrastructure (bases, training centers), on community development projects ($ 15 million), infrastructure development ($ 5 million) and economic development ($ 11 million).

However, external financing for these development projects fell short of actual commitments. The full commitment for development projects for 2010 is $ 670 million but to date only $ 41 million has been received with $17 million in Q3 10. This gap continues to reflect timing issues: spending commitments were effected with the expectation that their financing will be forthcoming and delays were incurred in the disbursement

3. Budget Support Financing

The recurrent fiscal deficit in Q3 10 of $ 280 million was considerably lower than in Q2 10 by $ 67million largely due to decisions regarding expenditure constraint. Under the current policy of expenditure restraint the fiscal deficit is projected to be slightly under the budget target of $ 1243 million.

- **Financing** of the budget deficit in Q3 10 through external budget support amounted to $ 178 million, substantial decline from the support received in Q2 10 ($ 318 million, table 7). This remains of particular concern, considering that some western donors (PEGASE, Norway, UK, and USA) had front loaded their budget support following PNA request. Regional contributed $ 110 million during the first half of 2010 (including Kuwait's $ 50 million contribution to the Trust Fund). This is about 20% of total budget support during this period, whereas the regional countries contribution to budget support has fluctuated in the 30- 44 % range over the last three years.

- At the end of Q3 10 budget support financing gap stood at $ 540 million.
- In Q3 10 net borrowing from the banking system of $ 89 million has raised the public debt to commercial banks to $ 875 million (table 8). In Q3 10 also an increase in the accumulation of arrears ($ 155 million) tookplace, major items are to the Pension Fund ($ 25 million), development expenditures ($ 40 million) and non wage expenditure ($ 88 million).

Institutional developments

Capacity building and reform initiatives continue within the Ministry of Finance. Of particular note in Q3 10 are:

- **Implementation of Budget Preparation Module in Bisan computing environment.** The Budget Directorate has successfully introduced a Budget Preparation Module (BPM) for preparation of the 2011 budget which allows Ministries to enter budget request details in Program format following determination of Ministry level budget ceilings by Ministry of Finance. Budget development is also based on a revised Budget Classification Structure (BCS) developed in the first half of 2010. The BPM will not allow Ministry detailed budget proposals in excess of the budget ceiling and also develops the Forward Year estimates automatically, based on economic parameters developed by the Budget Directorate consistent with the macroeconomic framework. The BPM is also interfaced to the FMIS, for transfer of budget ceilings once the preparation process is finalized and the budget is approved.
- The **Purchasing Module** within the FMIS has now been made operational, thereby providing greater control over the commitment process for expenditure. The objective of this reform initiative is to ensure that there are

sufficient funds available and reserved before contractual obligations are incurred.

- **The Human Resource and Wage System** is being redeveloped within the Ministry of Finance systems to be implemented on 1 January 2011. The objective of the redevelopment is standardize data on employment across Ministries, provide line ministries with greater control of employee hiring and to reduce the hiring cycle from the current 6 – 12 months to 45 days.