

Palestinian National Authority

Ministry of Finance

Fiscal Developments

Second Quarter, 2009

September 10,, 2009

The Second Quarter (Q2) of 2009

A. Budgetary Operations and Financing

1. Summary and overview

The recurrent fiscal deficit in the Palestinian National Authority budget, in Q2 09 of \$406 million, is lower than in Q1 09 (\$ 431 million) but exceeded the quarterly budget target of \$ 287 million (Table 1). This \$ 119 million gap is partly due to a shortfall in net revenues (\$ 47 million) and partly to excess spending (\$ 72 million). These trends indicate that the 2009 Budget deficit projected at \$ 1.15 billion is likely to be exceeded by about \$ 200 million, mostly due to the impact of the Israeli Gaza offensive on both revenues and expenditures. When the closure of Gaza is lifted and the PNA mechanisms for housing reconstruction and the rehabilitation of the economy are activated, the recurrent deficit will be even larger. The PNA request for the financing of a supplementary line item for Gaza in the 2009 budget of \$ 300 million has been approved by the Council of Ministers and should cover the higher deficit. However, it is essential that this supplementary allocation is financed by donor countries. Otherwise,, payment arrears are bound to accumulate. This would be detrimental to both the financial management reforms which are ongoing in the Ministry of Finance (MoF) and to private sector renewed confidence and investment plans.

Gross revenues of \$ 381 million fell short of their quarterly budget target (\$ 437 million), mostly due to weakness in domestic tax collections and the lingering effects of the Gaza siege on clearance revenues (Tables 1 and 5).

Recurrent expenditures during Q2 09 at \$ 767 million exceeded the budgetary target (\$ 695 million) entirely on account of non wage expenditures (Tables 1 and 2). Large one off commitments in operational expenditures accounted for much of the excess spending, which may also imply some savings in the coming months since commitments on these items will be much smaller by year end. On the other hand, part of the overspending in "Transfers" may become a more lasting feature because of a structural upward shift in social allowances provided to Gaza following the Israeli offensive. The PNA wage bill, at \$ 345 million in Q2 09 is well within the quarterly budgetary target of \$ 352 million. Both employment and wages have complied with the PRDP fiscal reform agenda.

Coverage of development expenditures on a disbursement basis improved significantly with \$ 57 million recorded in Q2 09 versus only \$ 6 million in Q1 09 (Tables 1 and 2). However, as coverage broadens, comparing quarterly data becomes more problematic in assessing real increases in development spending.

External budget support of \$ 148 million in Q2 09 fell short of donor countries commitments (\$ 287 million), compounding the shortfall experienced in Q1 09 (\$ 28 million, Tables 1 and 7). Nor was there any actualization of the donor pledges made at the Sharm el Sheikh Conference in Support of the Palestinian Economy for the Reconstruction of Gaza (\$ 2.6 billion). In particular, the \$ 300 million requested by the PNA to finance Gaza's early relief and emergency expenditures have not been forthcoming. While this can be partly explained by the continuous closure of Gaza, substantial expenditures already undertaken by the PNA, could have been financed.

The shortfall in external financing, coupled with the higher than budgeted fiscal deficit in Q2 09, resulted in large borrowings from the banking system and some accumulation of payment arrears.

2. Revenues

Gross PNA revenues, of \$ 381 million in Q2, increased by 17 % over Q1 (Tables 1 and 5). Nevertheless, they are lower than their budget target by \$ 31 million¹. Total revenues in Q2 also include \$ 15.4 million in income taxes paid by Palestinians working in Israel and remitted by the Israeli authorities during the monthly clearance session. Excluding this one-off item, total PNA revenues increased in Q2 09 by 6.5% over Q2 08 (in NIS terms) (Tables 1 and 2). For the first half of 2009, gross PNA revenues of \$ 706 million, when annualized, would fall short of the budget target by \$ 180 million². This shortfall can be equally divided between domestic revenues and clearance revenues³.

There is a possibility however, that PNA dividends may reach \$ 200 million in 2009 instead of the \$ 100 million budgeted⁴, in which case, the domestic revenue shortfall would be covered. On the clearance side, revenues would increase beyond current levels only if the Gaza closure is lifted during the second half of the year, and, if real growth in the Palestinian territories exceeds the 5% rate projected in the budget.

Gross domestic revenues in Q2 09 declined by 14 % relative to Q1 09. This is partly due to yearly income tax settlements, typically undertaken by corporations in Q1. Domestic revenues during the first half of 2009, at \$ 212 million are running about \$ 100 million less than their budget target on an annual basis. This shortfall is mostly due to the overall weakness in domestic tax collection performance. Tax revenues during the first half of 2009 have only grown by 4 % in NIS terms over the first half of 2008. Unlike clearance revenues, these tax receipts have not been significantly affected by the Israeli offensive on Gaza⁵. This revenue increase is substantially lower than the nominal growth of the West Bank economy over this period (11 %) and calls for some reforms in tax administration.

¹ Excluding the \$ 100 million in license fees expected in the second half of the year.

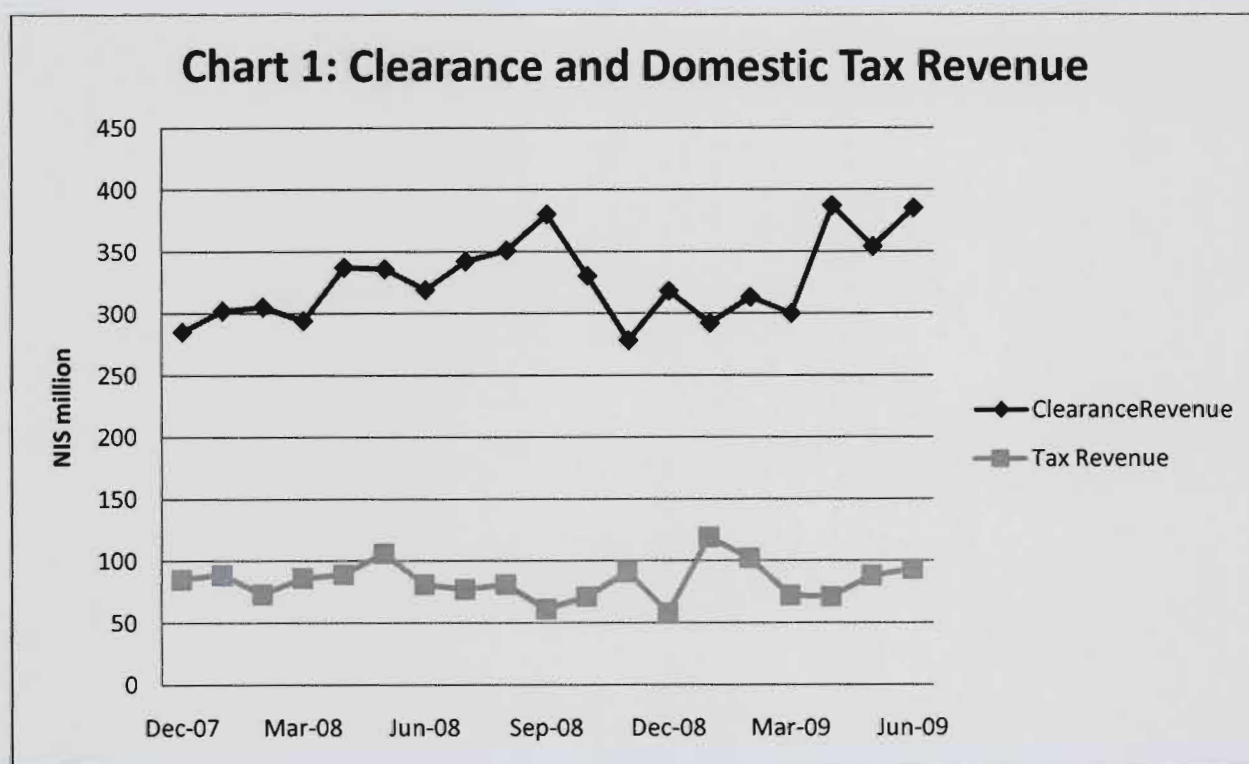
² Assuming same revenue performance in the second half of the year as in the second quarter, but excluding the one-off income tax receipt for Palestinian workers in Israel

³ Assuming second quarter performance to be maintained during the second half of the year.

⁴ The Zein-Paltel merger is expected to bring the PNA \$ 200 million in revenue

⁵ Domestic taxes in Gaza have been waived by the PNA since June 2007

As shown in Chart 1, domestic revenues have been flat since December 2007. Income tax receipts, at 1.2 % of GDP in 2008, hardly pay for the MoF tax administration, and are much lower than neighboring countries receipts which are in the 5-7 % of GDP range.



Clearance revenues in Q2 09, at \$ 283 million, increased by 35 % over the depressed levels of Q1 (Table 1 and 5). Comparing Q2 09 with Q2 08⁶, they increased by 13 % in NIS terms and registered the highest level attained since the first clearance sessions were initiated in 1996. There was some catch up effect in Q2 09 following the much lower clearance revenues in Q1 09 stemming from the Israeli offensive in Gaza (Chart 1). During the second quarter, there was a substantial increase in commercial imports to Gaza, now around 50 % of total Gaza imports. Nevertheless, Gaza has been under closure for over two years and imports are still about one quarter of their normal level⁷, with the dampening effect on indirect tax receipts, persisting. Thus, comparing the first half of 2009

⁶ Excluding Income tax payments by Palestinian workers in Israel of NIS 64 million received in May 2009.

⁷ In June 2009, 2,665 trucks entered Gaza, while the average monthly level during Jan 05-May 07 was 10,400 trucks

clearance revenues to those of the first half of 2008, there is only a 5 % increase in clearance revenues, whereas it should be in the 10% range⁸.

While clearance revenues, on a commitment basis have been averaging NIS 375 million per month during Q2 09, one third of these revenues are deducted for utilities and other services provided by Israel. Monthly deductions have averaged NIS 124 million. The largest deduction ranges between NIS 80-100 million for electricity bills owed to IEC. These have not gone down during the first six months of this year, notwithstanding efforts at having municipalities pay IEC directly. Deductions for water, sewage and hospital services average NIS 14 million per month. In addition, NIS 18 million has been deducted monthly since January 2009 by court order, to deal with litigation against the PNA in Israeli courts. Thus, clearance revenues received in cash in June 2009, amounted to NIS 249 million, whereas accrued clearance revenues amounted to NIS 385 million⁹ (Table 3).

Overall, clearance revenues on a commitment basis, at \$ 494 million during the first half of the year, would fall short of their budget target by \$ 95 million when annualized on the basis of their second quarter performance. This is in line with the shortfall forecast made in the First Quarter¹⁰, 2009 report

Tax refunds, at \$ 19.7 million during Q2 on a commitment basis, went up from the Q1 level (\$ 17.3 million) but were still below their 2008 quarterly average of \$ 29 million (tables 1 and 5). However, due to shortfalls in external financing and a higher fiscal deficit, tax refunds in cash were only \$ 0.7 million in Q2 09, while they were \$ 6.5 million in Q1 09 (table 3).

3. Expenditures and Net Lending

⁸ Clearance revenues during the first half of 2008 increased by 7.5 % over the corresponding period of 2007.

⁹ There is a lag of one month between accrued revenues and cash receipts.

¹⁰ MoF, Fiscal Developments, First Quarter 2009, May 30, 2009 p4 www.pmf.ps

Total expenditures, on a commitment basis in Q2 09, at \$ 767 million, increased by 5 % over expenditures in Q1 09¹¹ and by 19 % over Q2 08 (tables 1 and 2). However, these expenditure commitments include large one-off contracts under operational expenditures totaling \$ 51 million (tables 6a and 6b). While these contracts have inflated the second quarter deficit, they may result in savings during the second half of the year, since these spending commitments are not likely to be repeated.

Public expenditures during the second half of the year increased by 28% over spending during the first half of 2008 in NIS terms, mostly due to the spending associated with Gaza emergencies and the large contracts in Q2 09 mentioned above.

Assuming that the emergency expenditure incurred in Gaza (\$ 78 million) during the first half of this year is not repeated in the second half, first half expenditure execution, when annualized, would exceed the budget target of \$ 2.78 billion by \$76 million, or roughly by the amount of the emergency spending in Gaza, unforeseen in the 2009 budget.

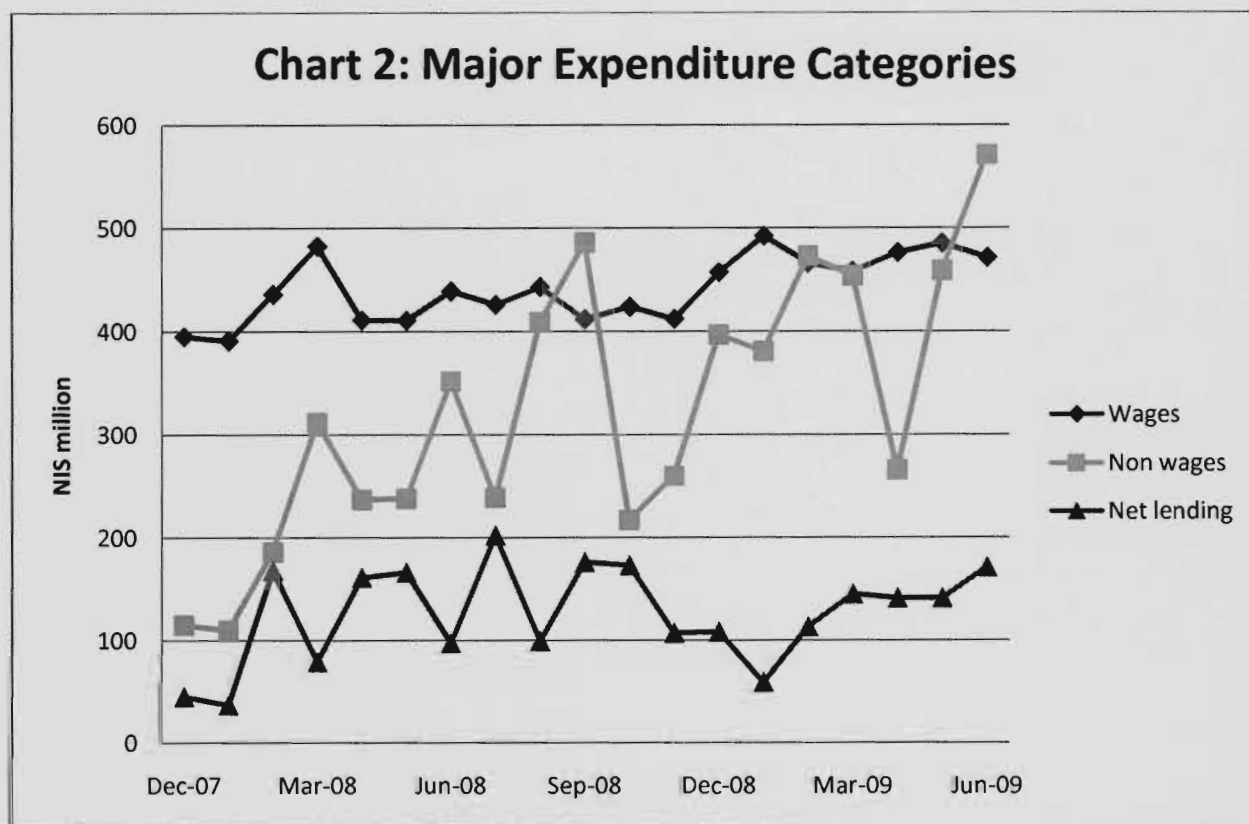
Wage Expenditures of \$ 345 million in Q2 09 increased by 9 % in NIS terms over Q2 08, due to the 4 % wage increase at the beginning of the year, and the hiring of teachers, health workers and security personnel (Tables 1 and 3). However, the wage bill in Q2 09 was almost the same as in Q1 09 (\$344 million), keeping it well within the quarterly budget target (\$ 352 million, Tables 1 and 2). The increase in the wage bill during the first half of 2009, when comparing it to the same period in 2008, amounted to 11% in NIS terms (Chart 2).

The civil service in the PNA increased from 82,559 in March 2009, to 83,631 by end June 2009. Security services, which have been highly praised for bringing stability and restoring law and order in the West Bank, increased from 61,750 at

¹¹ Q1 09 data, on a commitment basis, have been revised downward, from data previously issued, to remove duplicate entries in transfers and operational expenditures commitments.

end March to 62,096 by end June 2009. All in all, PNA employment increased by 2790 during the first half of 2009 over the level attained at end year 2008.

Non wage expenditures, on a commitment basis, of \$313 million in Q2 09 (Tables 1 and 2), are slightly below their Q1 09 level (\$ 318 million). Nevertheless, total non wage expenditures during the first half (\$ 631 million), show an 80% increase over the first half of 2008 in NIS terms, and are substantially higher than their semi-annual budget target (\$495 million). They now exceed wage expenditures. This is entirely due to overspending in operational and transfer expenditures (Chart 2).



Operational expenditures, (Table 2) at \$ 122 million in Q2 09 (Table 2) increased by 10% over Q1 09. June commitments by the Ministry of Health included \$38.3 million in spending on pharmaceuticals, of which \$ 37 million were listed as contracts for future deliveries (table 6a). It also included \$ 14 million

contracts for printing school books for the Ministry of Education in May and June 2009. Thus, of the \$ 69.8 million expenditures incurred in June, only \$ 20 million were spent in cash (Table 3). It is unlikely that such lumpy items would be repeated during the second half of the year. Nevertheless, operational expenditures commitments, having reached \$ 328 million by end July 2009, are likely to exceed to their budgetary appropriation (\$ 400 million) by year end. It should be stressed however, that of the \$ 232 million of operational expenditures incurred during the first half of the year, \$ 34 million were allocated for early emergency relief in Gaza.

Transfers, amounting to \$ 165 million in Q2 09, were lower than in Q1 09 (\$ 177 million), since most of the early relief for Gaza had been already provided during the first quarter of the year (table 2). Nevertheless, social allowances have increased significantly as a result of the Gaza offensive, including to the families of over 6500 casualties, those who lost their housing and jobs, and those who fell into poverty. Therefore, there has been an upward structural shift in recurrent transfer expenditures which had to be taken into account in the design of the 2010 budget. Assuming Q2 09 transfer expenditure levels to be sustained for the second half of the year and, total transfers in 2009 would exceed their yearly budget appropriation by \$ 70 million¹². The largest item in Transfers is payment for pensions which amounted to \$ 16 million in June 2009. These include pensions to West Bankers under the 2.5 % scheme and all pensions to security personnel. For years, the PNA failed to contribute its share to the Pension Fund for the retirement of security employees or to remit the employee contribution to the Fund. The PNA is now forced to repay this accumulated debt directly to the employees by having to disburse the full amount of the pension owed, instead of limiting its payments to its own contribution to the pension fund. In this respect, part of Transfers can be viewed as debt repayment.

The second largest item in Transfers is the Government share in pension contributions (\$ 11 million), recorded on a commitment basis, but not transferred

¹² Excluding \$ 44 million in transfers to families affected by the Israeli offensive

in cash, for lack of budgetary resources. This too is a PNA liability, which may be costly in the future, when the PNA will have to disburse full pensions to retired personnel from the Treasury, instead of only its own contribution to the Pension Fund.

Minor Capital expenditures at \$ 27 million during Q2 09, have fallen below their Q1 09 level (\$ 30 million, table 2) averaging \$ 9 million per month. The broadening of government membership on May 18, 2009 is likely to maintain this average over the coming months. In May and June, commitments were made for additional car purchases, computer equipment and furniture. Total minor capital expenditure may reach \$ 100 million by year end but it should be stressed that most of these expenditures were incurred in 2008 and paid for in 2009.

Net Lending during Q2 09 at \$ 109 million sharply increased over Q1 09 levels (\$77 million, table 1 and 2). This was foreseen in the First Quarter 2009 Fiscal Developments report¹³ which stressed that charges for electricity were much lower than average in January and February 2009 because of the Gaza offensive. Fuel deliveries to the Gaza Electricity Generating Company, averaging \$ 11 million months, did not take place in January and February 2009. Similarly, deductions from clearance revenues for electricity consumption in January 2009 were half their normal monthly level in Q2 09 (NIS 100 million). Higher PNA payments for electricity in Gaza, coupled with only modest progress in collecting electricity bills from municipalities in the West Bank have resulted in high net lending levels for the PNA, with no evidence of a downward trend.

Development projects expenditures reporting in Q2 09 was expanded. Spending of \$ 57 million was reported, a higher level than in Q1 09 (\$ 6 million), thanks to better data coverage. External financing, covered \$ 19.1 in Q1 09 and \$ 12.7 in Q2 09 . The remaining \$ 31 million were financed by the Treasury, mostly for community development projects.

¹³ Fiscal Developments, First Quarter 2009, MoF, p7 www.pnof.ps

Cash expenditures in Q2 09 (Tables 3 and 4) were substantially lower than expenditure commitments. In addition to the lower wage bill actually paid, (the difference amounting to the employee contribution to pensions, not remitted to the Pension Fund) non wage expenditure paid in cash, amounted to \$ 189.3 million as opposed to \$ 313 million in commitments. The difference does not entirely constitute arrears as indicated in the tables, but mostly reflects future payment commitments to private sector suppliers and will require substantial financing if payment promises are to be honored over the next six months.

Development cash expenditures were also lower than commitments (by \$ 9 million) and there were arrears in tax refunds (\$ 19 million, table 3). Total expenditure "arrears" , or payment obligations, of \$ 169 million in Q2 09 were partly offset by a transfer of income tax payments by Palestinian workers in Israel of \$ 15.4 million received in the May clearance session. On a net basis, these payment obligations amounted to \$ 150 million in Q2 09 versus \$ 30 million in Q1 09.

4. Financing

External budget support in Q2 09 of \$ 148 million (Tables 1 and 7) was substantially lower than in Q1 09 (\$ 259 million) and lower than the quarterly target for such support of \$ 287 million.

Thus, during the first half of the year, external budget support for recurrent expenditures fell short of donors commitment by \$ 168 million. The largest contributor was the European Commission, through PEGASE (\$ 214 million). Contributions from Arab countries amounted to \$ 95 million. This large shortfall forced the PNA to accumulate payment arrears and borrow from the banking system \$ 166 million in Q2 09, in addition to the \$ 121 million borrowed from the banking system in Q1 09.

This level of indebtedness from commercial banks may have gone beyond their prudential limits and would not have been possible, were it not for the expectation of a \$ 200 million grant from the United States, which actually materialized in July 2009. This only underscores the importance for the donors to honor their budget support commitment of \$ 1,150 million, as entered in the PNA 2009 Budget. Financing for Gaza of \$ 300 million for emergency expenditures, as part of the Sharm el Sheikh pledges of \$ 2.6 billion, is also essential to cover amounts already spent (\$ 78 million by end June 2009) and to ensure proper funding for the rehabilitation of the Gaza economy, once the closure is lifted.

By end June 2009, expenditure arrears and payment commitments to suppliers, had reached \$ 180 million, an unsustainable situation. Adequate external financing during the second half of the year will be necessary to prevent a further accumulation of arrears.

B. Institutional Developments

- A new, expanded government, comprising twenty members and headed by Dr. Salam Fayyad was appointed by the President on May 18, 2007.
- The new government issued a two year program on August 24, 2009: "Palestine: Ending the Occupation and Establishing the State." This program integrates the government's political vision with concrete plans in each ministry and agency to develop their institutions, building on the progress already achieved during the last two years, in preparation for establishing a Palestinian State within a two year period.
- Palestinian Customs adopted on August 10, 2009 ASYCUDAWORLD, a state of the art web system to facilitate trade and provide up to date information for policy making. It will simplify customs procedures, benefiting importers and exporters. This modernization program, which began in 2000, was funded by the European Union.

- The 2010 Budget Circular was issued to Ministries and PNA agencies on August 16, 2009.
- An amendment to the 2009 PNA budget, providing \$ 300 million, in early relief and emergency expenditures for Gaza was approved by the Council of Ministers on August 24, 2009