PRDP-TF: Quarterly Review
July-September 2009

In December 2009, the Palestinian Authority (PA) Ministry of Finance (MoF) finalized an updated report on its fiscal performance for the third quarter of 2009 and also provided information on its progress on implementing the policy reforms detailed in the PRDP-TF policy matrix. A close examination of the reports revealed that though the PA continues to implement its PRDP, in the third quarter of 2009 the pace of structural reforms slowed considerably. Despite a resurgence of growth in the West Bank, the PA's fiscal situation worsened mostly due to increased spending. In September the PA officially added $300 million to its budget to respond to the ongoing crisis in Gaza. However, the PA anticipates that the recurrent budget deficit will be around $150 million more than budgeted even after the $300 million increase in budgeted expenditures. This is mostly the result of recognizing in 2009 $133 million in commitments made in 2008. During the third quarter the PA continued to make progress on public financial management and reform of the social safety net. However, progress on the more difficult reforms has stalled. The PA has not yet passed the new draft procurement law or taken steps to address the unsustainable pension liabilities. During the third quarter, the PA did not move on establishing an electricity regulator as called for in their most recent Letter of Development Policy. However, it is reported that there has been progress in the late fourth quarter when this report is being drafted. The PA is making efforts to strengthen its fiscal controls and accelerate structural reforms. Consequently, after consulting with the IMF, the World Bank is continuing to support the PA's reform program through additional tranche releases from the PRDP-TF. However, the World Bank is expecting improved reporting on PA expenditures in the next quarter.

In the first three quarters of 2009 total net revenues in NIS terms were about 2 % below the budget target while total recurrent expenditures were about 5 % higher than the amended budget target (taking into account the additional Gaza emergency spending)[1]. In the third quarter the PA received $100 million in license fees from the telecommunications sector, which significantly improved revenues. Despite this, non-tax revenues were still substantially below the budget target, which anticipated more than $200 million in license fees and dividends during the year. During the third quarter, spending, both wage and non-wage, continued to grow. The original budget called for a deficit of $1.15 billion, which was amended to $1.45 billion to account for unexpected costs related to the crisis in Gaza. However, the PA now reports that it anticipates a recurrent budget deficit of as much as $1.6 billion.[2] Given the depreciation of the US dollar in recent months, this puts the deficit in NIS terms on par with or slightly higher than the 2008 deficit. Large increases in foreign aid in the third quarter helped cover the

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[1] Throughout this discussion, budget targets are determined by allocating the full year target equally across months. Since the PA does not provide a detailed annual cash plan, this is the best approach and the one generally followed by the PA in its own reporting.

[2] The PA budget is executed in New Israeli Shekels (NIS). However, the Ministry of Finance publishes its accounts on the web in terms of US$ and donor assistance is pledged in US$. Consequently, this report uses US$ when discussing the overall deficit and need for external support and NIS elsewhere. The exchange rate averaged US$1=NIS 3.84 in the third quarter.

rising deficit and allowed the PA to pay down some of its short term bank borrowing. Domestic debt stood at about $522 million at the end of the third quarter, a net increase of $154 million in the first nine months of 2009, when the budget foresaw no new borrowing. In addition, the PA is continuing to accumulate arrears to the public and private sectors. Despite the estimated 5% real GDP growth, the recurrent operating deficit on a commitment basis is on track to be at least 25% of GDP; up from about 20% in 2008 and closer to the deficit of 2007, which was estimated to be 26.7% of GDP.

Net revenues jumped by nearly 35% from the previous quarter and were over 17% more than the third quarter of 2008. Much of this strength can be attributed to a one off payment of $100 million in fees from telecommunications companies. However, domestic tax collections were also up on the strength of VAT collections, which were more than 60% higher than in the third quarter or 2008. Tax collections in the first three quarters of 2009 were 16% above the similar period in 2008. This was despite the fact that the PA raised the threshold for paying income tax that led to a decline in income tax revenues by more than 9% in the first three quarters of 2009 compared to 2008. Clearance revenues have recovered from the decline suffered during the first quarter due to increased Israeli restrictions on Gaza during the first months of the year. Clearance revenues in second and third quarters of 2009 were more than 14% higher than in the same period of 2008, which reflects the higher economic activity, especially imports into the PA territories. Despite the improved performance of domestic tax collections, total revenues were some 5% below the budget due to the lower than expected dividends and fees and the fall in clearance revenues in the first quarter. Tax refunds were nearly 38% below budget projections, which helped raise net revenues. However, many of the expected claims for tax refunds may materialize later in the year or early in 2010.[3]

In the third quarter total expenditures and net lending exceeded the budget by a growing amount. To account for the situation in Gaza, $200 million was added to the budget for transfers and $100 million to operational expenditures. Yet in the third quarter, transfers and operational expenditures still exceeded their pro-rated quarterly budget targets by 21% and 37% respectively. For the first three quarters they were above the budget targets by 2.4% and 9.5%. In the first nine months of 2009, transfers were nearly 33% higher than in the first three quarters of 2008 and operational expenditures were over 115% more. The MoF reports that the bulk of this over spend is due to $133 million in budget commitments made in 2008 but not recognized until 2009. This includes $80 million in operational expenditures and another $53 million in minor capital expenditures.

The PA reports that non-wage expenditures have been growing because of the necessity to respond to the situation in Gaza and "compensate people who have lost their homes, to broaden social allowances and to the repair the damages sustained by electricity, water and road networks". In the first quarter of 2009, the PA reported spending NIS83.4 million on emergency relief for Gaza, which was administered by the UNDP to compensate non-refugees for damaged housing and another nearly NIS40 million for emergency infrastructure repair. In the third quarter, the PA provided few

[3] The difference between Net Total Revenue and Total Revenue is tax refunds. Local businesses report that it takes as much as a year to receive tax refunds.

details on the incremental expenditures beyond stating the need to increase social allowances and a spike in commitments for medicine and medical treatment abroad. However, the PA has provided a table of the major categories where the $300 million budget increment for Gaza is programmed. The PA has indicated that it is continuing to make cash payments to families that have lost their houses and that they have had to increase payments to the Israeli Electric Company as it is no longer receiving any payments from Gaza. In addition, the EU's Pegase program made an unscheduled disbursement and the World Bank provided an additional $5 million through the SSNRP project. The PA expects non-wage expenditures to fall in the fourth quarter and if they do not, the PA's 2009 recurrent deficit could be even higher than currently anticipated.

Table 2:Breakdown for the supplementary 300 million dollar for Gaza Reported by MoF

No.	Item	Description	Amount in US
1	Electricity sector	Petroluim-Dor Alon Co.	18,000,000
		Maintenance of network & connections	13,200,000
		Rehabilitation of the station	4,020,000
		Electricity consumption fees	85,000,000
2	Water sector support	Rehabilitation of water & sewage	6,100,000
		Water consumption fees	3,000,000
3	Education sector support	Rehabilitation of schools	2,645,000
		Rehabilitation of expenses and universities	5,324,060
4	Health sector support	Rehabilitation of hospitals	5,000,000
		Abroad treatment	40,000,000
		Medical supplies and medicine	15,000,000
5	Social individual support	Direct support	60,700,000
		International support	29,200,000
6	Non governmental support		6,000,000
7	Local governors and camp committee support		4,000,000
8	Rehabilitation of crossings and boarders		3,000,000
	Total		**300,189,060**

Information provided in mid-December 2009.

The third quarter PA wage bill exceeded its budget target by 3%. The wage bill in the first three quarters of 2009 was about 1.5% above the budget target and nearly 11.5% greater than in the first three quarters of 2008. Part of the excess in wages can be explained by the government's decision to provide every eligible employee a NIS600 payment to compensate for having to borrow when the PA did not pay salaries on time in 2006 and 2007. The PA reports that it had 147,153 employees at the end of the third quarter, which is well below the cap of 153,000 that they committed to in the most recent Letter of Development Policy. However, clearly if the PA reached that level of employment it would be substantially over budget and the wage bill as a share of GDP would be greater than the targeted 22%.

The PRDP commits the PA to increasing employment by no more than 3000 net employees with the majority of them in health and education. However in the first nine months of 2009, the PA added a net of 4,216 employees, of which 2,251 were in the already large security sector. The security forces had a net increase of 926 in the third quarter alone, bringing total employment in the sector to 63,022. Health and education sectors combined added only 877 net employees in the first three quarters of the year with an additional 181 in the Ministry of social affairs. Security has clearly improved in the West Bank and some of this can be attributed to the new National Security Force Battalions and other formations that have been recruited, trained and deployed to the streets of the West Bank. Security in the West Bank appears to have improved but maintaining such a large force is a substantial burden on the PA's fiscal position.

Table 2: Net Change in Employment in Most Significant Sectors
End-December 2008 - End-September 2009

Security Forces	2,251
Education	406
Health	471
Ministry of Social Affairs	181
Religious Affairs and Endowments	152
Land Administration	115
High Judicial Office	108

Source: PA Ministry of Finance Monthly Reports

In the third quarter of 2009, the PA continued to make efforts to increase utility collection rates and to reduce net lending. The Palestinian Energy and Natural Resources Authority (PENRA) reports that by the end of June there were 90,000 single phase pre-paid meters installed in the West Bank and another 6,000 three phase meters all of which were financed by European donors. In addition, there were 50,000 pre-paid meters installed using domestic resources. PENRA reports that they finalized the first phase of installing pre-paid meters by the end of the third quarter and have tendered to procure 139,000 more for installation in 2010. There has been little movement on institutional changes. The PA passed the new electricity law in May of 2009 but by the end of the third quarter there had been little progress towards implementing it. The new electricity regulator had not been established and there was no action on establishing a rising block tariff or other social tariff to protect the poor.[4] The new electricity law calls for all electricity distribution to move from local governments to the established distribution companies by May 2010, but there has been no new progress towards achieving this goal since the law was passed. The PA continues to enforce its system of requiring proof of utility bill payment to obtain some services and to require all municipalities, villages, and utilities to submit detailed information of their electricity and water debt. In addition, the PA provides a subsidy to local governments that can show they have paid their full bill to the Israeli Electric Company of up to 5% of the bill. These efforts have had some effect and net lending dropped by nearly 25% between the second and third quarters. It is on track to achieve its annual budget target of NIS1,520,000 and in the first nine months of the year it was more than 6% lower than in the similar period in 2008. While the PA is making progress on reducing net lending, it is unlikely to be fully eliminated in the electricity sector until the new electricity law is implemented and

[4] In December 2009 when this report is being prepared the PA has taken steps to establish the regulator but it is not yet active.

electricity distribution is moved from local governments to the distribution companies and they are run on a commercial basis.

In February 2009 the Council of Ministers issued a decree to merge all on-going cash assistance programs using the poverty targeting database developed under the World Bank supported Social Safety Net Reform Program (SSNRP) as the main mechanism for targeting assistance. In the third quarter the Ministry of Social Affairs (MoSA) improved its draft strategy for implementing the decree. MoSA reviewed and updated its proxy means test for determining eligibility for payments based on data from the 2007 household census and 2007 household expenditure and consumption survey (PECS). The EU is working closely with the MoSA to finalize the merger of the system and progress has been steady to date. It is essential that this merger be completed as soon as possible to both improve the efficiency of the social safety net and to help improve the PA's fiscal position.

The PA continued to make steady progress on improving its public financial management systems (PFM) in the third quarter starting with the budget cycle. The Ministry of Finance (MoF) issued the 2010 budget circular on August 16, 2009 and a technical team from MoF and the Ministry of Planning and Development supported ministries to prepare submissions by September 16, 2009. Each ministry has received electronic budget forms and has access to the new data base to enter budget data. The primary budget for each ministry was submitted to MoF for review by September 20, 2009.

MoF is steadily rolling out its electronic financial management system. By the end of the third quarter 57 line ministries and institutions were connected. 32 ministries currently use the system while the remainder need additional training or to finalize their connection to the new system. The MoF is making progress on closing non-zero balance bank accounts at line ministries. So far 154 have been closed and it is expected that all will be closed by the end of 2009. The internal audit department of the MoF sent final draft audit reports to five ministries for final comments and teams are in the process of auditing four other ministries and institutions. In addition, the MoF is finalizing its 2008 accounts and will soon submit them to its external auditors. This process has been slow but extremely productive. The MoF working with external consultants has been taking action to modify and improve its accounting systems as issues are discovered while compiling accounts. This has slowed the process but should make it much more efficient in the coming years. The MoF continues to improve its commitment controls and cash management. It is now able to report at least a part of its external debt, which is estimated to have declined by $3.6 million to $364 million during the first nine months of the year. This is mostly long term concessional loans. The external debt is reported to be about 14% of GDP, which is low relative to most developing and developed countries.

The PA continues to implement the PRDP, however progress has slowed considerably and fiscal discipline has deteriorated. In the third quarter the PA did not made progress on some of the most important but difficult reforms. The electricity regulator was not been established, the public procurement law has not been passed and except for reviewing a report on pensions provided by the World Bank, the PA has not taken any steps to address the unsustainable public pensions system. Spending has exceeded the budget with transfers and operational expenditures accounting for the bulk of. In September the budget was amended to include an additional $300 million in response to the crisis in Gaza. The PA is currently working to provide a more detailed description of how this is being allocated. The PA recognizes that it needs to reenergize the reform process and strengthen its fiscal controls. The World Bank is supporting this process through additional disbursements of the PRDP Trust Fund.

Despite the increasingly difficult fiscal situation, in the second quarter of 2009 the PA continued to make progress on the reform agenda presented in the PRDP. However the pace of reforms has slowed as the easiest measures have been taken and the remaining reforms have proven to be more difficult and politically sensitive. In implementing the reforms detailed in the PRDP-TF policy matrix, the PA continues to face three significant challenges. The first is to successfully implement the new electricity law and transfer electricity distribution from local governments to commercially run companies. This will require a high level of effort and significant expertise, but unless it is successful it is unlikely that net lending will be eliminated. Second, the PA has committed to passing and implementing the new public procurement law, which will require drafting new regulations and an extensive training program for public employees engaged in procurement. Finally, the PA has yet to begin to tackle the insolvent public pension system.