



معهد أبحاث السياسات الاقتصادية الفلسطيني (ماس)



Palestine Economic Policy Research Institute (MAS)

**الاستدامة المالية للسلطة
الوطنية الفلسطينية:
التجربة التاريخية والآفاق المستقبلية**

أحمد قباجة

2012

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**Fiscal Sustainability of the Palestinian
National Authority:
Experience and Future Prospects**

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**Fiscal Sustainability of the Palestinian National Authority:
Experience and Future Prospects**

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Funding: This study was funded by the Arab Bank for Economic Development in
Africa (BADEA) – Islamic Development Bank (IDB) – Al-Aqsa Fund

Palestine Economic Policy Research Institute (MAS)
Jerusalem and Ramallah

ISBN 978-9950-374-27-0

Foreword

Since its establishment in 1994, the PNA has not been able to cover its overall costs without foreign support; it was only capable of covering its recurrent costs in the period of 1994-1999. Thus, the PNA has utilized foreign aid to cover its round-the-clock development costs that were invested in rehabilitating its infrastructure, and building its institutions and capacity.

The major change in dependence patterns happened in 2000. The Occupation Authorities started to re-occupy and impose a system of closures in the lands that were put under the jurisdiction of the PNA. In addition, they started laying off Palestinian labor working in Israel. These factors led to a marked decrease in economic activity; it slashed PNA revenues while simultaneously requiring it to increase public spending on unemployment benefits, healthcare provision, education, etc, to offset the social effects of the economic decline on the Palestinian residents. Furthermore, the 2007 divide, exacerbated the budget problem. The PNA transfers around 45% of its budget to pay public employees, distribute social transfer payments, provide medications and health care services, and improve education services in Gaza. It does so in a period where the contribution to PNA revenue from Gaza declined from 28% in 2005 to 2% after the divide.

These factors weakened the PNA's financial situation while inevitably increasing its dependence on foreign aid. Despite the major steps that the PNA took to control spending and increase revenues (which have doubled between 2007 and 2010), financial sustainability remains an elusive goal. The dependence of the PNA on foreign aid puts it in a vulnerable position where any halting or delaying of scheduled payments leads to immense macro and micro-economic consequences. Furthermore, the recent withholding of Palestinian taxes and customs collected by the Israeli ministry of finance by the Israeli government put the PNA as well as our economy on the verge of collapse.

This study is most timely because it analyzes the prospects for financial sustainability while searching for pragmatic ways to shift to a self-reliant model. I would like to thank the main researcher, Ahmed Qubaja, for his efforts and dedication to this study. I would also like to thank the editors and the peer reviewers who provided their input and important

contributions to the end result. Finally, I would like to extend my sincere thanks to the Arab Bank for Economic Development in Africa, and The Islamic Development Bank - The Aqsa Fund for funding this study, which represents one of the studies in the “PNA research priorities program”.

Dr. Samir Abdullah
Director General

Executive Summary

Achieving fiscal sustainability is a bottom-line goal of any state, as it reflects the success of a state in managing its financial resources and meeting its physical obligations. The present study provides a detailed analysis of the financial features of the Palestinian Authority, examining revenues and expenditures of the Palestinian Authority between 1995 and 2011, and reviewing the problems that cramp the PNA's ability to dent its fiscal deficit. The different definitions of the term 'fiscal sustainability' suggest that realizing sustainability does not necessarily mean that the revenues of a state must cover its expenditures; rather, the state can borrow to plug its budget deficit provided that first it has the resources allowing it to plug its budget deficit provided that first it has the resources allowing it to plug its budget deficit provided that first it has the resources allowing it to plug its budget deficit provided that first it has the resources allowing it to plug its budget deficit, and second its debt-GDP ratio remains stable.

Ever since its establishment, the PNA has sustained many economic and political upheavals, both locally and internationally. Initiated as an aid-dependent authority under Israeli occupation, the PNA's financial position has always been dependent on foreign aid and subject to the volatility of the political situation given the economic and political ties with Israel. Such vulnerability has impacted the size and nature of domestic economic activity, as well as the revenues and expenditure of the Palestinian Authority, eventually influencing the fiscal sustainability of the PNA, which has gone through five key financial stages:

- ✧ The first stage (1994-1999): Spending was being funded primarily from local revenues with a steady decline in the current budget deficit, but enjoying a surplus in the budgets of 1998 and 1999.
- ✧ The second stage (2000-2002): Economic and social indicators declined, echoing unstable political circumstances and harsh economic blockade during the years of the second intifada, forcing the PNA to employ an army of unemployed workforce in the public civil and military services. This, in turn, led to an increase in current spending with a decline (or relative stability) in revenues, ultimately leaving the economy unable to plug the deficit.
- ✧ The third stage (2003-2005): Despite the financial reform initiated in this period, the PNA's expenditure continued to rise due to two reasons: putting into effect the Civil Service Law; and the rise of the number of governmental employees to 146 thousand.
- ✧ The fourth stage (2006-2007): This is one of the most disturbing stages, where the PNA was unable to pay the salaries of employees owing to withholding clearance revenues by Israel. During this stage,

many donor countries stopped the flow of financial aid to the Hamas-led government.

- ✧ The fifth stage (2008-2011): Given the improvement in tax management and the foreign donors opening aid spigots, revenues rose significantly, engendering a decline in the budget deficit in 2008 and 2010. However, the basic problem remained unsolved given the monthly certain liabilities (accounting for more than 50% of the expenses) and uncertain revenues (e.g. international aid and transferring clearing revenues).

The Palestinian National Authority's funds involve tax revenues (direct and indirect taxes) and non-tax revenues. The indirect taxes (VAT, customs and fuel tax) provide the major part of the treasury revenues. According to international reports, the PNA's treasury sustains an annual loss of half a billion dollars as some Palestinian importers and traders do not report the actual volume of their imports, while some continue smuggling goods into the Palestinian territory. On the other hand, the direct taxes (income tax) accounted for a scant 7% of total tax revenue. The poor contribution of income tax in tax revenues is a result of tax evasion; the small number of tax brackets; and low tax rates. Despite the income tax amendments made to tax brackets, the contribution of this tax to overall tax revenues is still mediocre (barely 7% in the last five years, compared to 47% in Egypt and 22% in Jordan, though the tax system in Jordan operates only two brackets and allows greater tax breaks than the Palestinian system; while the Egyptian tax system allows less tax breaks and imposes brackets that are by far equal to its Palestinian counterparts). The high tax revenues in these two countries are attributed to the levies of corporate tax (contributing 78% in Jordan and 79% in Egypt to total income tax revenues). Therefore, the Palestinian Authority should fight tax evasion and provide the necessary conditions that improve the performance of Tax Department staff, which will eventually increase income tax revenues.

The study searched for ways to increase the revenues of the Palestinian Authority within the current system. It suggested the possibility of adding another tax bracket (i.e. renege on the last amendment) to increase the revenues of income tax. The study arrived at this conclusion after estimating the value of the income tax collected from a virtual person whose annual income is half a million shekels a year (assuming that s/he enjoys an annual exemption only). The total income tax paid by this person within the recent amendments in 2011 was (81750 NIS), which is less than s/he would have paid under the five-bracket system (11062 NIS).

The study also tackled the problem of tax evasion among the self-employed whose contribution to the income tax revenue is minimal and disproportionate to their large number (208,500 in 2011). Assuming that all self-employed people are equal in income and committed to pay their taxes, the study argues that the income tax for each self-employed individual would be 269 NIS a year. This is a small amount if we consider the number and the nature of activities of individuals who are self-employed. Based on this, the per capita income of this group (on the aforementioned presumptions) would be barely 3,000 shekels a month, which is unreasonable given the nature of these free professions (involving physicians, engineers, lawyers, etc). In Egypt, for example, there are special mechanisms to estimate the income of the self-employed if ledgers are not available. Egyptian Income Law provides precise and detailed instructions on how to estimate the tax burden for free medical and legal professions, such as location, the nature of customers and other things mentioned in this study. These detailed instructions indicate how difficult it is to arrive at an accurate estimation of the income of such professions, as well as the need of very competent tax staff personnel.

In 2009, VAT revenues accounted for 30% of the total revenue in the Palestinian Territory. The study compared this ratio to other countries and found resemblance between the most selected countries except for Turkey and Jordan (50.9%, and 37.6%, respectively). The split between the West Bank and the Gaza Strip has adversely affected the OPT value-added tax. According to the World Bank, the Gaza Strip contribution to OPT VAT revenues in 2006 was 17%, but fell to 6% in 2010. Had the 2010 VAT revenue remained as it was in 2006, this would have added an extra annual return of \$ 42 million to the Palestinian treasury.

The study also analyzed the fees the PNA collects from Palestinians traveling via Al-Karameh Border Crossing (Allenby). As stated in the agreement concluded between the Palestinians and the Israelis, the departure fee levied at Allenby Bridge Border (\$ 26 at the time) goes to the Israelis and the Palestinians (with 54% and 46%, respectively). The Israelis have gradually raised the fee (standing at \$ 40 in 2011). However, the Palestinian Authority's share of \$ 12 has not changed. Within the new charges, the PNA's share would be \$ 11.7 million, which is not the case; i.e. the PNA had in 2011 lost \$ 4.1 million. Though this is a small amount of money, it is still a right the PNA is entitled to, no matter how much this agreement is inequitable.

The study examined current expenditures only and excluded development expenditures which, under some bilateral agreements concluded in 1994, are supposed to be exclusively financed by international organizations. The Palestinian budget has divided current expenditures into wages and salaries, and non-wage expenses. Data published by the Ministry of Finance reveal that the current expenditures of the Palestinian Authority are steadily growing. The major current expenditures go to social services (representing 43% of the total current expenditure in 2011 and 2010) and security and public order services (constituting 31% of total current expenditure in 2011 and 32% in 2010). The security services, education sector and health services drain the bulk of expenditures. The security system (represented by the Ministry of Interior and Security) accounted for 31% of total current expenditures in 2011, well above the share of the vital Ministry of Health and the share of the imperative Ministry of Education (11% and 19.4 %, respectively).

The study used current spending-GDP ratio to compare the Palestinian situation with other countries. In 2009, this ratio was 43% in the OPT, compared to 11.4% in Egypt and 23.5% in Jordan. Apparently this ratio is too high in the OPT. However, one should be aware of the fact that these ratios depend on two variables: current expenditure and GDP. As such, the rise in this ratio might not necessarily indicate an increase in current expenditures. Rather, the rise might be attributed to the small GDP.

The study examined the unusual considerable value of the PNA's bill of wages and salaries as the major problem in the current expenditure item. Again, the study drew a comparison between the size of this item in the Palestinian Territory and in some other countries. The study found that this ratio is larger in the OPT (whether as a percentage to total expenditure or as a ratio to GDP). According to the World Bank standards, the ratio of salaries and wages bill to nominal GDP in several selected countries was 10%, compared to 23% in the Palestinian Authority.

The Palestinian pension system was another issue raised by the present study. Between 1995 and 2010, the ratio of retirees to in-service staff rose from 1:22 to 1:5, certainly due to an increase in the number of retirees to about 35 thousand. The dilemma of the Palestinian pension system is further compounded by the 2004 Law No. 11 pertaining to bonuses and salaries of members of the Legislative Council, ministers and governors. Under this Law, the Prime Minister, the Palestinian ministers, President of the Legislative Council, members of the Legislative Council, and Governors receive as pension a minimum of 50% of their monthly salaries

regardless of the length of time they spent in office; i.e. the minister shall receive \$1500- \$2400 as a monthly pension.

Despite improvement in revenue collection, the budget deficit remains a major challenge. In 2011, this deficit totaled one billion U.S. dollars, or 12% of GDP. Since some donors did not meet their obligations, the Palestinian Authority had to borrow from banks or postpone payments to the private sector. This, in turn, aggravated the problem of the public debt, which totaled 2.213 billion U.S. dollars in 2011, or 25% of GDP (the Palestinian public debt law set a ceiling of 40%). One of the main PNA's double bind is that most of the borrowed money is used to plug the deficit in the current budget, and a little is used in investment projects that generate revenue.

The study concluded with recommendations pertaining to the aspects of income, expenditure and public debt:

- ✧ Enhancing liaison between all tax departments to facilitate the process of tax auditing and the verification of data obtained from each party to fight the problem of tax evasion.
- ✧ Focusing on refining the performance of the current tax system rather than changing it.
- ✧ Cooperating with the private sector to discuss the feasibility of transferring some public servants to the private sector under the principle of 'partnership' to dent the wages and salaries bill.
- ✧ Keeping the Palestinian merchants informed of the various customs laws to minimize the loss in customs revenue.
- ✧ Adopting a decentralized method in tax revenue collection to improve tax compliance.
- ✧ Minimizing and, eventually, dispensing with the PNA's lease of private buildings and merging governmental institutions to reduce the cost of buildings.
- ✧ Reducing the costs of the security system and revisiting the society's needs of all these security services.
- ✧ Increasing allocations for the education sector, which is a major player in the long-run economic growth.
- ✧ Employing loan funds to finance productive projects (rather than covering current expenditures) which will yield serviceable macroeconomic results.
- ✧ Providing more details in the budget (with detailed budget items allowing for proper analysis and sound management) for ease of inspection and for the sake of transparency.

