PRDP-TF: Quarterly Review
April – June 2009

In August 2009, the Palestinian Authority (PA) published an update on its fiscal performance for the second quarter of 2009 and also provided detailed information on its progress on implementing the policy reforms detailed in the PRDP-TF policy matrix. A close examination of the reports revealed that in the second quarter of 2009 the PA continued to make progress on implementing its reform agenda, though the pace of reform has slowed as the easiest actions are accomplished. Despite a small resurgence in growth in the West Bank, the PA faces a precarious fiscal situation. The recurrent deficit in the first half of the year was more than 12 % higher than the budget target and for the PA to reach its deficit target it will have to substantially increase revenue and lower expenditures in the second half of 2009. Much of the difficulty can be traced to the situation in Gaza, which has reduced revenues while also requiring the PA to make unexpected expenditures for emergency relief. However, excluding spending in Gaza, expenditures have still been running slightly ahead of budget. Despite the difficult fiscal position, in the second quarter of 2009 the PA carried on implementing structural reforms including holding the line on public employment and improving public financial management. However, the PA has not yet passed the procurement law, taken steps to address the unsustainable pension liabilities or made significant progress on developing a rising block tariff for electricity as called for in their most recent Letter of Development Policy. The World Bank, after consulting with the IMF, has agreed to continue disbursements from the PRDP-TF to support the PA's reform program.

In the first half of 2009 net revenues, excluding one-off items such as license fees and dividend receipts, were about 5 % below the budget target while total recurrent expenditures were about 3 % higher than the budget target (not taking into account the additional Gaza emergency spending)[1]. In addition, in the first half of 2009 the PA received only a small portion of the expected non-tax revenue which is mainly in the form of one-time receipts. To cover this gap the PA has had to resort to large-scale, short-term borrowing from local banks to tide it over until foreign assistance materializes. In addition, the PA is once again accumulating arrears. Some of the failure to meet the budget targets can be attributed to the situation in Gaza. In August 2009 the PA introduced a budget amendment indicating that it will require an additional $300 million to meet emergency needs in Gaza[2]. However, even abstracting from the funds required for Gaza, the recurrent operating deficit is on track to be larger than called for in the original budget. Given current expectations of revenues, if spending in the second half of the year is at the same level as the first half, and not including Gaza relief, the recurrent

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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 was US$1=NIS 3.81 on August 31, 2009.

deficit on a commitment basis could be as much as 20 % of GDP, i.e. above the budget target of 18 %. With the Gaza aid included, the deficit could rise to 25 % of GDP.

Net revenues in the first half of 2009 were more than 15 % below budget target and around 13 % lower than the similar period of 2008. Some of this decline can be ascribed to Israel's Operation Cast Lead in Gaza. During much of the first quarter, shipments of fuel and other goods to Gaza were even more restricted than they had been earlier. Consequently, clearance revenues in NIS terms in the first quarter of 2009 were nearly 23 % below budget and more than 11 % less than the first quarter of 2008. While there was some recovery in the second quarter it did not fully make up for the lost revenue. But the fall in clearance revenues was only a part of the overall shortfall in domestic revenues. Domestic tax revenues in the first half of 2009 hit their budget target and were about 4 % higher than the first half of 2008, non-tax revenues fell well short. In 2008, the PA received a large amount through one-time receipts including $55 million in cash dividends from the Palestine Investment Fund and nearly $80 million as a license fee from Wataniya Telecommunications Company[3]. The 2009 budget anticipated additional large receipts from various sources and non-tax revenues were projected at NIS 1.4 billion. Unfortunately, only NIS 255 million materialized in the first half of the year, leaving a large hole in the budget. However, in July 2009 the PA received $100 million from the telecommunications company Zain after it acquired Jawwal (another telecommunications company) and another $100 million is expected. If this occurs these receipts would largely fill the gap in non-tax revenues.

Total expenditures and net lending in the first half of the year were about NIS 675 million or 12 % higher than the budget target. They were more than 30 % higher than in the first six months of 2008. Much, but not all, of the higher spending can be attributed to the needs in Gaza and the PA reports sending $78 million in emergency aid in the first half of the year. The excess spending was driven by non-wage expenditures as the wage bill met the budget target. While transfers fell by about 5 % in the second quarter they still exceeded the pro-rated budget target for the first half of the year by more than NIS 300 million. Operational expenditures grew by more than 10 % between the second and first quarters and exceeded the first half budget target by more than NIS 160 million or about 20 %. Some of the growth in transfers reflects about NIS 125 million in emergency aid to Gaza reported in the first quarter and another NIS 48 million in the second quarter. However, pension payments account for the bulk of transfers and their growth highlights the pressing need for the PA to undertake pension reform. Not only are the various pension schemes underfunded, but they are unsustainable even if the PA was making all required contributions. While there have been some large expenditures on pharmaceuticals and textbooks in the second quarter, these do not fully explain why operational expenditures have been rising.

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[3] An AFP report on September 3, 2009 indicates that Israel may not be fulfilling a contractual obligation to free up 4.8 megahertz of frequencies by mid-September, at which point Wataniya may seek financial remedies from the PA (amounting to hundreds of millions of dollars) to recover its investments since the contract was signed in July 2008. See also: Office of the Quartet Representative. September 10 2009. *WATANIYA: Technical note on the need for 4.8 MHz of bandwidth.*

The PA continues to control the wage bill and it met its budget target for the first half of the year. The budget provided a 4% increase in wages to help offset the unexpectedly high inflation in 2008. However, this included the legally required general wage increase of 1.25 %. As of the end of June, total PA employment was reported at 145,727, a net increase of 1,418 over the first quarter and 2,790 in the first half of the year. In the first six months of 2009, there was a net increase of 1,325 in the security forces while the Ministry of Health lost 94 workers (see Table 1). The increase in security personnel reflects the need to staff the new security units that are being trained in Jordan. Net employment in the West Bank increased by 3,077 and in Gaza declined by 296.

Table 1: Net Change in Employment in Most Significant Sectors
End-December 2008 - End-June 2009

Security Forces	1,325
Education	639
Health	-94
Ministry of Social Affairs	133
Land Administration	108

Source: PA Ministry of Finance Monthly Reports

In the second quarter of 2009, the PA continued to make efforts to increase utility collection rates and to reduce net lending. The PA 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. 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. However despite these efforts, in the second quarter net lending rose to more than NIS 453 million and exceeded the budget target by about 19%. Net lending in the first quarter was about 16% below budget because of the cutoff in fuel shipments to Gaza during the first part of the year. But the large increase in the second quarter reflects more than just a recovery from the low spending in the first quarter. It is clear that the issue of net lending will only be solved when the new electricity law that mandates that all electricity distribution is performed by commercially run companies is fully implemented. The PENRA reports that it has drafted a six month plan to ensure that all required sub-regulations are issued. However, beyond this, there seems to be little substantial movement on implementing the new law.

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 second quarter the Ministry of Social Affairs produced a draft strategy for implementing the decree. However, the draft is currently being reviewed and there has been no substantial progress towards implementing the merger. 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 continues to make slow but steady progress on improving its public financial management systems (PFM). One of the most important recent accomplishments has been the connection of 19 ministries to the new computerized accounting system. Of these, 10 ministries are fully operational within the new accounting system. The PA Computer Department is working on connecting another 13 ministries to the system. In the second quarter the Government Debt and Cash Management Department completed a cash plan for 2009 and reports that ongoing monthly adjustments are made to reflect the actual expenditures and revenues recorded by the Accounting Department.

Another significant recent achievement has been in how the PA recognizes commitments. Previously the commitments for many items were only recognized close to the point of payment. The connection of the line ministries to the new electronic accounting system has allowed the MoF to begin recognizing commitments as soon as the invoices are received and entered into the system. This has improved the transparency of the accounting system. This improvement led the MoF in May to go back to its previously published accounts and update them with more accurate information on commitments. Though the new system provides the MoF with more information about commitments they are still not able to monitor commitments from the point at which they are first incurred. Achieving control of commitments is a priority for the MoF as this is necessary to fully control expenditures.

The MoF Internal Audit Department has completed the audit of the main MoF General Directorates, and published the final audit reports for all of them. In addition, it has published the risk assessment report for five line ministries and it's expected to produce the final audit reports for the five ministries by the end of August. During the second quarter the MoF continued to work with external advisors on the financial statements for 2008. The main focus has been on reconciling the accounts with the banking information. The MoF aims to provide the statements to the State Audit and Administrative Control Bureau in time to have the audit completed by the end of 2009.

A major goal of the PA in 2009 is to pass and implement a new public procurement law. In the first quarter of 2009, the High Standing Committee for national legislation met and finished the final draft of the procurement law. The MOF initiated a decree to be approved by the Council of Ministers, which will establish a General Procurement Committee. However, there has been no progress made on this front. The PA has also made little progress on addressing its public pension system. At the PA's request the World Bank initiated a small study on the costs of the current system and options for reform. However, the Bank has not received full information on the security sector and consequently has so far been unable to produce accurate estimates of the future costs of the schemes.

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 are 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.