



**M A S**

**Palestine Economic Policy Research Institute**

**Final Report  
Round Table Discussion (2)**

**The PNA's 2012 Budget:  
The Plan versus Implementation**

**March 2013**



## **Executive Summary**

### **The PNA's 2012 Budget: The Plan versus Implementation**

**Date: March 11, 2013**

#### **Introduction**

This roundtable discussion seeks to tackle the reasons and the scope of the discrepancy between the 2012 draft budget the PNA prepared and the on-ground results of the implementation of the budget throughout the year. In light of the actual performance, the analysis, thus, aims to identify the reasons behind this variance, with an eye to enhance the ability of the PNA to develop more accurate, proper financial plans.

#### **Presenters:**

Dr. Numan Kanafani: Director of research at MAS

Dr. Omar Abdel Razek: Former finance minister and member of the sitting Palestinian cabinet

Basem Khoury: Former minister of economy and director of *DAR AL SHIFA'* Pharmaceutical Co.

#### **Key Discussion Questions**

- ✧ What is the overall evaluation of the performance of the budget in this year? Was the prediction error a result of beyond-control factors? Did the PNA have an option of making a piecemeal financial relapse rather than the dramatic tailspin which figured in the inability to pay salaries?
- ✧ Were the methods of budget drafting, oversight and accountability satisfactory during the preparation and the implementation of the budget? Where and how can these methods be improved? What lessons can be learned in relation to the 2013 budget?
- ✧ When will we have a serious fiscal policy that replaces the commonplace exercise of matching some hypothetical figures together; i.e. when does the Ministry of Finance start functioning beyond the mundane job of a mere salary cashier?

#### **Summary of the presentations of the keynote speakers**

D. Numan Kanafani opened up the meeting, illustrating that the current roundtable discussion comes to round off the previous roundtable session which MAS prepared on the PNA's 2013 budget. He noted that the first session has made way for representatives of the private sector, public sector and trade unions to set forth proposals and comments about the budget and how to break through the financial bottleneck that threatens the stability of the Palestinian economy. Kanafani then introduced keynote speakers and thanked them for accepting the invitation.

Dr. Kanafani highlighted the purport of discussing the 2012 budget given the absence of a definite budget for 2013. Analyzing the 2012 budget, he said, would allow us to deduce several lessons and identify errors that can be avoided in the current year's budget. Kanafani went on to review the stages the Palestinian budget has undergone: back from the foundation stage (between 1994-1999), to the recession stage (between 2000 and 2002), to the financial reform stage, to the Hamas government stage and, finally, the government of financial reform. Then, he referred to the final stage which started in 2008- marking the political split. Kanafani asserted that the budget has always been on the brink of a crisis due to volatility, as well as certain expenses and uncertain revenues. Finally, Dr. Kanafani reviewed the key figures in the draft budget versus the actual implementation, explaining and analyzing the discrepancy between these figures.

In his talk, Dr. Omar Abdel Razek underscored that both the Palestinian budget and the process of preparing this budget endure chronic problems that coincided with the establishment of the Palestinian National Authority. Abdel Razek continued to say that, according to the International Monetary Fund, the PNA has already made significant progress in the formulation and preparation of the budget to the extent that the Fund is now aware that the Palestinian National Authority is able to formulate, manage and implement fiscal policies. However, the process of preparing the

budget, according to the background paper presented in this meeting, still builds on random expectations and continues to rely on foreign experts, Abdel Razek remarked.

Abdel Razek then moved to tackle the two themes of the present discussion (the overall evaluation of the performance of the 2012 budget: plan vs. implementation; and methods of budget drafting, oversight and accountability) noting that to answer these questions, there should be an in-depth scientific research that can provide adequate answers, such that drafting and expectation methods are properly reviewed to account for the various items of expenditure and returns in ministries and institutions within a medium-term or short-term planning process. The PNA should also review the mechanisms of endorsing the various budget items, as well as the stages of preparation, debate, amendment, approval and adoption, he commented.

Regarding the third theme, Abdel Razek believes that it requires going over the fundamental problems the Palestinian budget sustains. These problems, he continued to say, are exposed, but "I beg your indulgence for a few minutes to openly discuss these problems and, thus, propose some solutions."

There are many problems hindering the sound formulation of a fiscal policy, he said. The most detriment challenges are instability; overdependence on the Israeli economy; poor natural resources; the occupation and its restrictions (on everything, especially agriculture, trade, movement, communications and external relations); investment legal and administrative environment (investment management); the surrounding political environment (freedoms and the rule of law); the share of the informal economy; the nature of the production facilities (size, technology and marketing outlets – and the impact of these on public revenues –); outputs of the educational process; quality of health care; monopolies; and the intervention of the security services. He stressed the need to reconsider the anti-monopoly law; revisit the investment promotion law and the management of this sector; as well as putting an end to the security services intervention: calling off the security check condition and protecting investors from extortion. All these procedures, he said, suggest that the ultimate solution to this intractable budget problem requires, in the first place, ending the occupation, and not the other way round.

With regard to revenues, Abdel Razek advised that the Palestinian Authority must change its philosophy regarding the Paris Protocol, and, eventually its strategy towards it. He remarked that the philosophy the PNA adopted when it signed the Protocol is still in place (or, the PNA has done nothing yet to find an alternative though many people in the decision-making community are convinced of its illegitimacy): the Palestinian economy's correlation with the Israeli counterpart is an opportunity for the former to integrate into and benefit from the development of the latter in terms of employment and investment opportunities which had then been promoted. It had also been circulated then that the similarities between the structure of the Palestinian economy and the Arab economies would make openness to the Arab world harmful to the Palestinian interests as a result of the expected competition.

As such, he continued to say, Palestinians should, by all means, buckle down to put an end to the one-partner character of the economy (long-term goal), and renounce the present collection and billing mechanisms, in which Israel collects clearing revenue on behalf of the PNA (short and long-term goals); hence the need to develop plans to achieve the two goals.

Abdel Razek emphasized that the macro-formula of collecting customs and tax revenues should replace the existing micro-formula of billing, and that the consolidated bill mechanism should be changed to facilitate the process of documenting business deals, and enhance control at crossings. The PNA should exert all efforts to import from the Arab world, especially raw materials, with a tax regime that enhances competitiveness of the national products. The products imported from international market (albeit via Israel) should be made second priority behind promoting national products.

Abdel-Razek gave prominence to adopting serious and definitive programs to fight corruption and reinforce credibility necessary to build confidence. The PNA should launch an educational campaign that raises awareness of the importance of taxes, with detailed information on the development of public projects that have already been implemented and those to be executed in the

coming years. To boost confidence, the PNA must distribute public health services evenly among and within governorates, so as to alleviate pressure in the cities. Concerning taxes, the PNA should reduce VAT rates in line with the development stages of the economy; and reconsider the rates and the bases of income tax (focusing on profits) and property tax (to cover all communities, with special treatment of privately owned houses).

Concerning the expenditure side of the budget, Abdel Razek outlined the problem of the wage bill and the inflated number of staff (with thousands who receive salaries but do not go to work, both in the civil sector and the military sector). He exposed the disguised unemployment (with a rate of more than 30%) and its impact on the Palestinian economy. He commented that there exists a structural imbalance between the share of salaries of security services and the real need for such services. He suggested that the PNA may discharge the national security service (but not the police and investigation department) that is not needed any more, he said.

Abdel Razek concluded with a number of policy recommendations: allowing volitional resignation from governmental jobs; encouraging moving to the social services sector; changing senior management allowances to bonuses rather than financial grades; imposing discriminatory fees on public services with a social solidarity mechanism that takes from the rich to empower the poor, and thus raising the quality of services to compete with the private sector (e.g. establishing special funds to help the poor's access to services and these funds pay the fees on behalf of the poor); enhancing the contribution of the private sector in the provision of competitive services in education and health (i.e. complying with high quality standards and incentives that lead to savings in public expenditure on these services); and finally tightening control over the bidding process (transparency and real competition) and over the processes of implementation and delivery (abiding by quality standards and terms of tenders). (See Dr. Abdel Razek's presentation attached to this file).

In his presentation, Mr. Basem Khoury posited two observations. First, the PNA crossed red lines in its attempts to solve the crisis. The government passed an income tax law with major amendments, the most serious, according to legal experts, is Article 5 of Paragraph 16, which gave the Minister of Finance and the Prime Minister powers that are inconsistent with the Basic Law (which now serves as a constitution). The government has, thus, monopolized legislative, executive and judiciary powers. The government is by no means allowed to take advantage of the financial crisis to cross red lines and pass procedures that are unconstitutional and violate international norms.

In the second observation, Khoury voiced that the policy of raising corporate tax and income tax will not succeed, and 2012 figures are the evidence of this argument. The analytical view of budget figures indicate that they are unviable. He used some figures to back his point of view. For example, despite the fact that local taxes saw a decline of 4.5% in 2011 (as a result of the economic crisis), the budget reported that local taxes will grow by 17% in 2012. Indeed, a 5% growth (which has already happened) is the highest expected rise given the status quo and the existing parameters.

All these facts, he continued to say, signal that what happened was like building castles in the air, as the budget adopted the most optimistic scenario, while the economic and political realities, the global trends, and the past experience have all taught us something totally different. It is time then to think out of the box. "I believe that there are three areas of financial and administrative reform that can help us change our economic / financial status, but these have yet to be implemented:"

First: Land registration (all land located in areas "A" and "B", which is about 40% of the territory of the West Bank): It is estimated that less than 20% of this land has *PROPERTY REGISTRY CERTIFICATES*. Now after 20 years of its establishment, the PNA has only adjusted land issues in three geographical areas. Of course, land registration has different political, economic and financial dimensions. The conflict with Israel is a struggle for land and, thus, ownership matters are the bottom-line. Besides, the registered land can be used as collateral for loans, which, in turn, stimulates the economy. In addition, land tax is levied only on registered land. In some accounts, a comprehensive national campaign to register all lands in areas "A" and "B" within 5 years will generate an annual tax return of \$150 million, in addition to creating 5,000 job opportunities for

engineers, land surveyors and administrative staff. These figures have been startling for the World Bank. There will never be a real economic development without considering this issue, Khoury underscored.

Second: The shadow economy: It is estimated that more than 50% of economic activity is not declared for tax. The big challenge is how to deal with this distortion. Definitely increasing the income tax will not help. On the contrary, some entities, to avoid taxes, hide some purchases, thus stripping the PNA off VAT returns, which constitute 80% of total taxes. With the increase of the income tax, 2012 witnessed a significant increase in the phenomenon of the shadow economy. Addressing this issue will, in some estimates, provide the PA coffers with additional \$150 million. The solution might rest in exempting low-income earners from income tax, but not VAT. Some might argue that this is unacceptable by the donors, but this is untrue, Khoury remarked.

Third: Controlling imports and markets: The persistent attempts by the PNA to fight the manipulation of customs data (to reduce owed VAT and customs) have not yet fully prospered. Incorporating the customs and income tax together, which has recently started, will of course help to solve this problem. However, the sound solution might go beyond the mere integration of these items. It requires formulating some instructions and developing the existing laws (and their enforcement) in full liaison between the Ministries of National Economy and Finance. All dealers must be bound by the "label card" affixed to all shelf goods, a procedure taken by most economies. In developed economies, this label is coupled with a serial number (in the form of a Bar Code) allowing full tracking and control of the item in terms of quality and compliance with the regime of taxes, fees and customs. Fortunately, the technologies needed to apply this system is already available, and the impact of this application to control the market and protect the consumer and increase returns is unquestionable. Khoury noted that that the PNA's budget, once the 'bar code' technique is applied, will earn additional \$200 million annually.

The application of these three procedures will definitely change the PNA's economic status, Khoury reiterated. Once again, we need to think out of the box, he said. According to him, the main problem lies in the absence of an all-inclusive national plan crafted by all segments of the society- a plan in which every group feel they are equal partners in this country, bearing the burdens and responsibilities, rather than the existing disproportionate relations that have generated a sense of "inferior and superior subordinate" among the majority of the people.

Judging from the shrinking of the production base, Khoury observed, one can clearly notice the distortions existing in the Palestinian economy. Seven years ago, industry and agriculture accounted for about 32% of GDP. Today, they barely represent 19%. Experts agree that the presence of a solid production base is the key factor which guarantees the efficacy, sustainability and competitiveness of an economy. Further, the Palestinian economy's attachment to the Israeli economy leads to the destruction of the purchasing power, since the prices in the oPt are identical with those in Israel, while salaries in the oPt are barely one third of salaries in Israel. The step-by-step disengagement from the Israeli economy, and access to the Arab and Muslim markets is the only way out of the bottleneck. He noted that the oPt's economy needs a comprehensive, integrated national plan that accounts for all details- a plan developed by all concerned parties: the government, the private sector, unions of government employees and any other relevant party ready to assume responsibilities, all towards the realization of the "real partners in this country" motto. (See Presentation of Mr. Basem Khoury attached to this file).

## **Summary of the Discussion**

Mohammed Masrouji, President of the Palestinian Businessmen Association:

Unfortunately, those who now speak of formulating monetary policy do not hold to these stances when they assume a real financial decision-making position. He professed the arguments of Abdel Razek and Khoury, reckoning that these observations are consistently spoken, but they remain dead ink. What counts is how to move from words to action, he wondered.

Walid Al-Ahmad, Al-quds Real Estate Investment Company:

One cannot talk about changing attitudes towards agreements with the Israeli side before talking about ending the occupation.

Bassam Zakarneh, Public Workers Union:

It is very daunting to talk about drafting the budget and fiscal policy formulation while fiscal policy-makers are unnamed. It is not decent to draw up a budget while the Palestinian Legislative Council is inactive, a move that delegitimizes the entire process. Zakarneh remarked that more than 60% of public sector employees live below the poverty line (their salaries were dented in 2005 by 45%), and therefore, one cannot talk about salaries cuts. In addition, the PNA still needs to hire more employees (up to 4000), especially in the health sector.

Omar Sha'ban, Pal Think:

The problem in drawing up the budget is structural in nature, since nothing substantial has changed except for the decline in international aid. The unification of the West Bank and the Gaza Strip may help in settling the financial crisis. The Strip is a very important market and it seems that nobody in the Palestinian Authority is interested in retaking this market, which Israeli companies are working hard to control.

### **Recommendations**

- ✧ Evaluating and reviewing the PNA's 2012 budget is necessary to deduce lessons in the formulation of an effective fiscal policy underlying the preparation of budgets in the coming years.
- ✧ It is very critical to craft a serious Palestinian fiscal policy that goes beyond the mere commonplace exercise of matching some hypothetical figures together. This entails revisiting a lot of things, particularly the agreements with the Israeli side, the wage bill, the items of international trade and the promotion of national products.
- ✧ Revenues can be improved through implementing land registration and registration of products (through the bar code). This will significantly enhance the base of local revenues.
- ✧ The budget crisis is structural in nature, and, thus it is not tentative; hence the dire need to start thinking about nation-wide radical solutions that are applied gradually.

## **Background Paper**

### **The PNA's 2012 Budget: The Plan versus Implementation**

This paper provides background information for a discussion roundtable that tackled the reasons and the scope of the discrepancy between the 2012 draft budget the PNA prepared and the on-ground results of the implementation of the budget throughout the year. In light of the actual performance, the analysis, thus, aims to identify the reasons behind this variance, with an eye to enhance the ability of the PNA to develop more accurate, proper financial plans. The paper involves 3 sections:

First: A brief historical overview of the financial situation of the PNA (1994-2011).

Second: A review of the 2012 budget, the government target vs. real figures

Third: 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<sup>1</sup>:

##### **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:

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<sup>1</sup> 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 – 2011)

This epoch marks the political split between the West Bank and the Gaza Strip. In financial terms, this means that the Ramallah government would bear the brunt of Gaza's expenditure (salaries, etc.), while receiving nothing in return from the Strip (including revenue clearing). There are inconsistent figures on the clearing loss and the share of the Gaza Strip from the budget's expenditure of Ramallah's government. Table 1 below summarizes the developments in the general budget between 2008 and 2011. The budget saw a relative improvement until the end of 2010. In early 2011, a declining trend would foreshadow an insisting downturn.

- ✧ Domestic net revenue grew during the three years between 2008 and 2011 from NIS 5.6 to NIS 7.3 billion. The increase came mainly from a 30% growth in clearance revenues and taxes.
- ✧ Along with a 30% increase in domestic revenues, current expenditure grew by about 15% during the period, resulting in a 3% decrease in the current budget deficit (before foreign aid).
- ✧ Nonetheless, because foreign aid for the current budget decreased by 54% during the period, the current budget after aid receded from a surplus of 1.6 billion shekels in 2008 to a deficit of 1.6 billion shekels in 2011.
- ✧ As of early 2009, 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 NIS 720 million in 2011.
- ✧ Strikingly, the relatively modest increase in spending between 2008 and 2011 came as a result of a decline in net lending, since the wage bill during the period rose by 23% and non-wage spending grew by 42%.
- ✧ The increase in the current deficit (as well as the deficit in developmental spending) led to a hike in the public debt at the end of 2011 to 8.3 billion shekels and a growth of arrears to NIS 1.9 billion (see the tables below).

**Table 1: PNA's General Budget, 2008-2012 (NIS millions)**

	2008	2009	2010	2011	2012 Draft budget	2012 Accrual
<b>Net public revenue</b>	<b>5,613</b>	<b>6,294</b>	<b>7,188</b>	<b>7,321</b>	<b>8,492</b>	<b>7,958</b>
– Local collections	2,012	2,305	2,778	2,642	3,087	2,775
– Clearance	4,017	4,347	4,695	5,095	5,859	5,617
– Tax rebates	-415	-358	-285	-416	-454	-434
<b>Current expenditure and net lending</b>	<b>10,332</b>	<b>12,568</b>	<b>11,473</b>	<b>11,897</b>	<b>12,114</b>	<b>13,403</b>
– Salaries and wages	5,202	5,779	6,017	6,381	6,813	6,844
– Non-wage expenditure	3,526	5,315	4,576	5,015	4,901	5,466
– Net lending	1,600	1,474	880	501	400	1,093
<b>Current deficit before financing (accrual)</b>	<b>-4,719</b>	<b>-6,274</b>	<b>-4,285</b>	<b>-4,576</b>	<b>-3,621</b>	<b>-5,445</b>
<b>Current deficit before financing (cash)</b>	<b>-5,345</b>	<b>-5,401</b>	<b>-4,009</b>	<b>-2,803</b>	<b>-3,621</b>	<b>-3,030</b>
Developmental expenditure	770	849	1,113	1,325	1,330	1,004
<b>Total deficit before financing (accrual)</b>	<b>-5,489</b>	<b>-7,123</b>	<b>-5,398</b>	<b>-5,901</b>	<b>-4,951</b>	<b>-6,449</b>
<b>Total deficit before financing (cash)</b>	<b>-6,115</b>	<b>-6,250</b>	<b>-5,122</b>	<b>-4,128</b>	<b>-4,951</b>	<b>-4,034</b>
<b>Financing</b>	<b>5,489</b>	<b>7,123</b>	<b>5,398</b>	<b>5,901</b>	<b>4,951</b>	<b>6,449</b>

	2008	2009	2010	2011	2012 Draft budget	2012 Accrual
- Current budget support	6,312	5,338	4,276	2,915	3,811	2,986
- Developmental expenditure support	770	184	487	605	1,140	601
- Bank financing	-813	693	311	334	0	490
- Net change in arrears	-1,335	990	364	2,043	0	2,573
- Complement arithmetic	551	-82	-40	4	0	-201
<b>Financial gap</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>Inflation</b>	<b>9.9</b>	<b>2.75</b>	<b>3.7</b>	<b>2.88</b>	<b>3.00</b>	<b>2.78</b>
<b>Exchange rate</b>	<b>3.58</b>	<b>3.94</b>	<b>3.73</b>	<b>3.58</b>	<b>3.80</b>	<b>3.85</b>
<b>GDP</b>	<b>21,867</b>	<b>26,475</b>	<b>31,073</b>	<b>34,996</b>	<b>*40,485</b>	

Source: Monthly financial reports published by the Palestinian Ministry of Finance 2008-2012. GDP data were obtained from the Palestinian Central Bureau of Statistics, Department of National Accounts.

\* The draft budget assumed a GDP growth rate of 9%.

## Second: A review of the 2012 budget, the government target vs. real figures

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.

The signs of a financial crisis particularly resurfaced insistently as of late 2010, but the crisis proper took hold in 2011. This, of course, was evident when the financial plan was developed, and it was supposed to be considered at time of drafting the 2012 budget.

### 1. Draft Budget, 2012

In April, 2012 (4 months into the fiscal year), the President of the Palestinian National Authority signed the 2012 budget bill. Table 1 summarizes the main items in the 2012 draft budget compared with the actual PNA's financial performance between 2008-2011.

The budget target of total net domestic revenues was 8.5 billion shekels in 2012, a 16% increase over actual revenue of the previous year (note that the rate at which revenue increased between 2010 and 2011 was barely 2%). On the other hand, the draft budget expected an increase of only 2% in current spending (considering a 2% decline in non-wage spending and a 20% drop in net lending). These rates, in addition to the deficit of NIS 190 million in developmental spending, led to a financial gap between expenditure and revenue that totaled 4.9 billion shekels, a deficit that the draft budget expected to finance through international aid.

A number of observations can be concluded from these figures:

- ✧ The draft budget expected an increase of 17% in local collection in 2012 (though the actual increase in the previous year was scantily 5%).
- ✧ The draft budget has not allocated any funds to pay arrears or part of the public debt. However, it did not explicitly anticipate any increase during the year.
- ✧ The draft budget expected 4.9 billion shekels as international aid, which was very upbeat, since this forecast was 40% higher than the real aid received in 2011.

### What are the fiscal policy features that can be discerned from the 2012 draft budget?

The draft budget does not look ambitious- arguably offering no plan or intentions to find a radical solution to the ever-insisting budgetary problems. The draft was developed on totally unsubstantiated assumptions, such as assuming a GDP growth rate of 9% and an increase of foreign aid by 40% over 2011.

On the other hand, the draft budget expected a decrease in the current deficit/GDP ratio (before financing) by 3 percentage points, from 13% to 10%, hypothetically generated by an assumed 16% increase of local revenues over spending. Manifestly though, the cut in spending would not come

from reducing the bill of wages and salaries (which was supposed to increase by 7%)<sup>2</sup>, but mainly from the reduction of "net lending". In short, then, it appears that the aim of the draft budget was to keep the status quo, though all indicators would show that an NIS 4.9 billion of international aid was only a wish.

## 2. Analysis of actual revenues and grants in 2012

The PNA's budget has atypically two types of figures for both revenues and expenditure: figures on the 'accrual basis' and figures on the 'cash basis'<sup>3</sup>. It is true that other countries have such types of figures, but the disparity between them is not as significant and chronic as in the PNA's budget. This is obviously a result of reliance on international aid and clearing revenues (which both are influenced by the political circumstances), on the one hand, and the poor regime of tax collection (and bureaucracy), on the other.

Recording performance on an accrual basis is necessary for knowing exactly the total amount to be collected and paid during the year, no matter whether there are actually collected (and paid) or not. The "cash basis" figures are also significant, because the difference between them and the accrual basis figures is the "arrears" that the PNA has to pay.

Table 2 presents the main indicators of 2012 actual domestic and foreign revenues vs. the draft budget targets. The last two columns of the table shows the actual revenues (on a cash basis and on an accrual basis) as % to the budget targets.

As the table illustrates, the net domestic revenues (on a cash basis) were 100% identical with the draft budget expectations. However, this was mainly at the expense of non-payment of tax rebates, since less than half of tax refunds were actually paid (only NIS 195 million out of NIS 434 million)<sup>4</sup>. The budget also obtained in-advance payments from the clearing account (i.e. the cash basis is greater than the accrual basis).

**Table 2: Indicators of general revenues and grants to the PNA during 2012**

	2012 Budget	Actual revenue (cash basis)	Actual revenue (accrual basis)	Actual revenue (cash basis) as % to budget	Actual revenue (accrual basis) as % to budget
<b>Net public revenue</b>	<b>8,492</b>	<b>8,541</b>	<b>7,958</b>	<b>%101</b>	<b>%94</b>
– Local collections	3,087	2,639	2,775	%85	%90
– Clearance	5,859	6,096	5,617	%104	%96
– Tax rebates	454-	195-	434-	%43	%96
<b>International aid</b>	<b>4,951</b>	<b>3,587</b>	<b>3,587</b>	<b>%72</b>	<b>%72</b>
– Current budget support	3,811	2,986	2,986	%78	%78
– Developmental expenditure support	1,140	601	601	%53	%53

Source: Tables of financial operations, data of income, expenditure and sources of funding (cash basis and accrual basis), Ministry of Finance.

The alarming discrepancy, however, concerns the international aid: only 72% of the target. Unmistakably, as long as spending does not decline in parallel with the drop in revenues, the budget will continue sustaining a huge deficit. Let's first look at expenditure figures before reviewing the deficit.

## 3. Analysis of actual public expenditure items during 2012

Table 3 presents the actual spending figures (on an accrual basis as well as on a cash basis) compared with the budget target figures. It is true that the budget achieved its target regarding the

<sup>2</sup> The draft budget established a ceiling for public employment (no more than 3 thousand) and for the salaries of staff working under temporary contracts (no more than NIS 4 thousand).

<sup>3</sup> "Cash basis" refers to the expenses actually paid (and received by debtor) during the year, no matter whether they were actually owed during this year or in the previous years. The "accrual basis", on the other hand, refers to the expenses and revenues that are due and must be paid (or received by the debtor) during a given fiscal year, no matter whether they have been paid or not. For example, if the government does not pay salaries owed during the year, the unpaid salaries are recorded in the budget figures on an accrual basis rather than a cash basis. Conversely, if a company in the current year pays taxes it had failed to pay in the past few years, these payments are recorded in the cash account rather than on an accrual basis.

<sup>4</sup> The actual local taxes (cash) were barely 87% of the target, suggesting a weak collection. Strikingly, however, the local taxes in the draft budget are 10% higher than the value on an accrual basis, suggesting erroneous estimations of local taxes.

bill of wages and salaries on an accrual basis, though it incurred a debt of 12% of the total value of the salaries at the end of the year. However, the actual non-wage expenses were by far higher than the target (by NIS 560 million), though about 10% of these costs were not actually paid during the year. At the same time, the "net lending" bill was almost three times the target amount<sup>5</sup>.

**Table 3: Indicators of the PNA's public expenditure and net lending during 2012**

(Million shekels)

	2012 Planned Budget	Actual expenditure (cash basis)	Actual expenditure (accrual basis)	Actual expenditure (cash basis) as % to plan	Actual expenditure (accrual basis) as % to plan
Current expenditure and net lending	12,114	11,631	13,403	%96	%111
– Salaries and wages	6,813	6,059	6,844	%89	%100
– Non-wage expenses	4,901	4,479	5,466	%91	%112
– Net lending	400	1,093	1,093	%273	%273
Developmental expenditure	1,330	786	1,004	%59	%75
Total current and developmental expenditure	13,444	12,417	14,407	%92	%107

Source: Tables of financial operations, data of income, expenditure and sources of funding (cash basis and accrual basis), Ministry of Finance.

Concerning the total current expenditure (NIS 13.4 billion) as compared to the actual spending on a cash basis, Table 3 shows that the government pledged 6% more than the target, but it did not pay 9% of its pledge. This means that the government did not pay about 15% of the total amount it spent in 2012.

#### 4. Fiscal Deficit

The steadily relative decline in local taxes (5%) between 2011 and 2012 (compared to a target increase of 17%), and the 13% increase in current expenditures (compared to a target growth of 2%) occasioned a deficit of 5.4 billion shekels in the balance of the current budget (50% increase over the target). During 2012, the donors provided about 3 billion shekels in support of the current budget, thus reducing the current deficit to NIS 2.4 billion. When the deficit in developmental spending is added to the current deficit, the total deficit figure will stand at NIS 2.8 billion in 2012 (see Table 4).

The government would have to plug this deficit by borrowing from banks (about NIS 490 million as loans) and through increasing the net accumulation of arrears by 2.4 billion shekels. These amounts constitute the increase in public debt that occurred during 2012.

**Table 4: Indicators of the PNA's deficit / surplus for 2012**

(Million shekels)

Item	2012 planned Budget	Actual expendit ure (cash basis)	Actual expenditure (accrual basis)	Actual expenditure (cash basis) as % to plan	Actual expenditure (acc rual basis) as % to plan
Current deficit (before grants and aids)	3,622-	3,090-	5,445-	%85	150%
Current deficit (after grants and aids)	189	-104	-2,459	%55-	%1300-
The total deficit (current + developmental) before aid	-4,952	-3,876	6,449-	%78	130%
The total deficit after aid	0	-289	2,862-		%990
Banks finance		490	490		
Net accumulation of arrears			2,573*		

Source: Tables of financial operations, data of income, expenditure and sources of funding (cash basis and accrual basis), and the Ministry of Finance.

\* This item includes expenditure arrears (1,990.5), clearing arrears (-479.3), outstanding tax rebates (239.4), non-tax refunds (-135.6), and other unspecified arrears (757.7 million shekels).

<sup>5</sup> The reason behind this sharp increase is likely the clearing amounts that Israel deducted at the end of the year and transferred them to Israel electricity companies. However, if this assumption is true, it is surprising that the clearing amounts actually paid were higher than the target figure.

## 5. Public Debt

The public debt continued to rise in 2012 though Article 5 of the 2012 Budget Law states that the PNA may not borrow from the banking sector in 2012 save for bridging purposes and provided that the balance of outstanding debt at the end of 2012 should not exceed the 2011 corresponding figure.

**Table 5: Public Debt, end of 2012**

Item	(\$ Millions)		
	December 2010	December 2011	December 2012
Domestic public debt	793	1,158	1,336
External public debt	985	1,175	1,059
<b>Total public debt</b>	<b>1,778</b>	<b>2,333</b>	<b>2,395</b>

Source: Tables of Financial Operations, Table 8, The Ministry of Finance, December 2012.

The public debt (excluding arrears) at the end of 2012 totaled \$2.4 million, up by \$62 million from 2011. The structure of the debt in 2012 was also different from that of 2011. While the external debt fell by 10%, the domestic debt rose by 15% (see Table 5 and note that the figures, unlike in previous tables, are in the US dollars)<sup>6</sup>.

Regarding arrears, Table 6 illustrates their distribution and development between 2009-2011. It should be noted, though, that some of the arrears items contained in the Table do not appear in the budget figures.

There are no data available on the arrears in the second half of 2012, but the Finance Minister has recently disclosed some figures that may unfold the indebtedness of the Palestinian National Authority at the end of 2012 (see Table 7). The public debt totaled \$3.9 billion (nearly 40% of GDP).

**Table 6: The PNA's Structure of Arrears**

	(Million Dollars)			
	2009	2010	2011	2012 January - June
Contributions to the pension fund				
- Share of employees	43.8	49.6	104.5	71.9
- Share of the government	91.0	46.1	160.1	78.2
Outstanding expenses	117.9	24.7	98.6	63.6
Net lending	19.7	27.6-	0.0	0.0
Developmental projects	30.3	23.6	75.4	23.6
Tax refunds	35.9-	10.5	102.8	47.3
<b>Total</b>	<b>266.7</b>	<b>105.6</b>	<b>541.3</b>	<b>284.9</b>

Source: International Monetary Fund (IMF), September 2012.

**Table 7: PNA's Public Debt, 2012**

Item	(\$ millions)
	\$ millions
Debt owed to local banks	1,384
External debt	1,100
Debt owed to Pension Fund	970
Arrears owed to suppliers	400
<b>Total</b>	<b>3,850</b>

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

<sup>6</sup> Note that the value of the shekel fell strongly against the dollar between 2011 and 2012 (from 3.58 to 3.85). Thus, the increase in the deficit and debt as valued by the dollar conceals the rise in the value of the dollar. For example, the public debt (excluding arrears) increased by 3% when measured by the dollar, while it rose by 10% when measured by the NIS.

## 6. Crisis of paying salaries and collecting local taxes

The financial crisis of the PNA tenaciously resurfaced in 2012 mid-year as the budget failed to pay employees' salaries (and allowances of the retirees, as well as part of the social assistance) in a timely manner. Table 8 shows the periods of *INTERRUPTIONS* and late payments of *PUBLIC SERVANTS' SALARIES*. The Table illustrates that the salaries had been paid in due dates between January 2009 and May 2012. Although, growth in public employment has completely stopped since mid-August 2012, the bill of salaries and wages has continued to drain about 50% of the total current expenditures during the period (according to the International Monetary Fund). 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<sup>7</sup>.

On the other hand, the local taxes have only moderately increased (and even fell when measured by the dollar, even on the accrual basis) in 2012 compared to 2011. Markedly, the impact of efforts to raise the collection of income tax- as well as the raise in corporate tax rates and VAT rates since 2012 midyear- has yielded nothing substantial<sup>8</sup>. According to the IMF, this relapse is engendered by the fact that tax-payers often deduct income tax and value added tax from the arrears that the government owes them<sup>9</sup>.

**Table 8: Periods of INTERRUPTIONS and late payments of PUBLIC SERVANTS' SALARIES (2009-2012)**

	Salaries paid in due time	From Jan. 2009 To May 2011
July 5: Disbursing (50%) of June salary	Delay in paying salaries	June 2011
August 25: Disbursing the remainder of June salary		
	Salaries paid in due time	From July 2011 To May 2012
<b>2012</b>		
July 12: Paying 60% of June salary (with a minimum of NIS 2000)	Delay in paying salaries	June
July 22: Disbursing the remainder of June salary		
August 11: Paying 70% of July salary (with a maximum of NIS 4000)	Delay in paying salaries	July
August 27: Paying the remainder of July salary		
September 9: Disbursing 50% of August salary (with a minimum of NIS 2000)	Delay in paying salaries	August
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).		
October 18: Disbursing 50% of September salary (with a minimum of NIS 2000 and a maximum of NIS 4000)	Delay in paying salaries	September
October 22: Disbursing the remainder of September salary (just before Eid al-Adha).		
November 11: Paying part of October salary (with a minimum of NIS 1000 and a maximum of NIS 2000)	Delay in paying salaries	October
November 22: Paying the remainder of October salary		
December 23: Paying part of November salary (with a minimum of NIS 1500 and a maximum of NIS 4000)	Delay in paying salaries	November
January 30: Paying the remainder of November salary		
January 20: Paying part of December salary (with a minimum of NIS 1500 and a maximum of NIS 4000)	Delay in paying salaries	December
February 4: Paying the remainder of December salary		

See detailed schedule of salary payment interruptions (2006-2013) at MAS web page [www.mas.ps](http://www.mas.ps)

### Third: Round table discussion themes

First: What is the overall evaluation of the performance of the budget in this year? Was the prediction error a result of beyond-control factors? Did the PNA have an option of making a

<sup>7</sup> The global average is taken from the International Labor Organization (ILO). See *Economic and Social Monitor*, Issue 26, October 2011, MAS.

<sup>8</sup> In addition to the two-year suspension of income tax exemptions for 13 companies.

<sup>9</sup> 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.

piecemeal financial relapse rather than the dramatic tailspin which figured in the failure to pay salaries?

Second: Were the methods of budget drafting, oversight and accountability satisfactory during the preparation and the implementation of the budget? Where and how can these methods be improved? What lessons can be learned in relation to the 2013 budget?

Third: When will we have a serious fiscal policy that replaces the commonplace exercise of matching some hypothetical figures together; i.e. when does the Ministry of Finance start functioning beyond the mundane job of a mere salary cashier?

### **Attendance Record for Round Table (2) The PNA's 2012 Budget: The Plan versus Implementation**

Name	Institution
Abdul-salam Taha	Ministry of National Economy
Samir Huleileh	Ward for Printing Services
Mohamemd Masrouji	Businessmen Association
Bassam Zakarneh	Public Workers Union
Mahmoud Najjar	Palestinian Center for Research
Omar Sha'ban	Pal Think for Studies / Gaza
Waleed Al-ahmed	Jerusalem Real Estate Investment Company
Azmi Abdul-rahman	Ministry of National Economy
Shada Abdul-samad	FES
Ingrid Ross	FES
Maha Abu Shousha	Abu Shousha Company
Dr. Atef Alawneh	Bank of Palestine
Adnan Abu Hummus	PADICO
Dr. Saed Khalil	PMA
Dr. Jameel Zaher	Palestinian Investment Fund
Obaida Salah	PMA
Omar Abdel Razek	PLC
Shehada Husein	PMA
Haitham Wheidi	Investment Promotion Agency
Mohammed Qarrash	Palestinian Economists Association
Dr. Hazim Shinnar	Ministry of National Economy
Mesyef Mesyef	Ministry of National Economy
Anwar Qabajeh	Ministry of Planning
Zeyad Karabliyah	Palestinian Fund for Employment
Jihad Zamari	PADICO
Shaker Sarsour	PMA
Doja Michael	MAS