

**PRDP-TF: Quarterly Review  
July – September 2016**

- 1- Public revenue grew by 22 percent in the first three quarters of 2016, mainly due to one-off transfers by the Government of Israel (GoI) totaling NIS1.2 billion.** Following the Israeli-Palestinian ministerial level discussions earlier in the year, the GoI transferred to the PA NIS580 million covering some VAT receipts collected on imports to Gaza in addition to a refund on fees charged to handle Palestinian imports. This in addition to an increase in petroleum excise due to larger imports of Israeli fuel to Gaza led to a 15 percent increase in clearance revenues<sup>1</sup> (year-on-year). Non-tax receipts also grew by close to 86 percent due to the Israeli transfer of accumulated Allenby bridge exit fees (NIS58 million) and equalization and health fees collected from Palestinian workers in Israel over the years (NIS593 million), as part of the recently signed electricity deal between the PA and the GoI. The Palestine Investment Fund transferred to the PA NIS71 million in investment profits in the first three quarters of 2016, which also helped boost nontax revenues. On the other hand, domestic tax collections declined by 2.5 percent in the first three quarters of 2016 following a decline in income tax and VAT receipts as the number of tax violation cases settled by the Large Taxpayers Unit were lower than in 2015.
- 2- Public expenditure grew by close to 5 percent and exceeded the prorated budget by 6 percent in the period between January and September 2016.** High expenditure growth was mainly driven by an increase in the wage bill, which constitutes about half of total expenditure. The cost of living allowance has so far not been disbursed and the zero net hiring policy has been generally maintained in 2016,<sup>2</sup> but unbudgeted increases for teachers, engineers and some high ranking officials pushed wage bill growth to 6 percent in the first three quarters of 2016 (year-on-year), compared to 3 percent assumed in the budget. Expenditure growth was also driven by an 8 percent rise in transfers following an increase in social spending in Gaza and in retirees' pension allowances due to the disbursement of payments owed since 2015. Net lending<sup>3</sup> also grew by 7 percent as Palestinian utility distributors continue to accrue dues to the Israeli suppliers, particularly for water and sewage, while the share of electricity net lending has been maintained at last year's level. Spending on goods and services grew by 1.4 percent due to an increase in the cost of referrals to local hospitals while the cost of referrals to Israeli hospitals has slightly declined compared to 2015.
- 3- Strong revenues offset the increase in spending, but a significant drop in donor support led to the accumulation of further arrears and debt by the PA.** The PA's total deficit amounted to US\$744 million in the first three quarters of 2016 – 27 percent lower than in the same period in 2015. Aid received was US\$549 million: US\$474 million in budget support and US\$75 million in development financing. Aid received was 14 percent lower than in 2015, and 46 percent below budget. As a result, a financing gap of US\$195 million ensued in the first three quarters of 2016. The PA resorted to the domestic banking sector and increased its net domestic bank financing by close to USD100 million to finance part of the gap, raising the stock of its domestic debt to USD1.5

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<sup>1</sup> Clearance revenues are VAT, import duties and other income collected by the GoI on behalf of the PA and transferred to the latter on a monthly basis.

<sup>2</sup> According to the PA's employment numbers, the net increase in the number of PA employees amounted to 94 during the first nine months of 2016. 774 employees were hired in the West Bank while 681 departed from the labor force in Gaza. The number of employees abroad increased by 1. Net employment in the health and education sectors increased by 104 and 276, respectively, while it was reduced by 158 in the security sector.

<sup>3</sup> Net lending represents deductions by the GoI from clearance revenues it collects on behalf of the PA for unpaid utility bills by Palestinian public utilities and local governments.

billion, as of September 2016. Even though the PA has been repaying arrears from previous years, new ones were generated, hence the net accumulation of arrears amounted to USD125 million in the first three quarters of 2016, as the PA struggled to close its financing gap. The PA's total stock of arrears to the private sector now stands at USD420 million, based on data provided by the MoF.

- 4- The financing difficulties are expected to continue throughout the remainder of the year.** According to Bank staff projections, the total deficit is expected to reach USD1.27 billion in 2016, while aid is projected at USD663 million (USD566 million in budget support and USD97 million in development financing). As a result, the financing gap is projected at USD0.6 billion. However, part of this gap has already been financed through arrears and borrowing from local banks between January and September 2016. The remaining gap is projected to reach USD0.4 billion. Given that borrowing from domestic banks is fast approaching the limit set by the PMA, the majority of the gap is expected to be financed through further arrears, unless additional donor financing is identified.
- 5- Some progress has been achieved in the PA's reform agenda so far in 2016, but more needs to be done.** The PA has continued to focus its efforts on revenue reform through widening the tax base and increasing the number of taxpayers. However, this has not been reflected in an increase in domestic tax collections because most of the additional taxpayers are low earners and their contribution to the tax system has been very small. Efforts on the tax policy front have not progressed as hoped and amendments to the income tax law to expedite and facilitate the settlement of tax violations are yet to be approved by the President. On the expenditure side, the PA appears to be making progress in controlling medical referrals to Israeli hospitals. But referrals to local facilities have been on the rise, pushing up the overall referral costs. Encouragingly, the Palestinian Cabinet has recently approved a health referral masterplan that was prepared in cooperation with the World Bank and aims to streamline the overall referral process. In addition, the MoH has been working with the Bank and the WHO to reform the overly generous health insurance system, which is the main source of hemorrhage. The PA and the GoI have signed an agreement in September to regulate aspects of their relationship in the electricity sector. This is an encouraging step that can build upon the work already done by the PA to control electricity net lending through signing MoUs with electricity providers requesting them to pay 90 percent of collections to the Israeli supplier. Similar efforts are also needed in the water and sewage sectors as net lending in these areas has witnessed a significant increase in 2016.
- 6- Progress in various areas of Public Financial Management (PFM) has been uneven.** Reporting of arrears has significantly improved as it now covers the total stock and repayment from previous years, but more needs to be done to make the presentation of arrears in the MoF's monthly reports clearer. A commitment system that ensures a budget allocation is secured for any expense prior to its contracting has already been implemented in four out of the five pilot ministries agreed upon through the Bank's Development Policy Grants (DPG).<sup>4</sup> The State Audit report on the 2011 financial statements, published in May 2016, identified a range of weaknesses in the accounting practices of the PA that need to be urgently addressed. The MoF has produced the 2012 statements for audit, and is receiving technical support to improve its ability to prepare the reports, however it is too early to say whether the accounting weaknesses have been properly addressed. More work is also needed to ensure that the clearance of the backlog of outstanding financial statements (2013-2015) is expedited. Some progress has been achieved in public procurement reform. The new procurement law entered into effect as of July 1, 2016. The Higher Council for Public Procurement Policy has recently made its first recruitment by hiring two employees. The Standard Bidding

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<sup>4</sup> The system has been implemented by the ministries of Interior, Transportation, Public Works, and Local Government while it is yet to be implemented at the Ministry of Health.

Documents were recently completed and are expected to be submitted to the Cabinet soon for circulation to all public entities. The development of the single procurement portal is advancing well as testing will start in two weeks and its roll out is scheduled for January 2017.