MAS

Palestine Economic Policy Research Institute

Final Report
Round Table Discussion (1)

The PNA's 2013 Budget: How to get through the bottleneck?

February 2013

Executive Summary
The PNA's 2013 Budget: How to break through the bottleneck?

February 17, 2013

Introduction

This roundtable discussion is an insightful debate of the PNA's draft budget for 2013, which comes amidst the financial crisis that has hit the PNA hard. MAS hosted, Dr. Nabeel Kassis, Minister of Finance, as keynote speaker, to address proposals and recommendations regarding the 2013 budget.

Presenters:

Dr. Samir Abdullah, Director General of MAS: Introduction
Dr. Nabeel Kassis, Finance Minister: Keynote address

Key Discussion Questions

- How will the financial crisis be addressed? What are the prospects for increasing revenues and reducing expenditure?
- How to build a national consensus on austerity policy?
- When and how will we have an actual fiscal policy that goes beyond the mere balancing of revenues and expenditures and the concerns about paying salaries?

Summary of the presentations

Dr. Samir Abdullah opened up the meeting by welcoming the Minister of Finance and the audience. In his brief introduction, he provided a definition of the public budget, saying that it is an instrument for re-distributing resources according to the priorities of the economy as envisaged by the government. He pointed out that the budget usually requires parliamentary approval, given its importance as an instrument of government. Rejection of the budget by parliament might lead to the fall of government. Dr. Abdullah went on to explain that under the Oslo Agreements, the PNA is charged with responsibility for all financial issues, including budget preparation, It is fully responsible for the needs of the Palestinian people in the occupied territory, yet it receives insufficient revenues and resources. Indeed, the PNA barely receives 80% of tax revenues paid by the Palestinians in the occupied territory; controls only 40% of the land area; and has access to less than 20% of the water resources. These impediments restrict the development of the Palestinian economy, since the bulk of these resources has remained under the Israeli security control. This has, in effect, curtailed Palestinian investment prospects that could have, otherwise, led to economic growth and increased revenues, and, thus, plugged the budget deficit. Given this adverse situation, the only prospect available (apart from international aid that is expected to finance the deficit) is a transparent, equitable burden-sharing strategy that enables the PNA to continue providing services, especially in relation to the education and health sectors, which have recently seen frequent strikes.

Dr. Nabeel Kassis
In his presentation, Kassis first elaborated on the deficit which is placing the national budget in a bottleneck. He added that notwithstanding the importance of focusing on the developmental side of the budget (which, of course, augurs well for the development of sectors that promote the economy), we find ourselves forced to focus on the operational (or current) side of the budget, it being understood that any savings in the operational budget may be allocated for funding projects that impact on the growth in the Palestinian economy. The source for such funding can only be tax revenue, which is unlikely to provide more than a small part of the funding needed for development project. Therefore, we have to rely on foreign aid to finance development projects, he said.

Kassis revealed that the 2013 budget suffers from a total projected deficit of $ 1.4 billion (more than one third of the size of the budget). Therefore, he continued, the PNA can only finance this deficit either through additional foreign aid or by cutting expenditures and increasing revenue, or both. However, the PNA is unlikely to receive additional foreign aid (as compared to 2012); hence the need to cut costs and increase revenue.

It is no secret, Kassis added, that the wage bill accounts for the largest share of operating expenses (56%), and therefore reducing operating expenses will most likely mean reducing the wage bill. This does not necessarily entail reducing individual wages and there are measures that can be implemented to achieve the desired overall reduction. The revenues, on the other hand, involve taxes that can be increased by expanding the tax base and combating tax evasion and tax avoidance. This is what the Ministry of Finance seeks to achieve through improving its tax collection mechanisms. Raising tax rates, which may result in an increase of revenues, is not being currently contemplated by the Ministry, nor is there an impending decision to this effect. What is most important now is to increase the Ministry of Finance's capacity and to improve its performance in tax collection at the current rates, and also to determine what is the most effective use of such additional resources, whether paying bank loans, or paying suppliers' debts, or reducing the deficit in the pension fund. These are all important areas where arrears and deficits need to be addressed besides financing development projects (including agriculture and manufacturing), Kassis said.

Kassis remarked that applying the above mentioned measures, whether reducing the salary bill or expanding the tax base is not going to be easy. Therefore, he said, other additional measures need are being contemplated, in particular reducing net lending (the funds that the Palestinian Authority lends to local councils to pay water and electricity bills), which arises from Israel's deduction of such dues from tax revenues that it collects on behalf of the PNA.

Kassis pointed out that the Ministry of Finance is currently working on the draft budget within the current constraints of the US freezing payment of promised aid and Israel's withholding of tax revenues. He emphasized that it is not possible to find a fast, ready-made solution to the current financial crisis; hence the need to listen to ideas from various parties. As an example of such ideas voiced recently, he mentioned one that came from a member of the private sector who suggested that the private sector might be able to absorb a certain number of government employees on cost sharing basis, with the government and businesses each paying half of these employees wage bill.

Summary of Discussion

Samir Hulieleh, PADICO
According to Mr. Hulieleh, the problem is in the first place related to the number of labor market's new entrants who cannot find jobs, rather than the number of the current government's employees (or the stalled economic growth). The Palestinian Authority must develop a policy designed to absorb large numbers of those entering the labor market each year. It must also create mechanisms to employ them. Hulieleh said that reducing government expenditure is less adverse than raising taxes.

Samer Salameh, Ministry of Labor
Mr. Salameh pointed out that the government's cuts always target the most vulnerable groups. The public servant is always considered the only party that should incur the costs of the status quo. He referred to the issue of security services, saying that the PNA can reduce expenditure through cutting back on security costs.

Mahmoud Ziyadeh, Federation of Independent Trade Unions
Mr. Ziyadeh stressed the role of actuating a genuine partnership between all parties, so that we can promote the national project and address the structural imbalances in the budget. It is a burden-sharing task in which no party bears the brunt alone. He pointed out that 75 thousand graduates enter the labor market each year, and these do not find job opportunities. Besides, 75% of the private sector institutions do not comply by labor laws.

Haidar Ibrahim, General Union of Palestine's Workers
Mr. Ibrahim remarked that the purport is in promoting production (whether in agriculture or industry) and refraining from accepting the Israeli product at the expense of the Palestinian product. He added that it is very important to control the credit granted to government employees with low income.

Bassam Walwiel, Ministry of Agriculture
Mr. Walwiel maintained that the crisis is basically triggered by the grand responsibilities the PNA assumes, along with little left powers. The solution is to build a strategic policy aimed at building a long-term plan that takes into account all the circumstances, supports the economy and accelerates growth.

Yousef Daoud, Birzeit University
Mr. Daoud remarked that since 1996, economic studies have shown instability of the fiscal position of the PNA and the unlikelihood of sustaining financial stability. The PNA, however, has done nothing in the past ten years to strengthen its financial position. He referred to the renewable energy that, he believes, can provide large sums of money to the Palestinian Authority treasury once it is introduced.

Nassar Nassar, Nassar Companies
In his talk, Mr. Nassar stressed that corruption is a major cause for the PNA's financial crunch. Frequent travels of PNA's high-profile staff (with luxury cars and escorts) drain fifty million dollars, an amount that is much higher than the ten million dollars the PNA took as an excuse to stop the application of the Investment Promotion Law.

Nasr Abdul Karim, Birzeit University
Dr. Abdul Karim commented that finding a quick, ready-made solution for the PNA's crisis is out of the question. The real problem is the way the PNA deals with issues. It issued more than one decision and revoked them in a couple of months. He said that this signals the PNA's impairment when it comes to decision-making and its failing in crafting a thoughtful methodology and setting priorities that may alleviate financial distress across the board.

Mohammed Ala'moor, Businessmen Union
Mr. Ala'moor emphasized that economic and financial policies should echo the priorities of the Palestinian people, which is materialized in the general budget of the Palestinian National Authority.

Sha'wan Jabarin, Al-Haq
Dr. Jabarin focused on cutting expenditure on security forces. The budget and the control of the financial performance are policy-related, political issues that should meet certain priorities and consider transparency and credibility.

Majeda Masri, Birzeit University
In her contribution, Masri emphasized the need to establish a department that examines fiscal policies and their impact on the private sector and employment, as well as on the economy as a whole. The recommendations of this department can enable the PNA to design thoughtful policies that may mitigate the financial crisis.

Nabeel Kassis
Replying to the speakers' remarks regarding the financial history of the Palestinian Authority under the Israeli occupation, the dearth of resources and the large number of responsibilities, Kassis said that all this is obvious and that what we need now are solutions and proposals. He remarked that the problems of stalled growth and increased unemployment rates are currently global problems. He added that a fiscal policy unit is now under construction in the Ministry which he hopes will help address policy issues. Kassis also contended that some bad habits that are manifest in

exaggerated on the Palestinian National Authority even in matters that are within the capability of many citizens (like paying water and electricity bills), which increases the financial burdens on the Palestinian Treasury.

Maher Masri, Capital Market Authority

Mr. Masri elucidated that the minor details are not the core of the problem. Rather, the Ministry of Finance, in cooperation with concerned committees, must develop a clear policy that avails the macroeconomic performance, which eventually enhances microeconomics.

Nabeel Kassis

Kassis replied by saying that he took note of the many views and comments that may help him in preparing the draft budget, especially with relation to long-term policies rather than the short-term procedures. Kassis concluded the meeting by thanking the audience who took part in the discussion.

Recommendations

- It is possible to endorse a fiscal policy that can spare the PNA similar predicaments in the future. However, it is still not easy to find fast, ready-made solutions. It is also feasible to build a specialized unit that studies the fiscal policy and develops fiscal proposals that the PNA can adopt if it deems these proposals appropriate.
- The citizens must be aware of the current situation and, thus, reduce their dependency on the PNA in paying water and electricity bills, as well as installing meters. This dependency has instigated the Israeli side to deduct a lot of money from customs revenues owed to the Palestinians.
- We must consider all suggestions and recommendations of all parties, including the private sector- the leader of production and advancement of the Palestinian economy. Among these suggestions is the private sector's proposal that it absorbs a certain number of government employees on the basis that the public sector pays half of these employees wage bill and the government pays the other half.

Background Paper
The PNA's 2013 Budget: How to break through the bottleneck?

This paper provides background information for a discussion session debating the draft budget of the Palestinian National Authority for 2013, and proposing actions to overcome the financial crisis the PNA is going through. The paper involves 4 sections:

First: A brief historical overview of the financial situation of the PNA (1994-2012).
Second: A review of the draft budget for 2013.
Third: Some observations on the draft budget in light of anticipated changes during the year.
Fourth: Introducing round table discussion themes.

First: A brief historical overview of the financial situation of the PNA (1994-2012)

The history of the financial position of the PNA can be divided into five distinct phases[1]:

I. Establishment phase (1994-1999)

Following the signing of the Declaration of Principles, an international conference was held in 1993. In that conference, $2.4 billion was pledged to finance the reconstruction program (1994-1999). This amount was raised later to $3.4 billion. It was implicitly understood that these funds would be allocated for development agreement, and that the Palestinian National Authority would gradually fund the current budget from domestic resources. A study of the budget data for this period led us to the following observations:

- The finance of current expenditure came mainly from local revenue. Besides, the current budget deficit was always on the decline (the budget had a surplus in 1998, while 1999 saw a balanced budget).
- The international aid would go to developmental expenditure, while the ratio of developmental expenditure to current spending was high (approximately 22% in 1998).
- The number of the public sectors employees totaled 98 thousand in 1999 (about 44% worked in security services), with a bill of wages and salaries totaling $524 million (or about 55% of current spending).
- In a short period, the National Authority was able to significantly increase revenues of income taxes and indirect taxes, although indirect taxes were much higher (representing about 80% of domestic revenues compared to 50% in the Arab States and 30% in Israel during the same period).
- During this period, the PNA succeeded in controlling spending and deficit, and it managed to raise domestic revenues to 20% of GDP (which is higher than in neighboring countries).

II. Years of the Intifada (2000-2002)

The harsh political conditions and the crippling economic blockade during this period had exhausted the budget. The most salient developments during this period were:

- Local revenues declined sharply, especially when Israel stopped transferring clearing revenues (up until the end of 2002, Israel transferred only 16% of the two years revenues).
- With increased social pressures and the closure of the Israeli labor market, the PNA was forced to increase spending and public employment, which rose in 2002 to 124 thousand employees, with an annual salaries bill of $ 665 million (23% of GDP).
- The growing gap between spending and revenue during these harsh years was spanned by two main sources:

---

[1] All the figures in the first section of this report are taken from:
- Webpage of the Palestinian Ministry of Finance.
- Periodic reports published by the Office of "International Monetary Fund" in the West Bank and Gaza Strip.
- Webpage of the International Labor Organization.

1. An abundant flow of international aid appropriated to current expenditure ($ 471 million in 2002 compared to a slight amount in 1998). The trend that emerged in that period (which would control the fiscal policy for years to come) left the public spending dependent on international aid. The contribution of foreign aid to current budget revenues in 2001 and 2002 was 44% and 46%, respectively, up from a scant 2% in the years prior to the intifada. Obviously, the main reason behind this significant increase in international aid was not only a result of withholding clearing revenues, but also a consequence of an increase in spending that was faster than the increase in domestic revenues.
2. Increase in outstanding debt and borrowing from local banks: The accumulated internal and external debt, as well as outstanding debt totaled approximately $1.2 billion (or 43% of GDP) in end 2002.

III. The start of fiscal reform (2003-2005)

The earnest fiscal reform started in June 2002 as a result of the pressure of the financial (and political) crisis, as well as pressure from donor countries. The most salient features of the reform were establishing the consolidated account; the aggregation of the PNA's wealth; reducing the PNA's activities in businesses through the Investment Fund; and establishing a ceiling for public employment. The transferring of clearing revenues and promises of donor countries to keep aid flowing (including aid to support the developmental expenditure) had helped the reform effort accomplish its objectives.

- The first task of the budget plan was to pay outstanding debts and part of the debt to local banks (given their impact on the local economy). The Legislative Council insisted that all previous years arrears ($415 million) be allocated to pay outstanding debt, and pay back some expensive loans ($65 million).
- By the end of 2005, the number of public servants hit 146 thousand (98 thousand at the end of 1999). The bill of wages and salaries saw two significant climbs: in late 2003 and in the second half of 2005. These increases (in addition to increasing the number of staff by 31 thousand in late 2005) raised the bill of wages and salaries from $665 million in 2002 to $ 1,001 billion in 2005.
- On the other hand, since 2003, net lending (the amounts the PNA pays for water and electricity bills, as well as the petroleum bill that is not paid by the citizens) increased dramatically, totaling $344 million in 2005.
- The ongoing growth in spending led to an increase in the ratio of public expenditure to GDP in 2005 to 49% (twice the rate in 1999). With this significant ratio, Palestine ranked second at that time (after Eritrea).
- The reform had not led to the projected significant improvement in the structure of the budget. The spending continued to increase at a faster pace than domestic revenues, and overdependence on foreign aid and borrowing from local banks never stopped. This led to an ongoing piling up of the public debt (as we will see).

IV. Hamas Government and the Government of National Unity (2006 -2007)

Following the Hamas win of the parliamentary elections in early 2006 and the formation of the government about a month later, the budget saw an entirely new situation. Israel withheld clearing revenues (transferring only 40% ($244 million) of the revenue due during 2006), and tax collection dropped dramatically. Further, local banks reduced their exposure to government debt (for fear of penalties and prosecution abroad) through deducting taxes owed to the government.

- To hold out this strict constraint on liquidity, the government then slashed expenditure in all budget items, and thus the public servants received only 40% of their salaries on average. Non-wage expenditure also fell sharply. However, spending remained higher than revenues, and the deficit was financed through advance payments from the Palestinian Investment Fund.
- In 2006, international aid doubled, but with different funding channels. With about $738 million, international aid in that year was more than twice the value of the aid in 2005. Four

hundred and twenty million dollars came from Arab states, while $146 million came from the European initiative (TIM). Reneging on the unified account system (given the multiple sources of funding and the various bodies receiving aid) hampered transparency and supervision on revenues and spending.

- In 2006, the number of government employees totaled 159 thousand (distributed evenly between civil servants and security forces).
- The second half of 2007 saw an influx of clearing revenues following the political split, the dissociation of the national unity government (which lasted for only six months) and the formation of a new government in Ramallah. This coincided with a rise in external support from $738 million in 2006 to $1,012 billion in 2007. In parallel, however, the budgetary spending increased by 80%, forcing the PNA to seek advance payments from the Investment Fund ($78 million) to finance the deficit (though the bulk of the deficit came from developmental spending, rather than current spending).

V. The Current Period (2008 – 2012)

The above analysis indicates that the PNA's budget has always been on the verge of a bottleneck. It boils down to this: the PNA has to pay a monthly certain bill (mostly salaries denting more than half of the budget) vis-a-vis uncertain revenues (international aid and clearing revenues, together representing about 80% of the current budget revenues). The problem becomes even more compounded when time is taken into account: even when aid and clearing revenues are sufficient to cover expenditure, their distribution over the months of the year may not be accordant with the distribution of monthly expenditure.

Table 1: Periods of interruptions and late payments of public servants' salaries (2009-2012)

	Salaries paid in due time	**From January 2009 To May 2011**
July 5: Disbursing (50%) of June salary August 25: Disbursing the remainder of June salary	Delay in paying salaries	June 2011
	Salaries paid in due time	July 2011 To May 2012
2012		
July 7: Paying 60% of June salary (with a minimum of NIS 2000) July 22: Disbursing the remainder of June salary	Delay in paying salaries	June
August 11: Paying 70% of July salary (with a maximum of NIS 4000) August 27: Paying the remainder of July salary	Delay in paying salaries	July
September 9: Disbursing 50% of August salary (with a minimum of NIS 2000) September 16: Disbursing the remainder of August salary (10% was deducted from salaries higher than NIS 4000, but then the deduction was disbursed on October 2).	Delay in paying salaries	August
October 18: Disbursing 50% of September salary (with a minimum of NIS 2000 and a maximum of NIS 4000) October 22: Disbursing the remainder of September salary (just before Eid al-Adha).	Delay in paying salaries	September
November 11: Paying part of October salary (with a minimum of NIS 1000 and a maximum of NIS 2000) November 22: Paying the remainder of October salary	Delay in paying salaries	October
December 23: Paying part of November salary (with a minimum of NIS 1500 and a maximum of NIS 4000) January 30: Paying the remainder of November salary	Delay in paying salaries	November
January 20: Paying part of December salary (with a minimum of NIS 1500 and a maximum of NIS 4000) February 4: Paying the remainder of December salary	Delay in paying salaries	December
2013		
	Delay in paying salaries	January

See detailed schedule of salary payment interruptions (2006-2012) at MAS web page www.mas.ps

Despite the relative improvement the budget enjoyed in 2008 (particularly in terms of payment of arrears and some accumulated debt) and in 2010 (in terms of the growth in local taxes and the payment of obligations), the financial crisis has reemerged in the following years, particularly regarding the increase in debt and the accumulation of arrears. The crisis particularly resurfaced insistently as of June 2012 in the form of delays in paying the salaries of employees. Table 1displays the delays in paying the salaries during the period 2009-2012.

The most discernible trends during this period were:

- Domestic net revenue grew during the four years between 2008 and 2012 from $1.6 to $2 billion. The increase came mainly from increased clearance revenues. In fact there was a decrease in domestic taxes collection even when figures are in nominal terms (i.e. before considering inflation, see Table 4).
- Along with a 32% increase in domestic revenues, current expenditure grew by 16% during the period, resulting in an increase in the current budget deficit (before foreign aid) by 7% (bringing the figure to $1.4 billion) between 2008 and 2012. This rise occurred despite the fact that the stated goal of all budget proposals during the period was to reduce dependence on foreign aid in financing the current expenditure.
- In conjunction with an increase in budget deficit before financing, there was an ongoing decline in foreign aid (from $1.9 billion in 2008 to $930 million in 2012), i.e. a decline of about 50%.
- The current budget (after foreign aid) had a surplus of $446 million in 2008. However, this surplus turned to be a deficit of $639 million in 2012.
- As of early 2010, developmental spending started showing deficit signs (after international aid), i.e. spending on development projects was higher than international aid allocated to these projects, which led to a deficit of $105 million in 2012 (apart from the current budget deficit after foreign aid).
- Regarding expenditure, bill of salaries and wages continued to inflate (an increase of 22% between 2008 and 2012). The bill drained about 50% of the total current expenditures during the period. This ratio is very high compared to the average in the Arab world (38%), though the Arab World average is already twice the global average[2].
- Non-wage expenditure increased rapidly (44% between 2008 and 2012). Likewise, net lending hiked by 100% between 2011 and 2012 after seeing a declining trend in the previous years[3].
- This revenue-expenditure structural imbalance compounded the public debt, including the accumulation of arrears (i.e. the government's outstanding debt). Table 2 shows the public debt figures end of 2012 (as summed up by the Finance Minister). Evidently, the amount of debt is only slightly less than double the domestic revenues of the Palestinian National Authority in 2012.

Table 2: PNA's Public Debt, 2012 ($ millions)

Item	$ millions
Debt owed to local banks	1,384
External debt	1,100
Debt owed to Pension Fund	970
Arrears owed to suppliers	400
Total	**3,850**

Source: Interview with the Minister of Finance, Al-Ayyam Newspaper, February 8, 2013.

2 The global average is taken from the International Labor Organization (ILO). See *Economic and Social Monitor*, Issue 26, October 2011, MAS.

3 Net lending is the amounts paid by the Palestinian government to cover utility bills (such as electricity and water) owed by some municipal councils and poor households.

Second: 2013 Draft Budget

The last column of Table 3 below provides a brief overview of the budget for 2013 as proposed by the International Monetary Fund (we use these figures only for representation purposes). The figures overtly show that the net domestic revenues are expected to increase by nearly 9% compared with 2012. Assuming an inflation rate of 3%, the draft budget figures practically expect an increase of domestic revenue by 6% in real terms, which is almost the same projected growth in GDP. The draft budget predicts that such an increase in domestic revenue will be generated from a 11% growth in clearance revenue and a 7% rise in domestic revenue collection.

Regarding expenditure, representative figures indicate projections of a slight decline, i.e. spending in NIS (in real terms) will decrease significantly in 2013 (taking into account inflation and an expected shekel appreciation against the dollar). Salaries and wages are expected to increase by only 6%. The 2% increase in other current expenses will be offset through reducing net lending by 54%.

These rates will lead to a $1.2 billion deficit in the current budget (before foreign aid and funding), an amount that is only 14% less than the 2012 deficit.

Unlike the 2011 draft budget, the 2013 virtual draft budget assumes that the PNA will not have to borrow from the banks. It does not either expect a change in the accumulation of arrears (increase or decrease). This implicitly suggests that the public debt (shown in Table 3) will remain unchanged until the end of 2013. The draft budget proposed by the International Monetary Fund assumes that the current deficit (1.2 billion dollars) and the developmental expenditure deficit (300 million dollars) will be financed by international aid. This is only a presumption rather than a projection (see the following section).

Third: Observations on the draft budget

Developing budgets is undoubtedly a predictive process that is often subject to erroneous forecasts. Unquestionably, the margin of error in the current Palestinian situation is larger than the global rates. This, however, does not preclude the need for providing logical justifications for budget targets. The draft budget for 2013 is not different from those developed in previous years. These drafts are at best a mere exercise to strike a balance between different figures without having sufficient information about the justification of various suppositions relating to income and expenditure.

We will use the IMF's figures only for representation purposes. Foreign aid figures contained in the draft budget are only preliminary assumptions aimed at reaching an agreement on how to deal with the financial crisis. The figures of the draft budget suggest $1.421 billion as international aid to the current budget, but the Finance Minister expects an international aid of only $1 billion, leaving a projected deficit of $412 in the current budget. On the other hand, there is evidence that opportunities to finance the deficit through borrowing from local banks or accumulating further arrears (as was the case in the previous years) are now almost zero[4]. How will the PNA raise more than $ 400 million during the year? Of course, there are only two ways available: either increasing revenues and / or reducing expenditure.

Table 3: PNA's General Budget, 2008-2013 (million dollars)

	2008	2009	2010	2011	2012	Draft budget 2013*
Net public revenue	**1,568**	**1,597**	**1,884**	**2,045**	**2,067**	**2,257**
− Local collections	562	585	702	738	721	774
− Clearance	1,122	1,103	1,259	1,423	1,459	1,619
− Tax returns	116 -	91 -	76 -	116 -	113 -	137

4 The IMF's report predicted that these opportunities have been virtually blocked since mid-2012. However, public debt (excluding arrears) rose during 2012 by NIS 866 million.

	2008	2009	2010	2011	2012	Draft budget 2013*
Current expenditure and net lending	**2,886**	**3,190**	**3,076**	**3,323**	**3,481**	**3,468**
− Salaries and wages	1,453	1,467	1,613	1,782	1,778	1,886
− Non-wage expenditure	985	1,349	1,227	1,401	1,420	1,451
− Net lending	447	374	236	140	284	132
Current deficit before financing (accrual)	**1,317**	**1,592**	**1,192**	**1,278**	**1,414**	**1,212**
Current deficit before financing (cash)	**1,493**	**1,371**	**1,075**	**783**	**802.6**	
Developmental expenditure	215	400	450	370	261	300
Total deficit before financing (accrual)	**1,532**	**1,992**	**1,642**	**1,648**	**1,675**	**1,712**
Total deficit before financing (cash)	**1,708**	**1,771**	**1,525**	**1,153**	**1,062.6**	
Financing	**1,532**	**1,992**	**1,642**	**1,648**	**1,674**	**1,412**
− Current budget support	1,763	1,355	1,146	814	775	1,412
− Developmental expenditure support	215	400	350	169	156	300
− Bank financing	227-	176	83	93	130	0
− Net change in arrears	373-	222	66	541	579	0
− Other (complement arithmetic)	154	-161	3 -	30	35	0
Financial gap	**0**	**0**	**0**	**0**	**0**	**0**
Inflation	**9.9**	**2.75**	**3.7**	**2.88**	**2.78**	**3.00**
Exchange rate	**3.54**	**3.9**	**3.73**	**3.58**	**3.85**	**3.80**

Source: Palestinian Ministry of Finance webpage
* The draft as obtained from the Bulletin of the International Monetary Fund, September 23, 2012.

Revenues

The IMF's report contends that 2013 projections of an increase in revenues so that they maintain the ratio to GDP at about 20% (as in 2012) are conservative[5]. The report adds that the projections are conservative in that they do not consider the impact of the rise in the VAT rate by 1/2 percent (which is supposed to generate an annual additional revenue of $25 million). On the other hand, the impact of efforts to raise the collection of income tax (from 1.6 to 2% of GDP) is not regarded in these projections[6]. The projections also ignore the impact of raising the corporate tax (from 5% to 20%), as well as the two-year suspension of income tax exemptions for 13 companies. Moreover, there are opportunities to significantly increase the clearance revenues following the finalizing of an understanding between Israel's Finance Minister and Palestinian Prime Minister in July 2012.

However, the opportunities to increase local revenues to figures higher than the projections are meager, since all the procedures mentioned above were actually implemented since mid last year, but local taxes in that year fell by 2.5% from 2011. The reason behind this is that tax-payers often deduct income tax and value added tax from the arrears that the government owes them, i.e. the government, willingly or unwillingly, pays part of its debts. This may also occur in the current year, hampering a further increase in revenue. On the other hand, the initial agreement with the Israelis on clearing arrangements have not so far led to any practical results, and there is no indication that this situation will change in the near future[7].

---

5 IMF (September, 2012). Recent Experience and Prospects of the Economy of the West Bank and Gaza. Staff Report Prepared for the Meeting of the Ad Hoc Liaison Committee.

6 The ratio of income tax to GDP in the Palestinian territory is lower than in other countries (between 3-4% in Lebanon, Jordan and Algeria). See "Financial sustainability of the Palestinian National Authority: Experience and Future Prospects," MAS (2012). On the other hand, the International Monetary Fund found low businesses' compliance rate (estimated at below 40 percent).

7 Some sources say the annual gain (when the Palestinian-Israeli understanding is applied) could range from $200 million to $450 million. The IMF report expects substantial gains from the increase in clearance revenues: a 10 percent improvement in collection could yield about NIS 420 million (1 percent of GDP) in additional revenue in 2013. See Background Paper for the Roundtable Discussion (7): Recent Amendments to the Paris Protocol Trade Arrangements, MAS (2012).

Still, foreign aid might increase by more than a billion dollars, which also seems unlikely in light of the political and economic situations in the Arab region and the international arena. It is noteworthy that the one billion dollar external aid includes $200 million of U.S. frozen aid, which is supposed to be transferred to the Palestinian Authority during the year.

Expenditure

If opportunities of increasing revenues are limited and opportunities for increasing the public debt are blocked, then the only available way is to reconsider the expenditure items. Perhaps the first thing that draws our attention in the draft budget is the pre-announcement that the PNA will not pay any of the arrears unless additional revenue or additional sources of funding are available. This means that reducing spending on this item is not possible because simply it does not exist. Hence, we are left with three general items: (1) salaries and wages bill (devouring 54% of total spending), which is expected to grow at the rate of 6%. (2) Non-wage expenditure (depleting 42% of total spending), which is expected to increase on an average rate of 2%. (3) Net lending (consuming 4% of total spending), which is expected to fall by 54% compared to last year. This outlook currently seems optimistic given the obstacles impeding the settlement of electricity bills and installation of prepayment meters.

There are many austerity measures that can be taken (the IMF suggested applying some of them as of mid 2012), including cessation of public employment (which started in mid-August 2012); reducing allowances of cost of living (to a maximum of 1.5%); reconsidering non-wage spending and retaining only the basic spending (although the PNA has emphasized that it will never compromise spending on social services, health and education); and refraining from implementing development projects unless external financing is available.

Table 4: Shares of some ministries and institutions of the total wage bill and transfer expenditure

	Salaries and wages as % to total bill of salaries and wages			Transfers expenditure as % to total transfers expenditure		
	2011	2012	2013 (draft budget)	2011	2012	2013 (draft budget)
PLO institutions %	1.36	1.57		2.40	2.59	
Ministry of the Interior and Security %	42.1	43.0		7.14	21.8	
Embassies %	1.17	1.37		0.29	0.33	
Ministry of Education %	27.2	26.7		8.03	6.74	
Ministry of Health %	8.9	8.8		1.92	1.59	
Ministry of Social Affairs %	0.78	0.82		31.4	36.2	
Total (million shekels)	6,358	6,812		3,037	3,319	

Source: Tables of financial operations, details of expenditure by item. Table 6 b (accrual basis), December 2011, 2012. Ministry of Finance.

However, these suggestions are too broad to be quite applicable. The practical austerity measures should be able to save up to 10% of current spending, which requires a detailed study of the various forms of expenditure in different ministries and institutions to identify possible areas for austerity.

The draft budget split spending into employees remunerations (52%), transfers expenditure (28%), and operating expenses (16%). A world Bank's report found that in 2007, transfers were about 13 percent of total expenditures but by 2011 they had risen to nearly 27 percent. In real terms, transfers grew by 88 percent in 4 years[8]. Although more than half of the transfers go to social payments, a large share of social payments target segments of society who may not be poor. The

8 World Bank (2012). Stagnation or Revival?: Palestinian Economic Prospects. Economic Monitoring Report to the Ad Hoc Liaison Committee. March 2012.

World Bank advises the PNA to review the other half of the transfers; however, there is no detailed information about the types and recipients of this other half of the transfers.

National Reconciliation

The national reconciliation between the governments of the West Bank and Gaza, if materialized, will add a new burden on the PNA budget. The National Authority pays about $500 million a year as salaries for about 37 thousand employees in the Gaza Strip. Since 2007, a large number of these employees have refrained from going to work at the request of the PNA[9]. The Hamas government employed about 23 thousand personnel (7,500 in the public civil sector and 15,500 in the security sector). The annual wage bill of these new employees is estimated at 180 million dollars[10].

Again, if the national reconciliation is realized, how can the budget manage the consequences? What are the financial implications? The Finance Minister says that the Ministry is preparing a budget supplement that takes the financial consequences of reconciliation into account. This is definitely positive and advantageous given the high probability of erroneous projections of revenues and expenditure in the current circumstances (the margin of error in the 2012 budget was - 7.5% for domestic revenue, +3% for spending and - 23% for predictions of external financing of the current budget). The PNA, should, thus, consider different alternative scenarios / budgets to be applied when needed.

Fourth: Key Discussion Questions

- How will the financial crisis be addressed? What are the prospects for increasing revenues and reducing expenditure?
- How to build a national consensus on austerity policy?
- When and how will we have an actual fiscal policy that goes beyond the mere exercises to balance income and expenditure and concerns about paying salaries?

[9] About 18 thousand employees in the Ministry of Health and the Ministry of Education have continued to go to work after the split.

[10] These figures date back to the end of 2009. See Roundtable Session: " The Challenges of Re-unifying the Palestinian Government Sector: Solutions under the National Reconciliation." (MAS). July 25, 2011.

Attendance Record for Round Table (1)
The PNA's 2013 Budget: How to get through the bottleneck?

Name	Institution
Ibrahim Abu Kamish	Al-Hayat Al-Jadeeda
Ahmed Yassin	Sharek
Marwan Toutah	Beisan Compamy
Husni Eaida	Arab Bank
Nassar Nassar	Nassar Companies
Amal Masri	BWF
Mahmoud Ziyada	Federation of Independent Trade Unions
Maher Masri	Capital Market Authority
Haneen Ghazawneh	MAS
Azmi Abdul Rahman	Ministry of National Economy
Mohammed Abdullah	Al-Quds
Zolfa Sharoor	Wafa News Agency
Saeed Barashi	BCI
Farid Ghannam	Ministry of Finance
Samir Huleileh	PADICO
Kamel Mujahed	Nama Agricultural Company
Ypusef Dalow	Birzeit University
Sha'wan Jabarin	Al-Haq
Majeda Salem	Birzeit University
Bassam Walwiel	Ministry of Agriculture
Samer Salameh	Ministry of Labor
Haidar Ibrahim	General Union of Palestine's Workers
Mohammed Ala'moor	Businessmen Union
Hala Khalayleh	Raya F. M.
Dr. Nasr Abdul Karim	Birzeit University
Nisfat Khoffash	National Commission for NGOs
Shada Abdul Samad	FES
Laila Saffat	Palestinian General Federation of Trade Unions
Allam Jarrar	NGO's Network
Abdul Qadir Huseini	Faisal Huseini
Shaher Yassin	Ministry of Agriculture