Palestine Economic Policy Research Institute

The Impact of Palestinian Trade and Fiscal Policies on Trade and Budget Deficits

Mahmoud El-Jafari
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Layout: Lina Abdallah

Funding: This Study was mainly funded by International Development Research Center- IDRC and the complementary funded by Ministry of Finance.

Palestine Economic Policy Research Institute (MAS)
Jerusalem and Ramallah

October, 2002

Publication Standards at the Palestine Economic Policy Research Institute-MAS

The Palestine Economic Policy Research Institute –MAS- engages in the publication of applied research papers and studies related to the Institute's program in the area of economics and social science and conducted by full or part time researchers.

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1. The approved research project should be conducted or supervised by a specialist senior researcher. The research must not have been published previously or submitted for publication elsewhere.
2. The terms of reference of the study are approved by an internal MAS scientific committee (consisting of senior researchers) to ensure accurate goals, appropriate use of scientific methodology and procedures and the timetable for completion.
3. The internal scientific committee supervises the work of the researcher or team of researchers through periodic progress reports.
4. The initial draft of the study is reviewed by the scientific committee for objective content-related amendments to be added to the second draft.
5. The second draft is then submitted for evaluation in accordance with the terms of reference to two or three external academic experts specializing in the subject. Provided that there is a positive evaluation by at least two experts, the researcher is asked to review the study taking into consideration the objective recommendations of these experts.
6. The study is presented for discussion at a public workshop attended by academics, researchers, and representatives from public and private sector institutions related to the subject of the research.
7. Comments and feedback from the workshop are incorporated into the study and the final draft is reviewed by the scientific committee to ensure that the necessary amendments have been made. The study is then edited.
8. Research papers written in English are translated into Arabic and published in both languages. An executive summary in English is attached to research papers written in Arabic.

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Summary

The Palestinian National Authority has relied heavily on tariff revenues to finance its expenditures. Tariff revenues account for more than 60% of total public revenues while salaries and wages constitute approximately 60% of total current public expenditures. These salaries are generally low and employees direct more than 60% of their wages to cover the consumption of goods (of which two-thirds are imported). These indicators reveal that tariff revenues are the main source of current expenditures, which are then reutilized to finance imports, of which 90% originate from or via Israel.

In the absence of a Palestinian developmental vision or appropriate trade and fiscal policies for the reform of structural distortions and imbalances inherited from prolonged Israeli occupation, trade and budget deficits have increased considerably and dependency on Israel has deepened. Moreover, public expenditure policies have encouraged an increase in imports, thus contributing to further dependency between trade and public finance. Consequently, the trade and budget deficit have been closely interlinked during the transitional period. In addition, the reliance of the Palestinian economy on external income resources has widened the gap between Palestinian aggregate supply and demand. The contribution of GDP to disposable national income is below 80%.

This study aims to identify and analyze the factors determining trade and budget deficits as well as the reciprocal relationship between them. It is anticipated that the empirical results of the study will assist Palestinian policy and decision makers in the formulation of fiscal and trade policies and structural reforms to reduce the distortions in the Palestinian economy, especially the widening gap between savings and investments, through effective supply policies and increased exports. The study also provides recommendations to reduce the trade deficit and increase public revenues mainly through the management of public expenditures to reduce the budget deficit and stimulate real growth in GDP.

The specific objectives of the study are outlined below:

- Examine and analyze the performance of fiscal and trade policies applied in the WBGS.
- Specify and estimate an econometric model of Palestinian trade and public finance policies.

To accomplish the objectives of the study, an econometric model comprising of 12 equations, three of them identical and nine structural, was specified and estimated. The model covers export and import demand for commodities and services in the WBGS. It also includes two equations for tariff and internal revenues. Two other equations for current and capital expenditures were specified and estimated. The identical equations include public revenues, current accounts, the budget deficit, and saving-investment gap.

Based on the estimated econometric model, the following empirical results were observed:

1. The GDP and tax performance have been the major determinant factors in internal revenues in the short and long term. The elasticity of internal revenues with respect to GDP and tax performance was 1.72 and –0.42 respectively.
2. Tariff revenues have been associated with commodity imports, tax performance, and labor remittances. Actually, tariff revenues have been highly responsive to changes in commodity imports (2.16), ten times greater than the elasticity of tariff revenues with respect to remittances from Palestinian labor in Israel.
3. Current public expenditures have been determined entirely by the total available revenues while inflation has had a negative impact on expenditures. In addition, developmental expenditures have been linked to foreign aid, although inflation rates were not taken into consideration when foreign aid was allocated.
4. Palestinian commodity exports have been highly responsive to a number of external factors, such as Israeli GDP, and were also negatively affected by non-tariff trade barriers (NTBs) imposed by Israel on Palestinian trade, the export price index and real exchange rates.
5. Palestinian commodity and service exports have been determined by GDP and real exchange rates.

Based on the empirical results above, the following recommendations are drawn to adjust the distortions in the Palestinian economy:

- Import prices could be increased through raising VAT rates, particularly on imported goods that have substitutes manufactured locally. Also, VAT rates could be reduced on locally manufactured goods to strengthen their competitive advantage in the local market. Price mechanism is an appropriate measure to adjust imports and promote demand for domestic production through improving the efficiency of the local market. This will narrow the trade deficit.

- Dependence on foreign aid and grants to finance capital expenditures should be reduced. The proportion of capital expenditures to total expenditures should be increased over time. This measure will make capital expenditures more stable to enhance private investments and consequently stimulate real growth rates in GDP.
- In the short term, the expected increases in tariff revenues could be utilized to promote local production and exports. As a result, the present deformed relationship between GDP and national income would be remedied through narrowing the gap between savings and private investments.
- Raising public revenues depends to a great extent on improving the tax system, enhancing the efficiency of tax administration, and reducing tax evasion. This will minimize the gap between actual and anticipated local tax revenues. In the long term, the adoption of the Automated System for Customs Data developed by UNCTAD will enable the compilation of trade statistics, thereby increasing tariff revenues via improvements to customs procedures.