MAS

Palestine Economic Policy Research Institute

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Background Paper[1]

Roundtable (2):

Evaluating the PNA's FY 2014 Budget and Identifying Changes Made to Fiscal Policies in the PNA's FY 2015 Budget

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[1] This document is an English translation of the original Arabic text. In the event of discrepancies between the original text and the English translation, the Arabic text shall prevail.

1. Background and Rationale

The PNA's budget process begins when the government formulates the general budget and submits a request of approval to the Legislative Council, which was created in 1996 following the general elections. The Basic Law (which was passed in 2000 and provided – in Articles 60 and 61 – for the specific rules governing the preparation and approval of the general budget) and the General Budget Control and Financial Affairs Law No. 7 of 1998 defined the powers and responsibilities regarding the preparation, adoption and appropriation of resources in the PNA budget. The public commitment to the provisions of the law improved gradually, especially after 2003. However, since the internal mid-2007 divide and the resulting suspended parliamentary work, it is the legally entitled PNA President who approves the government budget.

The FY 2015 budget has been drafted within a high degree of uncertainty in the local, regional and international political and economic context, which is believed to have unfavorably impacted the economic and financial conditions in the Palestinian Territory. The peace talks between the Palestinians and the Israelis came to a halt; the PNA solicited a UN Security Council Resolution calling for the establishment of a Palestinian state on the 1967 territory, joined a number of international organizations, and signed several international conventions; the Government of Israel vengefully withheld clearance revenues in early 2015; some donors suspended, reduced, or delayed financial aid to the PNA; and John Kerry's initiative to assist the Palestinian economy was suspended given the stalled political path. At home, only a few weeks into the formation of a Palestinian consensus government, Israel waged a war on the Gaza Strip, inflicting heavy losses to the infrastructure and productivity, which worsened the already worsening socio-economic situation, thus redoubling the burden on the PNA. Meanwhile, Gaza reconstruction efforts came to a deadlock as the Government of National Unity was not allowed to take full charge, donors failed to pay the amounts they pledged in the October Cairo Conference, and Israel continued to deny the entry of reconstruction material.

These factors, together with the unrest in Jerusalem and the West Bank triggered by inflammatory actions by the occupation authorities and colonial settlers, produced economic stagnation in 2014. According to the IMF Mission, the Palestinian economy shrank by nearly 1 percent in terms of real GDP last year, its first contraction since 2006. GDP fell by about 15 percent in the Gaza Strip, while it grew by 4.5 percent in the West Bank, with a sharp decline in the third quarter of the year. Unemployment rates continued to go up, reaching 41 percent in Gaza and 19 percent in the West Bank. Despite the dire economic and political situation in 2014, the PNA managed to keep the fiscal deficit under control thanks to high revenues, the Mission report concluded.

The Palestinian government developed two scenarios for the 2015 draft budget. The baseline scenario will be adopted if Israel rescinds its suspension of transferring clearance revenues and releases the funds withheld. The second scenario is the emergency budget endorsed by the Council of Ministers on 24 March 2015. This was supposed to take effect on 1 April 2015. The President approved the emergency budget and issued an executive order in accordance.

Within the government's policy of disclosing the details to the concerned authorities in the Legislative Council, the two-scenario draft budget was presented to the Legislative Council's Economic Community to elicit opinion. This is a very important step. Broadening the expert community involvement remains a prerequisite for an effective budget (as an economic policy) and a fundamental requirement for transparency and accountability.

Through this roundtable, the Palestine Economic Policy Research Institute (MAS) seeks to initiate an intelligent, well thought out debate among the various stakeholders to discuss two focal points: an outline of the FY 2014 actual values versus targets set at the beginning of the year; and discussing the appropriations in the 2015 budget with its two scenarios, and accordingly identifying the year-on-year significant changes in the major expenditure items and allocations to different sectors.

2. The FY 2014 Actual Values versus Targets

In the previous years, drafting the Palestinian government budget depended on revenue predictions that were supposed to be fully or partially fulfilled. Deviations from the budget were thus always possible, as the budget items were subject to relatively exogenous unstable factors. The wide gap between the actual values and the targets signals the uncertainty and the difficulty of making estimates at the beginning of the year. Below is a comparison between budgeted and actual figures for particular items in the 2014 budget.

It is clear from Table 1 below that the 2014 budget had major deviations – a far departure from the case in previous budgets. According to governmental data, the net revenue were $159.45 million (or 5.8 percent) higher than estimates, basically as clearance revenues were $218.33 million (or 12 percent) higher than the targets. Yet, domestic revenues were $70.01 million (or 7.6 percent) lower than the budget targets.

Looking closely into Table 1 below, one can easily detect that 2014 estimates relatively improved compared to the three years preceding it. In 2011, 2012 and 2013, the actual revenues were lower than targets; i.e., forecasts were quite optimistic. In 2014, clearance revenues were higher than targets, while domestic revenues were slightly lower (see Table 1). With all factors remaining the same for 2015, the favorable variance in the 2014 budget will help calculate the 2015 budget deviation.

The expenditure variance, on the other hand, was relatively low compared to the revenue variance, owing to PNA's austerity measures[2], which were supposed to reflect in the estimated budget. Table 1 reveals unfavorable variances in most expenditure items. In parallel with narrowed variances on the revenue side, deviations in expenditure declined markedly in 2014 (1 percent for salaries and 2.4 percent for current expenses) as compared with the previous years.

Overall, actual public spending was 4.6 percent (or $177.8 million) higher than the budget allocations, with the biggest unfavorable variance reported in net lending (70.4 percent or $ 117 million), or a target of $167 million versus an actual spending of $284 million. Other actual current non-wage expenses (operational, capital and transfer expenses) were about $40.8 million higher than targets, suggesting the PNA's failure to apply austerity policy for these items. Had not net lending been there, the government budget would have enjoyed a surplus, with funds appropriated to other sectors in need (see Table 1).

The government projected its 2014 budget deficit at about $1629 million, but the growth in the revenue side ($141 million) minus the increase in expenditure ($177.8 million) rendered an actual deficit of about $37 million higher that projections; i.e., a 2.9 percent unfavorable variance. As a result of reducing the target developmental expenditure from $350 million to only $260 million, the total actual deficit (after adding the developmental expenditure) dropped from $1,629 million to $1,576.5 million. The actual external financing was $52.5 million lower than projections despite the rise in external budget support, which was $185.1 million lower than targets. Meanwhile, donor funding for developmental expenditure was $98.3 million lower than targets (see Figure 1 and Table 1).

2 These imply that the PNA is able to control expenditure and force compliance with more austerity measures.

Figure 1: Estimated vs. actual values for Selected Items in FY 2014 Budget

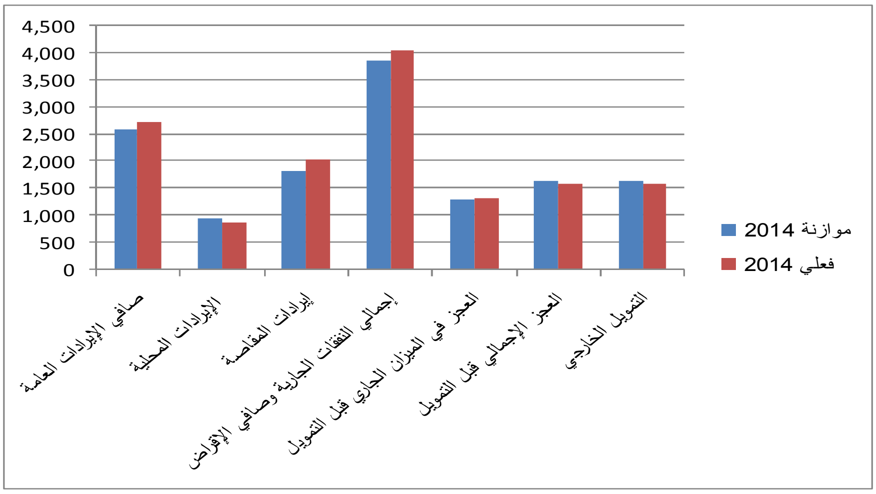

Table 1: Variance in FY 2014 Budget Compared with 2011, 2012 and 2013

($ Millions)

Item	2014 Estimated Budget	2014 Actual Budget	Variance in 2014 Budget		Variance in 2013 Budget (%)	Variance in 2012 Budget (%)	Variance in 2011 Budget (%)
			Value	%			
Net public revenues	2,586	2,726.98	140.98	5.5	-7.30%	-7.50%	-6.80%
Total revenues	2,742	2,901.45	159.45	5.8	-2.90%	-7.40%	-4.10%
- Domestic revenues	924	853.99	-70.01	-7.6	-4.50%	-11.20%	-9.10%
Tax revenues	647	596.96	-50.04	-13.0	-0.40%		
Non-tax revenues	249	268.25	19.25	1.6	-12.60%		
- Clearance revenues	1,818	2,036.33	218.33	12.0	-2.10%	-5.40%	-1.30%
(minus) Tax rebates	156	174.47	18.47	12.1	87.30%		10.70%
Total current expenditure and net lending	3,866	4,043.83	177.83	4.6	4.10%	9.20%	2.80%
- Salaries and wages	2,018	2,037.72	19.72	1.0	1.80%	-0.80%	4.20%
- Other current expenditures	1,681	1,721.84	40.84	2.4	-1.10%	10.10%	2.80%
- Net lending	167	284.01	117.01	70.4	159.20%	170.50%	-12.50%
Current account deficit before financing	1,279	1,316.22	37.22	2.9	31.30%	48.40%	32.20%
+ Developmental expenditure	350	260.45	-89.55	-25.6	-46.80%	-25.40%	-26.00%
Total deficit before financing	1,629	1,576.51	-52.49	-3.2	11.70%	-228.50%	12.40%
- External financing	1,629	1,576.51	-52.49	-3.2	-3.00%	28.50%	
- Budget support	1,329	1,143.19	-185.81	-14.0	13.80%	-22.60%	-15.80%
- Financing developmental expenditure	300	201.72	-98.28	-32.8	-64.60%	-48.00%	-66.20%

Financial Performance in 2013 and 2014

According to governmental data on actual performance, an improvement was in the first place a result of a historic increase in clearance revenues, which saw a growth of 20 percent in 2014, with its share in GDP increasing by 2.5 percent. This growth led to a 14 percent rise in total revenues whose GDP share jumped to 3 percent, while domestic revenue grew only by 2 percent. The slight rise in expenditure lowered the current deficit by 5 percent, while the total deficit remained unchanged.

Figures for deficit financing were as follows: an 18 percent drop in budget support (from foreign aid), a 20 percent fall in total borrowing a 20 percent decline in total external debt, and an 18 percent plunge in domestic debt and liabilities (as the government paid 18.4 percent of its debt to the private sector).

3. Components of The FY 2015 Budget

A. Baseline Scenario: Targets and Assumptions
According to IMF estimates, a high degree of uncertainty and various headwinds will likely prevent a strong economic recovery in 2015. Most notable is the non-transfer to the PNA of clearance revenues collected by Israel on goods imported into the West Bank and Gaza. These revenues account for about two-thirds of net revenues and are essential to the PNA's budget and to the Palestinian economy as a whole. Reduced wage payments and other public spending cuts necessitated by the suspension of clearance revenues in the presence of financing constraints will likely cause a sharp reduction in private consumption and investment. Further, Gaza reconstruction is proceeding more slowly than anticipated, reflecting insufficient progress on national reconciliation and unfulfilled donor obligations pledged in the Cairo Conference in October 2014. Given these facts, real GDP in 2015 is therefore set to rise only modestly, with a pickup in Gaza from a low base and a drop of nearly 1 percent in the West Bank, although the sharp fall in oil prices provides some relief to energy consumers. Medium-term growth will remain modest, unless there is an improvement in the political climate that would lead to a lifting of the restrictions in the West Bank and the blockade in Gaza[3].

The FY 2015 budget formulation came amid a political deadlock and economic deterioration with subversive repercussions on the various aspects of life in the Palestinian territories. One particular loser is the budget, the most important tool the PNA uses to implement its policies. The following section provides an overview of the most important items of revenue, expenditure and deficit (and its financing) in the FY 2015 budget. The paper then detects changes from the 2014 budget and the reasons behind these changes.

It is important to point out that the 2015 budget under discussion does not include the budget statement – the introductory part of the budget that outlines the government's financial future policy, as well as the data that have been invoked to provide estimates. It is therefore not easy to understand the assumptions of the government unless the figures are studied within the context in which the budget was drafted. This, however, does not rule out the fact that the government should always provide justifications for the budget estimates. Despite the absence of the budget statement, the paper will try to provide a comparative analysis of budget items and give explanations and general observations where possible.

Assumptions

- Proceeding with rationalizing expenditure across all items, particularly reducing net lending by NIS 20 million through cutting deductions in electricity and water bills;
- Increasing domestic revenues through raising non-tax revenues and enhancing efficiency of collecting taxes and expanding their base.

3.1 Revenue

At first glance, it seems that the authors of the budget tried to draw lessons from the past failures, and thus they were more conservative in estimating revenues. At $2,749 million, the target public

[3] Statement at the End of an IMF Mission to the West Bank and Gaza, January 29, 2015. Retrieved from https://www.imf.org/external/np/sec/pr/2015/pr1524.htm

revenues are only 6.3 percent higher than in the previous year, which is close to the growth rate expected in the 2014 budget plus the actual variance. The increase has a reasonable ground: clearance revenues are expected to grow by 5.8 percent to $1,924 million, while domestic revenues are projected to drop under this scenario by 12.4 percent (see Table 2).

3.2 Expenditure

In line with the general declared policy of the PNA that seeks to cut down on spending – or at least slacken its accelerated pace – and slash the deficit under the assumption that domestic and external revenues (necessary to finance expenditures) will remain relatively unchanged, every year budget drafters try hard (and thus expect) to curb the government's expenditure. Consistent with this austerity policy, the 2015 draft budget expects a 3 percent drop in total current expenditure and net lending to $3,751 million.

The salaries and wages bill is projected to see a significant decline of 5.7 percent or $115 million from the FY 2014 budget. While the decline is basically a result of stopping recruiting new employees, it is unclear how the government will deal with the additional costs ensuing from the understandings reached with Hamas, which might signal a significant budget variance in the wages and salaries item.

Net lending, in turn, is expected to inflate from $167 million to $200 million though the Israeli government deducted about $400 million from Q1 2015 clearance revenues and the re-estimation indicated that net lending depleted a massive $284 million in the 2014 budget against a target of only $167 million. On the other hand, the current year budget projects a 2 percent cut in non-wage expenditures (to $1684 million) on an expected decline in both operating and transfer expenses, though expenditure trends in previous years always showed counter movements (see Table 2).

3.3 The Deficit and Its Financing

As a result of changes in expenditures and revenues, current deficit (before financing) is projected to reach $1,102 million, which is 18.6 percent higher than the estimated deficit in the 2014 budget. Still, the actual deficit recorded in the budget after re-estimation totaled $1,322 million.

In the budget targets, the current deficit will be financed through foreign aid, whose allocations for budget support are expected to reach $1,100 million, an amount equal to the current deficit – a drop of about $229 million from the 2014 estimates. Interestingly, the re-estimation of this item showed that the foreign aid to support the budget in 2014 was $52.5 million lower than projections in that year, suggesting that the aid expected in the current year ($1,152 million) will more likely be a bit higher than in the previous year ($1,143 million).

The 2015 draft budget forecasts suggest that the PNA will look for relatively low funding from banks to finance the projected deficit. Though the estimates a year earlier expected the PNA to pay only $66.3 million of its debt to banks, budget workflow demonstrates that the PNA actually paid the banks a total of $110.9 million due to a surplus generated from clearance revenues in 2014. These figures denote that budget estimates for this item were inaccurate during the past few years and that unexpected developments in 2015 budget are quite likely.

The aid expected to finance development expenditure is conventionally incorporated within the external budget support. In the FY 2015 draft budget, funds for development expenditure are estimated at $250 million. The past data of the estimated versus actual figures clearly demonstrate that donor countries have more than once reneged on their pledges in this area. Importantly, there is no complementary relationship between developmental spending in the 2015 budget and the development plan 2014-2016 though the latter was approved and its implementation has officially started. The 2015 budget merely provided a list of proposed and existing projects with a total estimated cost of NIS 4.6 billion, the majority of which (NIS 4.4 billion) is expected to be financed by foreign aid and the rest by the PNA budget. Surprisingly, the budget failed to provide any suggestions or name alternative sources to cover the potential financial shortage in these projects.

Table 2: FY 2014 Budget (Estimated vs. Actual) and FY 2015 Draft Budget

($ millions)

Item	2014 Budget (Estimated)	2015 Budget/ Baseline Scenario	Change	2014 Budget (Actual)
Net public revenues	2,586	2,749	6.3	2,726.98
Total revenues	2,742	2,649	-3.4	2,901.45
Domestic revenues	942	825	-12.4	853.99
Tax revenues	647	569	-12.0	596.96
Nontax revenues	249	255.75	2.7	268.25
Clearance revenues	1,818	1,924.25	5.8	2,036.33
Tax rebates	156	100	-35.9	174.47
Total current expenditure and net lending	3,866	3,751.25	-3.0	4,043.83
Salaries and wages	2,018	1,903.25	-5.7	2,037.72
Other current expenditures	1,681	1,648	-2.0	1,721.84
Net lending	167	200		284.01
Current account deficit before financing	1,279	1,102.25	-18.6	1,316.22
Developmental expenditure	350	1,150	228.6	260.45
Total deficit before financing	1,629	2,252.25	-238.3	1,576.51
Financing	1,629	2,475	51.9	1,576.51
External financing	1,629	1,152.25	-29.3	1,143.19
Budget support	1,329	1,100	-17.2	
Financing developmental expenditure	300	250	-16.7	201.72
Domestic financing	0	-250		

B. Emergency Budget

The emergency budget was a response to various hostile conditions: Israel's withholding of Palestinian clearance revenues (which account for 70 percent of total domestic revenue); donors' delay in transferring aid pledged in the Cairo Conference; and Arab states' noncompliance with the financial safety net and other pledges made by Arab countries during the Arab summits (including Jerusalem funds).

The basic assumption of this budget is a bleak forecast that the current public finance crisis could deepen in the next few months if Israel again takes a retaliatory measure of withholding clearance revenues during the rest of the fiscal year. Under this scenario, the PNA, according to the IMF, will have to reduce wage payments, stop giving allowances, and cut non-wage spending; increase borrowing from banks; or accumulate more arrears. When reducing wage payments, the PNA needs to make reductions proportional and not absolute as low-income earners will otherwise be more affected. Also, remarkable donor aid is needed at the outset so as to bridge the gap created by clearance revenues suspension.

To achieve its objectives, the emergency budget has expected cuts in expenditure and increase in revenue, while maintaining debt limit and prudent borrowing rates, as well as keeping spending within reasonable limits. Those with a pay slip of NIS 2,000 or below will receive their pay in full. The others will receive 60 percent of their salaries. Meanwhile, ministries and governmental agencies will receive in cash 50 percent of their 2014 allocations as operational expenses, while households below the poverty line will continue to have their allocations as usual. In parallel and to keep the economy running, the government will pay part of the arrears owed to the private sector. Additionally, an amount of $800 million was appropriated to the Gaza reconstruction. The budget also allocated $300 million to development, to be financed by donor aid, and additional $20 million to be contributed by the treasury. If the current financial crisis comes to an end, a supplemental budget will be formulated with an amendment law.

The emergency budget was endorsed by the PNA President after the Cabinet's approval. Usually, the government formulates the general budget and submits a request of approval to the Legislative Council. However, since parliamentary word has been suspended and given the seven-year-long state of emergency, it is the legally entitled PNA President who approves the government budget.

4. Questions and Topics for Discussion

- What are the reasons behind the variance in the expenditure and the revenue sides in the FY 2014 budget? Why doesn't the PNA learn from its past experiences with respect to budget estimates, so as to avoid large deviations and produce more realistic estimates?
- How to maximize revenues and reduce expenditure? Has the government taken these measures into consideration in the 2015 budget?
- How to tackle the problem of excess net lending? How to minimize its impact on clearance revenues?
- What are the tools needed to enhance the competent authorities' control over the financial performance of the government in accordance with the law?
- What are the procedures the PNA needs to take to avoid a chronic fiscal deficit under the assumptions of continued withholding of clearance revenues and unfulfilled donor pledges?