Palestinian National Authority

Ministry of Finance

Macro-Fiscal Unit

Fiscal Developments:

Fourth Quarter Report

and

Review of 2010 Performance

Feb 5, 2011

1. Summary and overview

FY 2010 summary and Overview:

The PNA recurrent deficit on a commitment basis in 2010 amounted to $ 1.15 billion, substantially lower than the $ 1.6 billion recorded in 2009 (Table 1). Total deficit was $ 1.45 billion after adding the development expenditures. Total financial support from donors amounted to $ 1.28 billion; substantially lower than the amended total budget deficit ($ 1.91 billion) (tables 1 and 7) [1].

Total recurrent expenditures in 2010, at $ 3.08 billion, included the payment of $ 130 million of arrears (outstanding purchase orders) carried over from 2009 (Table 1). Excluding these arrears, 2010 expenditures of $ 2.95 billion were kept below the amended budget appropriation ($ 3.17 billion) because of the strong control of expenditure, especially with respect to employment and wage increases.

It is worth mentioning the significant Budget target items during the FY 2010; Clearance revenues fell behind the budget target by 5%[2] on a commitment basis. Domestic Tax revenues amounted $ 474 million were significantly higher than the budget target by 26%. Finally, Wage Bill was higher than the budget target by 4% and amounted to $ 1.613 billion.

Second Half summary and Overview:

Looking at the second half of 2010, the recurrent deficit at $ 548 million was lower than the deficit incurred during the first half ($ 601 million). Particularly significant during the second half were: the 9% increase in clearance revenues, the 55% increase in Non-tax revenues, the 26% increase in tax refunds, the 22% increase in operational expenditure, the 80% increase in development expenditures of and the significant increase of the minor capital of 112%. Net lending decreased by 35% in the second half in comparison with the first half of the year.

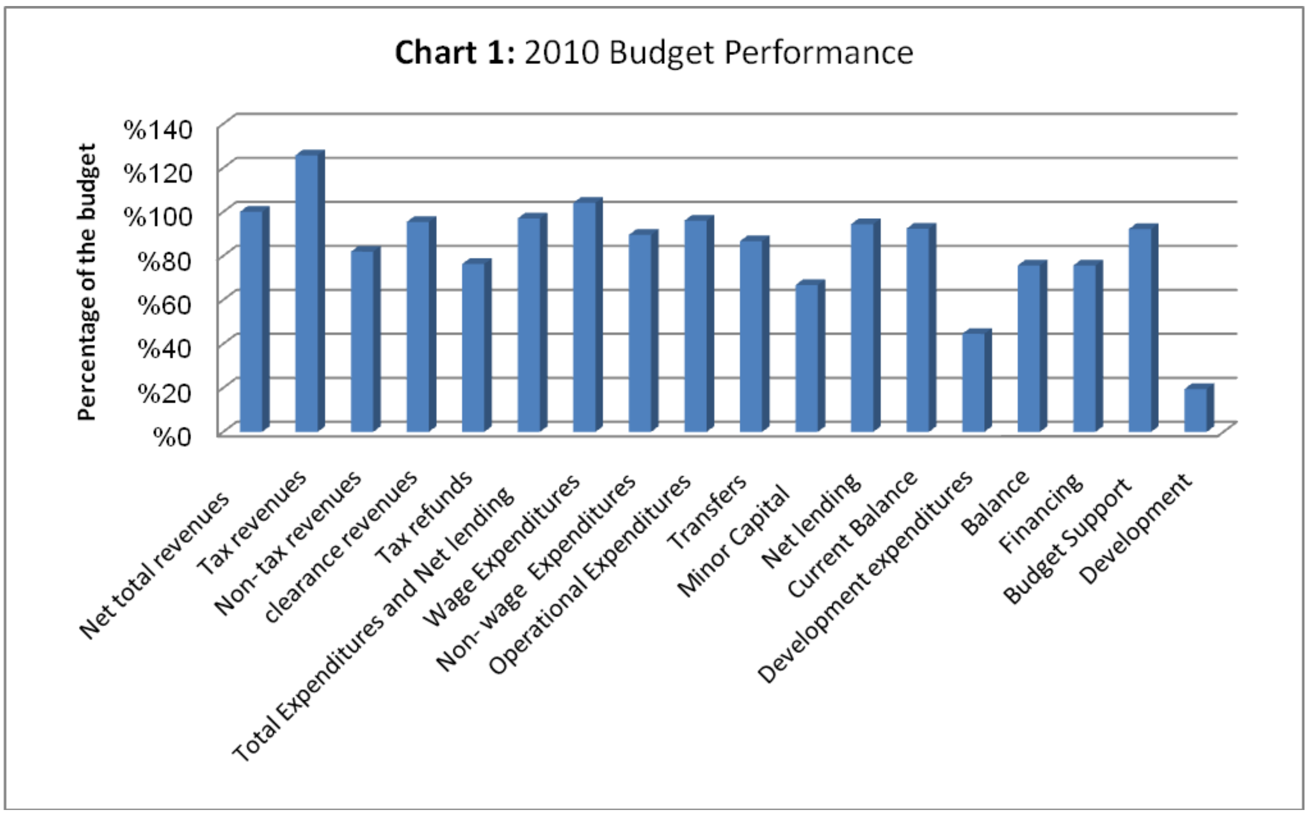
[1] Tables are in reference to the fiscal tables on the website www.pmof.ps

[2] Percentage changes are In reference to the summary figure in Page 4 of this report

Fourth Quarter summary and Overview:

The recurrent deficit in Q4 2010 on a commitment basis, at $ 331 million, was higher than the deficit in Q3 2010 of $ 217 million by 35%, mostly due to a 3% increase in the wage bill and 16% increase in the Non- Wage expenditures partly reflecting a 5% depreciation in the US dollar (Table 1). Clearance revenues ($ 336 million) increased by 5% over Q3 2010, while domestic tax revenues showed a decrease of 10% over Q3 2010. Net lending declined from $ 50 million in Q3 10 to $ 43 million in Q4 10. Tax refunds in Q4 2010 showed an increase of 48% over Q3 2010.

External budget support received during the first nine months of the year, averaged $ 234 million per quarter, which is lower than the quarterly level of external budget support required to meet the budget deficit in 2010 of $ 1.24 billion. In Q4 2010, external budget support of $ 443 million was received, leaving the gap between the budget deficit and financing around $ 97 million which was financed from Domestic Banks.



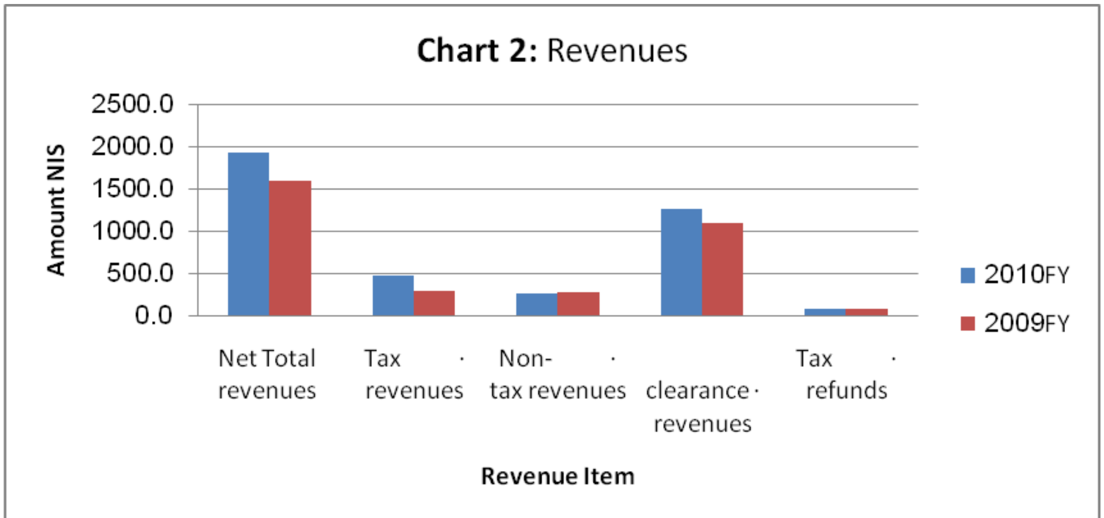
Consolidated Fiscal Operation Analysis of the FY 2010 on commitment Basis

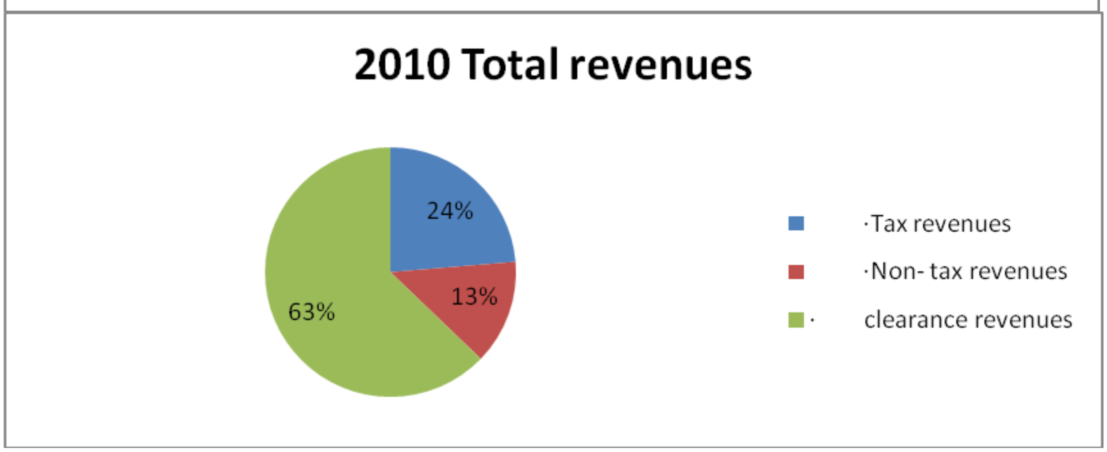
Budget Classification	Q4 2010	% Change on Q3 2010	Second Half 2010	% Change on the First Half 2010	FY 2010	% Change on FY 2009	FY 2010 Approved Budget	FY 2010 as % Budget
	$ m	%	$ m	%	$ m	%	$ m	%
Net total revenues	472.7	-11%	997.0	7%	*1927*	21%	1927	100%
· Tax revenues	104.9	-10%	220.3	-13%	474	57%	377	126%
· Non- tax revenues	59.5	-76%	164.2	55%	*270*	-5%	330	82%
· clearance revenues	336.2	5%	655.1	9%	*1259*	9%	1320	95%
· Tax refunds	27.9	48%	42.6	26%	*76*	-16%	100	76%
Total Expenditures and Net lending	803.7	8%	1544.7	1%	3076	-4%	3170	97%
· Wage Expenditures	413.6	3%	814.8	2%	1613	10%	1550	104%
· Non- wage Expenditures	346.7	16%	637.0	8%	1226	-9%	1370	90%
- Operational Expenditures	161	32%	271.0	22%	*493.4*	6%	514	96%
- Transfers	170	-4%	346.5	-3%	705	-15%	813	87%
- Minor Capital	15	73%	19.5	112%	29	-47%	43	67%
· Net lending	43.4	-14%	92.9	-35%	*236*	-37%	250	94%
Current Balance	-331.0	35%	-547.7	-9%	-1148.6	-28%	-1243	92%
· Development expenditures	95.4	-1%	192.0	80%	298.5	39%	670	45%
Balance	-426.4	27%	-739.6	5%	-1447.2	-20%	-1913	76%
Financing	426.4	27%	739.6	5%	1447.2	-20%	1913	76%
· Budget Support	443.4	60%	621.3	18%	1146.0	-15%	1243	92%
· Development	50.4	47%	77.2	45%	130.5	179%	670	19%
Net Domestic Bank Financing[3]	-36.6	294%	3.6	-96%	83.5	-53%	------	-----
Residual	-15.8	-----	1.6	-------	-10.6	------	------	-----

[3] This item includes the PNA indebtedness to commercial banks as well as the donor's money in the domestic bank accounts.

2. Revenue

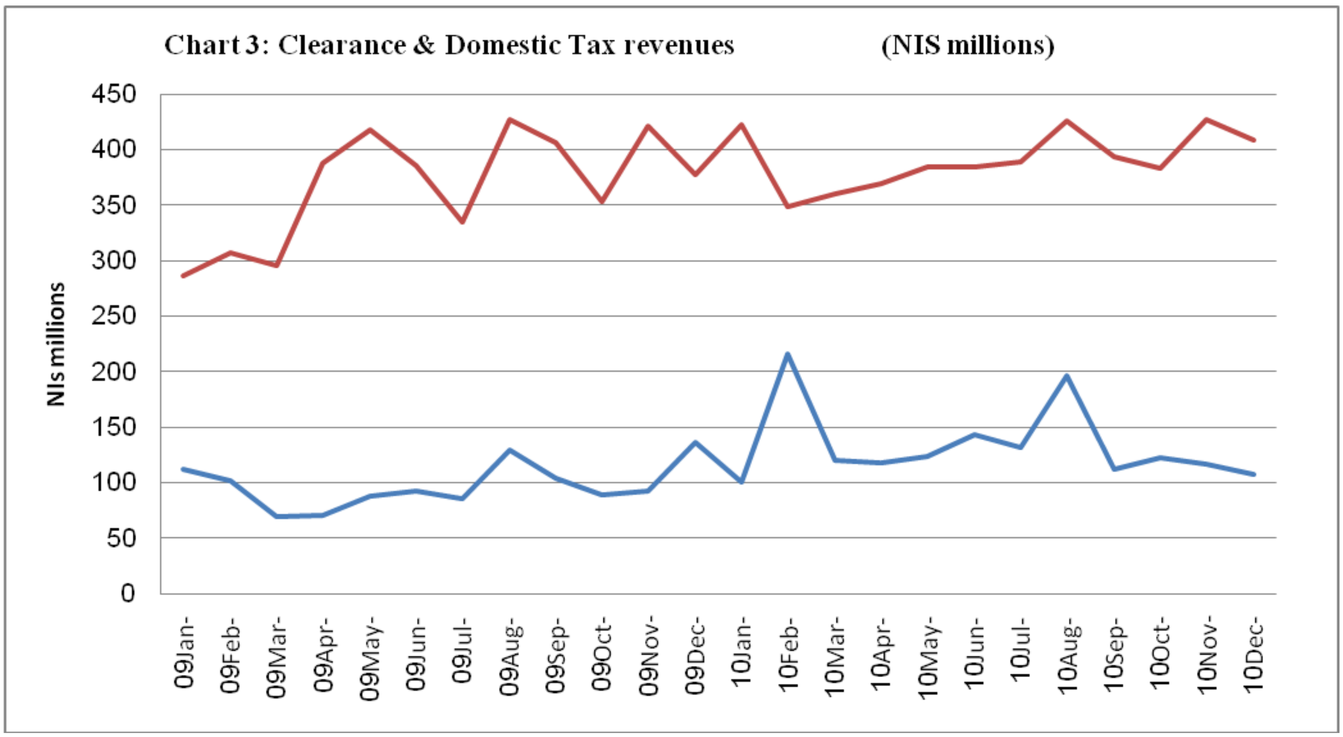
Net PNA revenue of $ 472 million during the Q4 2010 increased by 16% over Q4 09 in NIS terms. For the year 2010 as a whole, with PNA net revenue reaching $ 1.93 billion (which is 28% of the estimated GDP), there was a 21% rise over 2009 revenue, due to reforms in domestic tax administration and robust economic growth. The estimated real economic growth achieved in 2010 was 9% while the nominal growth rate was between 11%. PNA gross revenues exceed the $ 2 billion for the first time, even though the clearance revenues and non-tax revenues fell short of the budget target by $ 60 million and $ 90 million respectively.





Domestic tax receipts have been particularly strong since August 2009, with administrative reforms, benefiting the income and value added taxes as well as excises (see chart 1). The objective of the Palestinian tax administration is to raise income tax receipts from their 1.5% in 2009 GDP ratio to the 5-6% GDP ratio prevailing in neighboring countries. In 2010 the income tax was 2% of the GDP, the low income tax proceeds in Palestine, relative to neighboring countries, resulted from the 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 continuing to produce results. Tax revenues for 2010 amounted to $ 474 million and were 26% above the target budget. Income tax receipts in the second half of 2010 of $ 211 million increased by 49% over the same period in 2009. VAT receipts at $ 156 million increased by 7% over 2009. Excises on tobacco amounted $ 28 million during the Q4 10 showed a 15% increase over Q3 10, as for the whole year Excises on tobacco amounted $ 82 million.



Clearance revenue on a commitment basis, which accounts for 60% of PNA receipts, at $ 336 million in Q4 10, registered a 6% increase over Q4 09 in NIS; Still clearance revenues in the second half of 2010 have been very strong, with a 5% increase over the same period in 2009 and an increase of 7% over the first half of 2010. Comparing full year of 2010 to the full year 2009, an 8% increase was achieved, the strongest gains were achieved by petroleum excises (15% increases in NIS) which exceeded revenues from customs and in some periods it also exceeded the VAT.

Both VAT and customs revenues registered a 7% increase in 2010 compared to 2009. 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. Still the clearance revenues is not moving in parallel with the nominal growth rate due to the resulted from the economic restrictions which the GoI has imposed on the Palestinian territory and lack of communication between the PNA and the GoI in the collection process.

Deductions from clearance revenue averaged $ 20 million per month during Q4 10, mostly for paying municipal electricity and water bills to Israeli providers. For the year as a whole, accrued clearance revenue were $ 1.26 billion, while what was received in cash was around $ 1.01 billion, after deductions (Table 4). Part of the deductions pertained to the withholding, by court amounting to $ 25 million for the year, to defray expected litigation payments. As well as the deductions for paying municipal electricity and water bills to Israeli providers amounted around $ 240 million for the whole year.

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 2010 of $ 26 million were lower than those obtained in Q3 2010 ($ 34 million), but receipts for the whole year ($ 118 million) were higher than those collected in 2009 ($ 106 million, table 5).

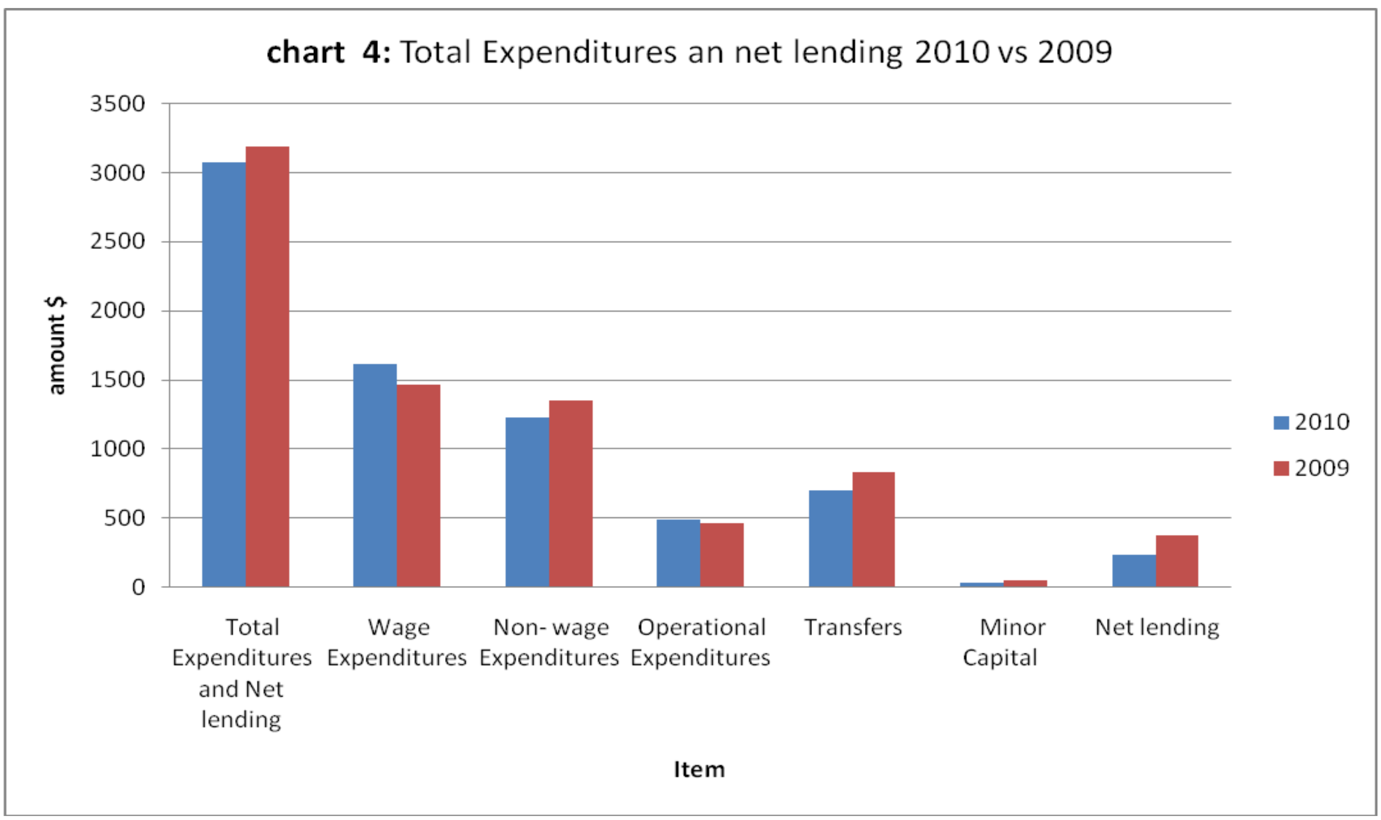
License fees amounted $ 11 million in Q4 10 and $ 34 million for the year 2010. The reason behind this low amount for license fee is the agreement done between the PNA and Jawwal and Zein telecommunication companies in August, 2010 to refund the $ 100 million prepayment made in 2009 for the merging agreement between the two companies which was subsequently cancelled, by deducting the $ 70 million from the 2010-2012 license fees, and by allocating $ 30 million to the 3G service fees. On the other hand, there was $ 40 million investment income from the Palestinian investment fund (PIF) received in 2010, as opposed to 2009 when there wasn't any investment income received.

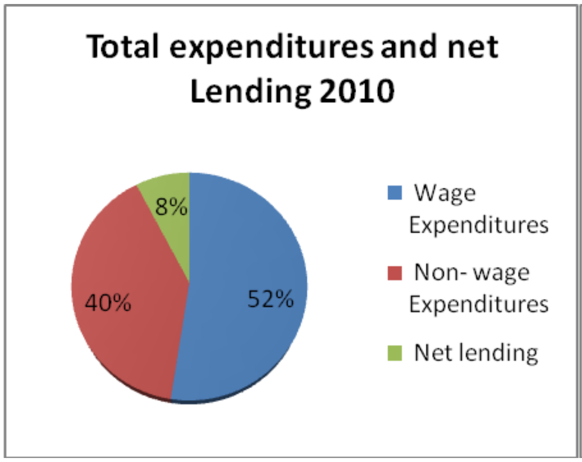
Tax refunds in Q4 10 amounted to $ 28 million was higher than the quarterly average of $ 16.1 million per quarter due to the availability of funds after the strong pick up in external financing that took place in October 2010. The monthly refunds are divided between the VAT (28%), refunds of some petroleum excises (68%) and refunds of Customs (4%). For the year 2010, tax refunds were $76 million, which was below the $100 million in refunds projected in the budget.

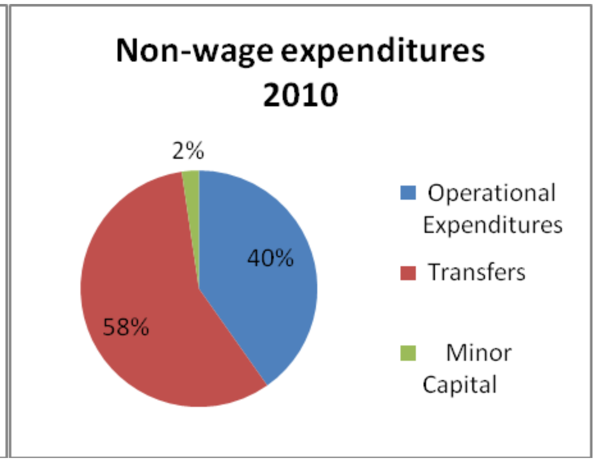
3. Current Expenditures

Total recurrent expenditures in Q4 2010 amounted to $ 808 million, on a commitment basis, with a 8% increase over Q3 10. The major increase over Q3 10 occurred in the non-wage expenditures which rose by about 16% over Q3 10 due to the massive increase in minor capital and operational expenditures by 73% and 32% respectively (Table 1). Wage bill showed an increase of 3% in Q4 2010 over Q3 2010.

For the year 2010 as a whole, recurrent expenditures have been tightly controlled. Showed Total recurrent expenditures amounted to $ 3.08 billon, (which included repayment of $ 130 million in 2009 arrears), which is 4% decrease over 2009 expenditure. Excluding these repayments, recurrent expenditures drawn on 2010 budgetary appropriations of $ 3.17 billion, amounted to $ 2.95 billion. The wage bill of $ 1.613 billion exceeded the budget appropriation of $ 1.55 billion, but this was entirely due to the unforeseen allowances paid to health and education employees in February, September and December 2010. Non wage expenditures amounted to $ 1.23 billion and were below the budget target by 10% which was $ 1.37billion.







The wage bill in Q4 2010 rose from $ 401 million in Q3 10 to $ 414 million in Q4 10. The increase was concentrated in December 2010 due to the entrance of additional teachers into the payroll which raised the civil servants wage bill by $ 1 million, and also due to the unforeseen allowances that amounted to $1.5 million for ministry of education employees, as well as the payment of some wage arrears in October 2010. **Employment** increases during 2010 (3317 additional hires) remained within the PRDP guidelines for limiting the growth of public employment

Non wage expenditure in Q4 2010 at $ 347 million was higher than Q3 2010 by 16%. This is due to the payment of some arrears or late payment to suppliers after the strong pick up in external financing which took place in October. For the year 2010, total expenditures of $ 1.226 billion which decreased by 4% over FY 2009 with the winding down of Gaza emergency expenditures, even though, about $ 100 million have become embedded into the budget due to higher allowances for unemployment, poverty and temporary shelter.

Operational expenditures in Q4 10 ($ 161 million) were significantly higher by 32% than Q3 2010. They had peaked in November at about $ 64 million (Chart 2). To pay previous commitments made in the third quarter to suppliers after the shortfall in external financing in that period.

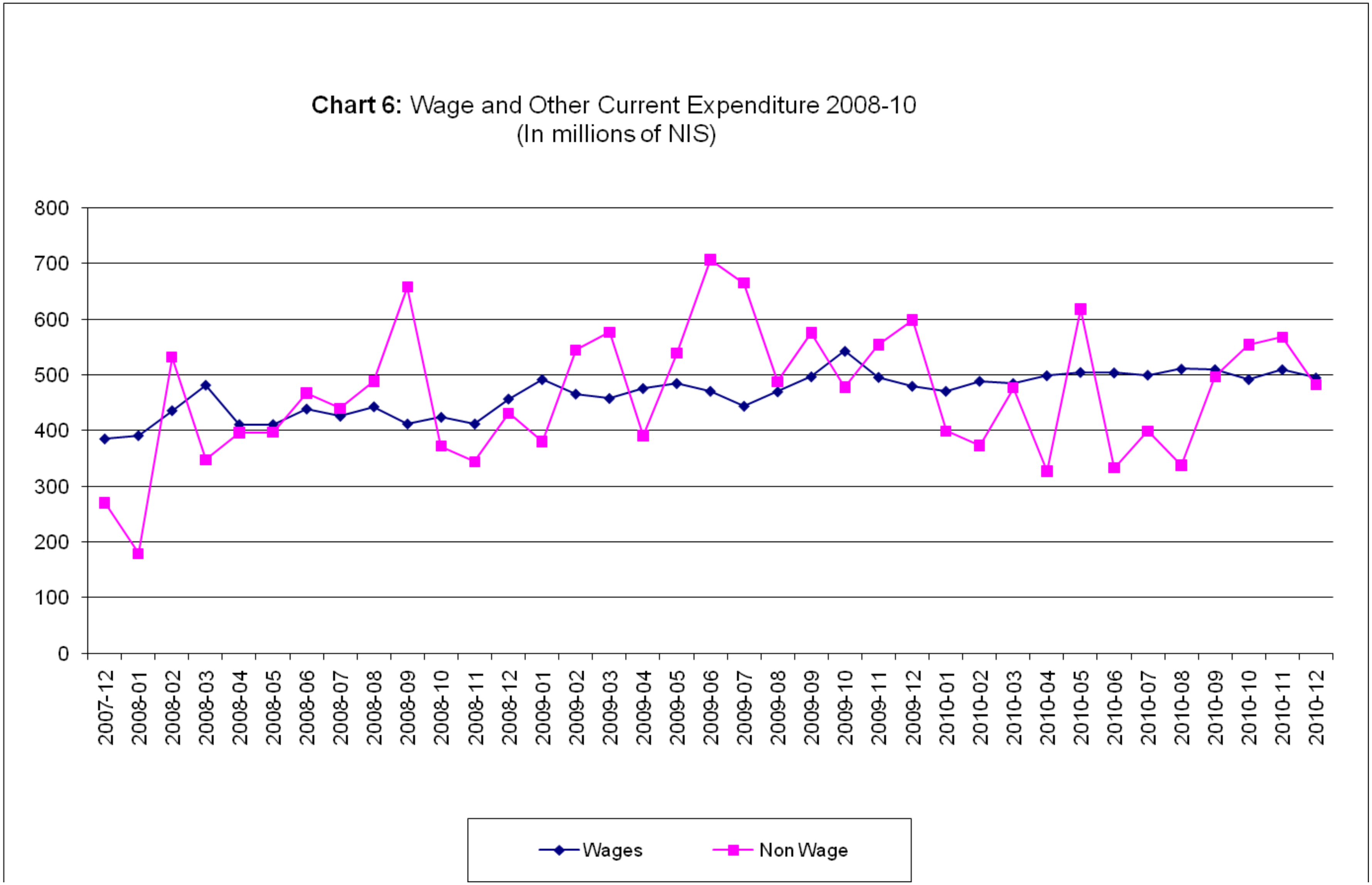


Chart 6: Wage and Other Current Expenditure 2008-10
(In millions of NIS)
800
700
600
500
400
300
200
100
0
2007-12
2008-01
2008-02
2008-03
2008-04
2008-05
2008-06
2008-07
2008-08
2008-09
2008-10
2008-11
2008-12
2009-01
2009-02
2009-03
2009-04
2009-05
2009-06
2009-07
2009-08
2009-09
2009-10
2009-11
2009-12
2010-01
2010-02
2010-03
2010-04
2010-05
2010-06
2010-07
2010-08
2010-09
2010-10
2010-11
2010-12
Wages
Non Wage

Transfer expenditures declined from $ 176 million in Q3 10 to $ 170 million in Q4 10. They had peaked in May at $ 90 million, but declined during Q4 10 to a monthly average of $ 57 million (table 2). The largest items in this category during 2010 are: social allowances ($ 219 million), the PNA pension payments ($ 212 million) followed by payment pension obligations to the Pension Fund ($ 176 million).

Net lending declined from $ 50 million in Q3 10 to $ 43 million in Q4 10. Following our policy of phasing out the electricity subsidies to local governments, net lending for 2010 amounted to $ 236 million, a 37% reduction from net lending in 2009. Substantial progress was made in reducing this electricity subsidy in the West Bank by gradually shifting bill collection to NEDCO. Both Nablus and Jenin municipalities no longer collect electricity bills from subscribers, shifting this task to NEDCO, which pays the supplier (IEC) directly. It was expected that the Gaza Electricity Distribution Company, which collects bill payments from consumers, would start purchasing fuel from its bill payments proceeds, to maintain the same electricity supply level[4]. The last payment for this fuel by MoF was made in September 2010.

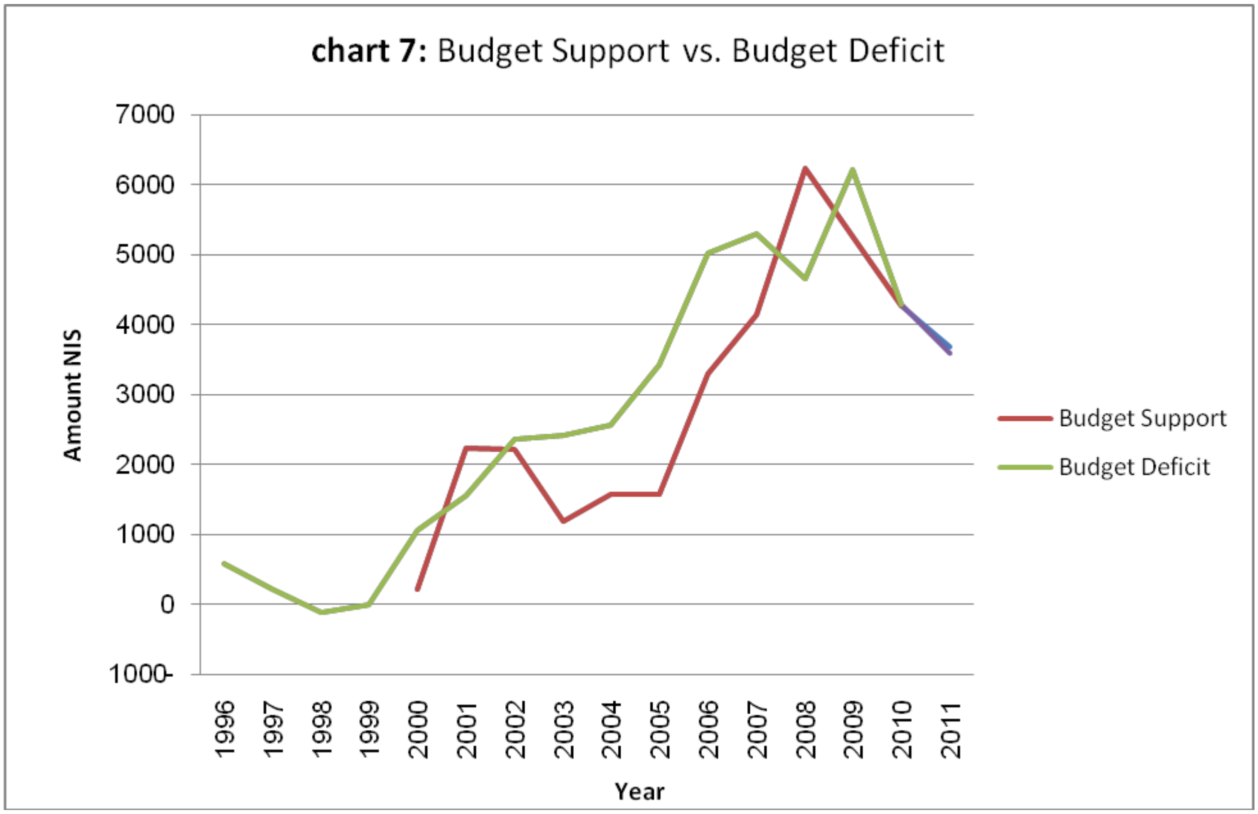
Development expenditures channeled through the PNA Treasury during Q4 10, were roughly at the same level as in Q3 10 ($ 96 million). Development expenditures channeled through the Treasury amounted to $ 298 million for 2010, a major increase over development spending achieved in 2009 ($ 215 million). However, part of the increase is due to larger donor financing through the Treasury, than was the case in previous years. Overall, it is likely that total development expenditures in 2010, including those disbursed directly by donors, may reach $ 450 million, exceeding last year's level of $ 400 million.

4. Financing

The overall fiscal deficit of $ 1.48 billion was mostly financed by donor countries through budget support ($ 1.15 billion) and development funding directly and through the treasury (estimated at $ 330 million). External budget support received during the first nine months of the year, averaged $ 234 million per quarter, which is lower than the quarterly level of external budget support required to meet the budget deficit in 2010 of $ 1.24 billion. In Q4 2010, external

[4] See First Quarter 2010 Report on fiscal developments, for details on the sliding scale www.pmof.ps

budget support of $ 443 million was received which is a 60% increase over Q3 2010. The largest contributions from the donors for 2010 were Kingdome of Saudi Arabia ($ 144 million), United Arab Emirates ($ 43 million), United States of America ($ 223 million), EU PEGASE ($ 375 million) and the World Bank administered PRPD Trust Fund ($ 285 million) (Table 7).



The shortfall was financed by raising the PNA indebtedness with commercial banks by $ 195 million and the accumulation of $116 million in arrears. Budget deficit financing brings the total PNA domestic debt stock by end of 2010, to $ 736 million. In addition, the Petroleum Authority's debt with commercial banks at end of December 2010 amounted to $ 95 million, bringing total PNA domestic debt to $ 839million, or 12 % of GDP. External debt, which is long term and highly concessional, amounted to $ 204 million at end 2010,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 developing economies.

It should be mentioned that the average exchange rate for the year at US $ 1 = NIS 3.73 ended up very close to the budget forecast of US S 1 = NIS 3.8. The Depreciation of the US dollar was 5% from 2009 to 2010.

5. Arrears

Total net arrears were $ 116 million, while total expenditures Arrears for 2010 amounted to $ 144 million. This amount is divided into wage expenditure arrears ($ 49.6 million), non-wage expenditure ($ 70.6 million) and development expenditures arrears ($ 23.5 million). The employee's contribution from the total of arrears was $ 49.6 million the government share was $ 46 million and arrears to the private sector is the rest which amounted to $ 48 million.

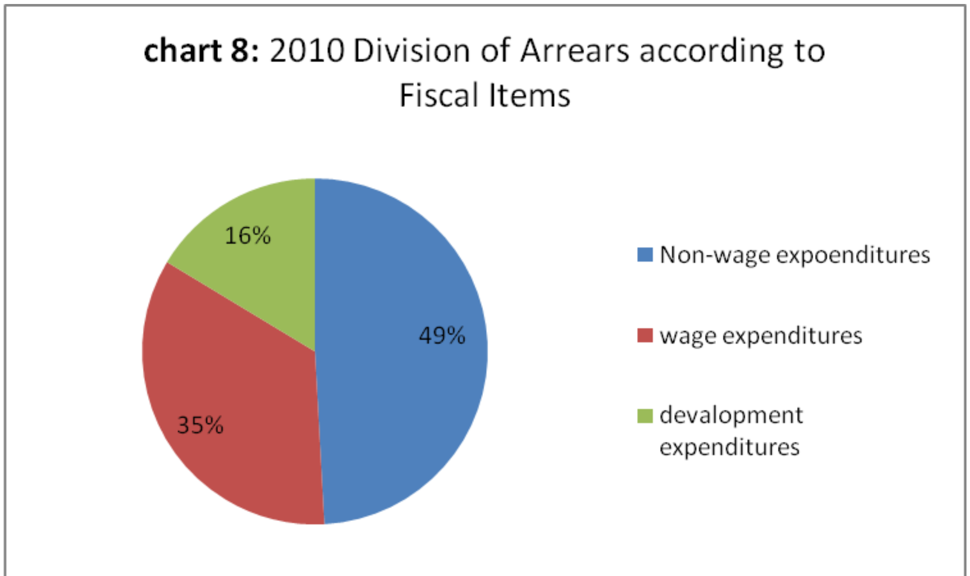
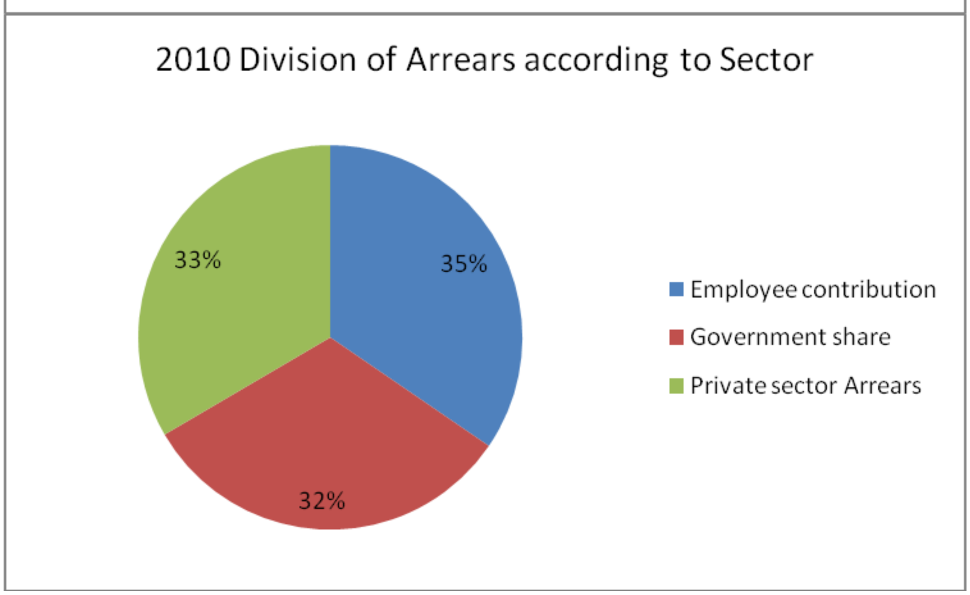


chart 8: 2010 Division of Arrears according to Fiscal Items



2010 Division of Arrears according to Sector

6. Institutional Developments and Progress in Reforms

- The Budget department is in the last stages of preparing the new budget for the year 2011.

- The Improvement in domestic revenue collection continues, progress was made in the following :

1. Ministry of Finance (MoF) issues payments to the Ministry of Local Governments (MoLG) through the ministry's Zero account to contribute their share for electricity bills paid by the municipalities and villages' councils, after MoLG started the process of collecting monthly electricity bills.
2. The municipalities and villages' councils continue paying their old debts of water bills as well as their monthly invoices.
3. MoF continues to withhold a Financial Clearance Certificate from any municipality or village council, until they fulfill their commitment to MoF in paying their utility debts.
4. Regarding PNA employees, MoF deducts the overdue electricity and water bills from their salaries to reduce the accumulated debts and reduce net lending.

- The Financial Statement for 2009 has been prepared and submitted for audit to the State Audit & Administrative Control Bureau. Also all zero balance accounts are functional, and around 340 accounts were closed by the fourth quarter of 2010, an increase of around 19 accounts closed over the third quarter of 2010.

- Reduction in net lending continues. During this quarter PERC & NEDCO prepared an action plan to include all the cities and villages in the Northern area of West Bank under the concession of NEDCO. The plan states that Qalqilya & Tulkarm shall join NEDCO during the first quarter of

2011, and all the remaining shall gradually join NEDCO within 2 years time frame.

- The Cabinet approved the composition of a task force to be part of NEDCO Board of Directors (BoD). This task force shall assist the BoD in managing NEDCO and supervise the smooth joining of the other cities and villages. After the approval of the Cabinet, PERC prepared the licensing regulations for the Generation and Distribution utilities. These regulations have been issued in the official gazette. In addition PERC has prepared the Tariff methodology and regulations to be submitted to the Cabinet for approval. The tariff will have an ascending scale with higher consumption to protect the poorer segments of society.

- Regarding Pension Reform, a technical assistance mission from the World Bank was held on November 1, 2010.The main objectives of the mission was to support the Ministry of finance and Palestinian Pension Agency colleagues as they proceed with the implementation of the PNA's pension reform action plan. The mission discussed policy options for the first and second pillar of pension reform, as well as disability and survivorship pension issues. Following the discussion it was understood that there was a necessity to revise the Pension Reform Action Plan and make it more specific. Therefore, the mission transmitted a revised Pension Reform Action Plan which the PPA confirmed could be implemented by June 2011.