Palestinian National Authority

Ministry of Finance

Fiscal Developments: 1st Quarter 2008

April 26, 2008

A. Budgetary Operations

1. Recurrent balance and financing

Budgetary operations on a cash basis during the first quarter of 2008 (Q1) resulted in recurrent deficit, before external budget support, of $ 317 million (table 1). While this deficit is expected to increase in the second quarter and stabilize thereafter, it is well within the PNA annual budget deficit projection of $ 1.36 billion, when annualized ($ 1.27 billion). During the first quarter of 2007, the deficit was $ 118 million. However, over the last year (March 2007- March 2008), the US dollar depreciated by 13% with respect to the NIS, which is used for the virtual totality of PNA expenditures and revenues. This makes comparisons of budgetary operations in NIS of Q1, 2007 with Q1 in 2008, more meaningful than in US dollars.

The first quarter recurrent deficit was financed by a large inflow of external budget support, amounting to $ 526 million, as opposed to $ 219 million in Q1 of 2007. The largest donor was the European Union, $ 180 million, (table 7), followed by Arab Countries ($ 153 million, mostly from the UAE and Saudi Arabia) and the United States ($ 152 million) After taking into account external budget support, a recurrent surplus emerged in 2008 of $ 209 million. In 2007 the recurrent surplus during the first quarter of the year was $ 101 million. Development expenditures are fully financed from abroad, and therefore the recurrent and overall balances including external financing are the same.

The large recurrent surplus obtained during Q1 of 2008, made it possible to repay substantial expenditure arrears ($ 146 million) which were carried over from 2006 and the first half of 2007. These arrears were repaid to PNA employees for wages owed to them, a well as transfers owed to the unemployed, retirees and the most vulnerable groups. Arrears to private sector suppliers and PNA autonomous institutions such as universities and hospitals were also settled. This injection of liquidity into the income stream amounted to 12% of quarterly GDP, a very substantial fiscal impulse, which should have had a positive effect on the economy in 2008. In addition, the PNA was able to repay the banking system some advances and overdue amounting to $ 74 million, thereby regularizing its financial situation with the banks. This regularization should provide the MoF with some room for maneuver, should it be faced with some liquidity shortage in the second half of the year.

By contrast, during Q1 of 2007, the PNA was not in a position to repay arrears to PNA employees and the private sector, as it was still under the financial siege imposed by OECD countries and was pressed by banks to repay its loans. In compliance with banks pressures, the MoF used an advance from the Palestinian Investment Fund of $ 41 million, in addition to its recurrent surplus of $ 101 million to repay the banking system. This was a withdrawal of liquidity from the income stream and could only have a negative effect on economic activity.

2. Revenues

Total revenues during the first quarter of 2008 of $ 331 million, as shown in table 2 (NIS 1.2 billion) have increased by 7% in NIS terms, over the same period of 2007 (NIS 1.13 billion). Gross clearance revenues, mostly made up of VAT and petroleum excises, are the largest source of revenues for the PNA (table 3) and these also increased by 7 % in NIS terms. Trends in clearance revenue are a good indicator of the Palestinian consumer disposable income. A 7% increase in nominal value over the last year mostly reflected price increases, particularly of petroleum products. This suggests that there was hardly any growth of disposable income in real terms[1]. This is consistent with estimates of zero growth in 2007 by the IMF and 0.7 % growth by PCBS.

Actual clearance revenues collected by the PNA in Q1 of 2008 in NIS were 17 % higher than in Q1 of 2007 due to lower deductions on behalf of municipalities. This may already reflect the agreement reached with municipalities on improving their collection efforts of electricity fees, (see below), although most of the agreement impact is expected during the remainder of the year. In addition, the PNA obtained in March 2008 a down payment of interest on the frozen clearance revenues (NIS 75.8 million).

Net domestic revenues amounted to $ 75 million during the first quarter (table 3), a 38 % decline from Q1 in 2007[2] in NIS terms. This large decline can be attributed to the siege imposed on Gaza and the exemption afforded to Gaza residents of some domestic taxes to compensate for the hardship which they are sustaining. Income taxes which amounted to NIS 160 million in Q1of 2007, declined to NIS 106 million in Q1of 2008 reflecting both the non payment of taxes by Gaza residents and the overall economic stagnation.

Tax refunds amounted to $ 37 million during Q1 of 2008 (table 1). This item includes VAT refunds of $ 9 million to the private sector, including exporters, and to organizations which are exempt from the tax. It also included about $ 28 million of tax rebates on petroleum products. Prior to 2008, this tax rebate was included in “net lending”.

[1] One third of clearance revenues are levied on petroleum products which witnessed a doubling of their prices during last year, while two thirds of revenues stem from taxes on the import basket consumed by Palestinians, including basic commodities such as wheat, which also underwent a spike in their prices. Therefore, the combined price increase for petroleum products and other imports may well have exceeded 7%.

[2] Gross domestic tax revenues in 2007 are not available.

If diesel fuel is sold in the West Bank at full price, including full excise taxes and VAT, smugglers would succeed in under pricing this product and driving down the Palestinian Energy Authority sales of petroleum products in the West Bank. This would result in a substantial loss of tax revenues. There is an equilibrium threshold price for diesel fuel where the loss in tax revenue due to smuggling equals the tax rebate necessary to prevent smuggling. Other products such as gasoline, kerosene, and liquid gas hardly need any rebates to maintain their sales. Over the last three months, diesel prices have been gradually increased to minimize the tax rebate, while remaining below the threshold price. Thus, the monthly rebate went down from $ 12.4 million in January to $ 7.4 million in March.

3. Expenditures

PNA expenditures amounted to $ 648 million during Q1 of 2008 (table 1). On an annualized basis, this amounts to $ 2.6 billion, or somewhat below the 2008 budget appropriation of $ 2.8 billion. While the expenditure level is expected to rise in subsequent quarters, the MoF is confident that the budget appropriation will be respected[3].

The wage bill was $ 365 million on a commitment basis and $ 406 million on a cash basis (table 6), the difference mostly relating to payments of wage arrears to PNA employees. Civil service employees accounted for 53 % of the cash wage bill while security services accounted for 47% (table 5). Within the civil service, education accounted for the largest wage bill (47 %), followed by health (15 %)

[3] Comparisons are difficult to make with Q1 of 2007 because of substantial changes in classification with respect to the wage bill and non-wage expenditures. A few transfer categories which were previously included in the wage bill, such as public employee pensions, temporary workers and transfers to the unemployed were shifted to transfers in non-wage expenditures.

The wage bill which was at $ 115 million in January of 2008 (on a commitment basis) did not have in it a large number of teachers, who were hired in 2007, but were not confirmed until 2008, when normal administrative procedures were resumed. Following the teachers integration into the payroll, the wage bill stabilized at about $ 125 million (table 5) for a total wage bill projected for 2008 at $ 1.49 billion which is very much in line with the budget appropriation of $ 1.48 billion.

Non wage expenditures amounted to $ 197 million during Q1, 2008 (table 1) on a commitment basis, a substantial increase over Q1 of 2007 ($ 111 million) This increase was mostly due to shifting transfer elements which were in the wage bill in 2007, as noted above, to the transfer component of non wage expenditures. Actual transfer expenditures on a cash basis were much larger (table 5, $ 302 million), because of the repayment of large arrears due to suppliers, the unemployed, the poor and vulnerable groups receiving transfers from the Ministry of Social Affairs, and retirees. In Q1 of 2008 transfers accounted for $ 161 million in cash or 53 % of total non wage expenditures. Operational expenditures amounted to $ 135 million, including repayment of arrears to suppliers (table 5). There were also about $ 6 million of small capital expenditures, mostly for community development projects, which were financed by the MoF.

Net lending includes mostly electricity bills (76 % in 2007), paid on behalf of municipalities, water (11 %), Ministry of Health bills owed to Israeli hospitals (11 %) and small payments (2%), for sewage and Ministry of Agriculture bills owed to Israel for services provided
The Israeli authorities would automatically deduct these unpaid bills from PNA clearance revenues. In 2007 net lending amounted to $ 535 million, or 45 % of PNA revenues and

10 % of Palestine's GDP. This massive subsidy to municipalities and consumers of utility services was clearly unsustainable.

Following the agreement with municipal councils (see below), the Mof has targeted a substantial reduction in net lending to $ 400 million in the 2008 budget.

During Q1 of 2008, net lending amounted to $ 86 million. While the first quarter tends to be lower than the subsequent quarters, recent indicators and trends suggest that net lending in 2008 may possibly fall under the $ 400 million target. In particular, the March payment of $ 33 million had fallen below the February payment of $ 42 million (table 1). Several municipalities increased their bill collection, even in Gaza, and are paying Israel Electric Company (IEC) directly.

A. Institutional Developments

During Q1 of 2008 capacity building and improvements in governance were carried out in the MoF:

- The 2008 budget was approved during the first quarter of 2008.
- An Accountant General Department was established in the Ministry of Finance, supported by a new electronic data base which links PNA expenditures directly to budgetary appropriations. This new Financial Management System will insulate expenditures and financial management from political interference. This system is linking directly budgetary appropriations with expenditures by line ministries so that all expenditure can be recorded on both a commitment and cash basis. It will allow for more accurate comprehensive and timely reporting on fiscal operations. It also establishes

direct linkages with the Treasury bank accounts.. This represents a very significant step towards attaining best practices in public finance.

- A new modern and simpler income tax law, with a maximum marginal rate of 15% for both individuals and companies, was passed and will be effective for 2008.
- The Ministry of Finance launched a new web site with extensive coverage of budget execution data, to be posted on the 15th of each month. This web site draws on the data base established by the new Financial Management System. This electronic system will cover all the financial transactions and entries of the Ministry of Finance. Electronic linkages to the Central Treasury Account will provide financial reconciliation of the accounting and banking information. As individual ministries are gradually integrated into the system, detailed data on their operations can be downloaded and analyzed. This new reporting system reflects best accounting practices and is a major step in enhancing transparency and accountability.
- The Customs and Excise Department launched a major campaign against the undervaluation of imports by traders. A large number of revaluations have been effected which will result in higher tax collection.
- An agreement, on February 5, 2008, between the Energy Authority, the Ministry of Finance and the Municipal Councils was reached on modalities for payment of electricity bills by municipalities. A key provision in the agreement is for the municipal councils to pay IEC directly for their consumption of electricity. Another provision is to exempt vulnerable and well identified groups from utility payments. As part of the collection plan, over 10,000 pre paid meters have been installed in various areas.
  Eventually the three electricity distribution companies would be in charge of collecting and paying electricity, thereby relieving the MoF from this responsibility.