

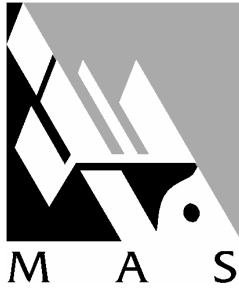


Palestine Economic Policy Research Institute (MAS)

# **Assessing Fiscal Policies of the Palestinian National Authority**

**Omar Abdel Razeq**

**2016**



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**The Palestine Economic Policy Research Institute (MAS)**

Founded in Jerusalem in 1994 as an independent, non-profit institution to contribute to the policy-making process by conducting economic and social policy research. MAS is governed by a Board of Trustees consisting of prominent academics, businessmen and distinguished personalities from Palestine and the Arab Countries.

**Mission**

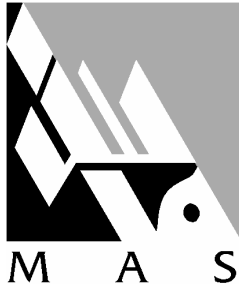
MAS is dedicated to producing sound and innovative policy research, relevant to economic and social development in Palestine, with the aim of assisting policy-makers and fostering public participation in the formulation of economic and social policies.

**Strategic Objectives**

- ♦ Promoting knowledge-based policy formulation by conducting economic and social policy research in accordance with the expressed priorities and needs of decision-makers.
- ♦ Evaluating economic and social policies and their impact at different levels for correction and review of existing policies.
- ♦ Providing a forum for free, open and democratic public debate among all stakeholders on the socio-economic policy-making process.
- ♦ Disseminating up-to-date socio-economic information and research results.
- ♦ Providing technical support and expert advice to PNA bodies, the private sector, and NGOs to enhance their engagement and participation in policy formulation.
- ♦ Strengthening economic and social policy research capabilities and resources in Palestine.

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Palestine Economic Policy Research Institute (MAS)  
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## **Foreword**

Fiscal policy studies constitute an essential component of the research carried out by the Palestine Economic Policy Research Institute (MAS), and the present paper “Evaluation of the Fiscal Policies of the Palestinian Authority” addresses a topic at the core of MAS's mission and objectives. When considering the fiscal policies in Palestine, a country under occupation, one must exercise extreme caution. The approach should be somewhat different from those used in independent economies, where the state enjoys the freedom to exercise its legislative and executive powers and to access and utilize its national resources without external restrictions except for those stipulated in agreements which the state has willingly entered.

Palestine relies heavily on foreign aid and suffers high uncertainty resulting from an unstable political context and the ugly truth that the occupying power keeps a firm hold on two thirds of Palestinian public revenues which has frequently been subject to deductions and withholding. Such Israeli measures have thwarted Palestinian planning and management of public finance as well as created barriers and distortions that are not encountered in states that have sovereignty over their land, ports, and resources. Worse, the divide between the West Bank, including East Jerusalem, and the Gaza Strip has not only split the land, but also adversely impacted Palestinian politics, thus creating more distortions with consequences that should be put aside when analyzing the fiscal policies, per se, and their compliance with established standards.

We at MAS trust that this study will promote a productive debate over the sound fiscal policies that need to be adopted. The author was careful not to delve into problematic areas that are difficult to study objectively. Instead, the focus is on areas that can be fathomed with universal scientific objectivity. The author is an academic who specializes in fiscal studies and the arguments, analyses, conclusions, and recommendations in this paper are those of the author and do not necessarily represent MAS views. We are, however, quite confident that the research will be an important supplement to MAS fiscal policy research efforts.

We would like to thank the author and the research staff, and are hopeful that decision-makers will make utmost use of their work. We are also grateful to the Arab Monetary Fund for funding this study by a grant allocated via Al-Aqsa Fund and the Islamic Development Bank.

**Nabeel Kassis, PhD**  
**Director General**



## **Executive Summary**

The study aims to assess Palestinian fiscal policy over the period 1995 – 2015 through tracking and analyzing the developments in its preparation process, tools used, the legal environment and effects on macroeconomic activity. The study relied upon data of the public budget indicators, both budgeted and actual, published by Ministry of Finance (MoF) the Palestinian Central Bureau of Statistics (PCBS) and the Palestinian Monetary Authority (PMA). Information regarding the legal environment was obtained from the Palestinian Gazette, official Journal of the Palestinian National Authority (PNA) and the internet sites of many institutions which collect Palestinian laws for various goals. Developments of the procedures and institutional arrangements were tracked through the special reports of the International Monetary Fund (IMF) and the World Bank, which are prepared for the Ad hoc Liaison Committee of the donor countries. The fiscal and related reports which are published by MoF on its internet site were of great use.

The Paris Economic Protocol has been the reference framework for the tools of Palestinian fiscal policy. In addition, Israeli aggression against the Palestinian people and economy and international assistance constitute external constraints upon Palestinian fiscal policy, while characteristics of the Palestinian economy (scarce resources) constitute the main internal constraint.

Israel continues to be an occupying power, enforcing economic, political and social restrictions on Palestinians, and it has used the Paris Protocol on Economic Relations (especially its hold over “clearance revenues”) to achieve political ends. In addition, Israel destroyed economic and social infrastructures during the destructive wars it waged against Gaza during the last few years.

International assistance to the PNA has helped to finance the “current” and the “development” budgets. It has been important in the building of a viable Palestinian economy, in financing an important part of the deficit, and in implementing vital development projects in areas where the PNA has not been allowed by Israeli occupation to function (Area C including the Jordan Valley and E. Jerusalem). Despite its importance, International assistance effectively embodies an external constraint since it nurtures dependence on external sources of income and exerts pressures on PNA’s economic and social priorities.

Internal constraints of Palestinian fiscal policy consist mainly of lack of resources due to absence of natural resource exploration activities most of which is prohibited by the occupation authorities, which control and exploit plentiful Palestinian resources including water, metals, Dead Sea minerals, and arable lands of area C. Moreover, the absence of PNA sovereignty over important Palestinian areas has been preventing the use of such resources like tourist sites in Jerusalem (and elsewhere) and natural gas fields in the sea opposite Gaza Strip.

Reviewing the existing literature on assessment of fiscal policy, it was concluded that Palestinian fiscal policy should be evaluated through:

- Reviewing legal developments and the need for further efforts.
- Reviewing developments in the procedures followed in preparing the public budget and comparing them with those recommended by International and academic organizations.
- Evaluation of the elasticity and equity of the Palestinian tax system.
- Analysis of the effectiveness of the Palestinian fiscal policy through its impact on macroeconomic activity.

#### **Palestinian Fiscal Policy: Platforms and General Framework:**

The so called “second wave” of fiscal reforms of 2003 was adopted after the formation of the “reform government” established in the wake of the destructive Israeli invasion of the West Bank and Gaza Strip (WBGS) to end the Aqsa Intifada (the first wave began in 2001 in the context of what was called the “Palestinian Policy Framework”). This has since constituted the reference for Palestinian fiscal policy platforms:

- Reduction of the deficit/GDP ratio as a main goal. For example, the goal in the 2008 budget was to reduce the deficit/GDP ratio from 27% in 2007 to 22% in 2008 and in the 2009 budget the ratio would reduce to 17%. This reduction was to continue to 11% in 2012. The goal is to reach a ratio between 5% and 10%.
- Reduction of the wage bill is a second main goal. This is to be achieved through limiting new public employment to the replacement of those who leave the public sector (retirement, death, resignation,...) with few exceptions only for ministries of education and health. The Government adopted the “wage containment plan”, agreed upon between the donors and the PNA in 2005. This plan aimed mainly to maintain a stable wage bill for security employees and impose a ceiling on employment in education and health services (this ceiling, for example, was 2000 jobs in 2005). The plan also called for not implementing the salary raises for

teachers or the second stage of the Civil Service Law of 1998 (this part of the plan was not adhered to by the PNA). The plan also called for the reduction of the ratio of the wage bill to total estimated public revenues in the 2006 budget to 80%. An international donor fund, managed by the World Bank, was established to support the fiscal reforms. Disbursements of the funds were made conditional on the implementation of the fiscal reforms.

- Reform the transfer expenditures systems with the aim of redirecting social assistance to families who live below the poverty line.
- Reduction of the so called “net lending” item of the budget through reducing subsidies to petroleum products and restructuring the electricity sector. The former includes reducing subsidies for electricity generation and distribution in Gaza Strip. The electricity sector was restructured by establishing independent electricity-distribution companies in the West Bank, owned by municipalities and run independently.
- Developing the administration of public revenues (tax departments) and establishing a special unit for relations with “big” accounts (large tax payers). This also called for the improvement of tax collection through widening of tax bases in order to deal with the low rate of tax compliance and the high rate of tax evasion.
- Dealing with the “arrears” issue, namely payments due to public employees (salaries and pension fund) and the private sector (suppliers of goods and services to the Government).
- Revision of some laws: pension and retirement, civil service, electricity, corporate, investment encouragement, and procurement laws.

These reforms were adopted as basis or a platform for the Palestinian fiscal policy regardless of the general economic situation. However, Palestinian fiscal policy has depended on economic growth (occurred during the recovery of 2007 – 2012) to achieve its relative successes in reaching its goals.

### **Legal Developments 1994 – 2015**

The legal environment for Palestinian fiscal policy has developed significantly since the establishment of the PNA in 1994. A set of new laws, related to fiscal policy, have been issued: The Budget Organic Law, Income Tax Law, Public Debt Law, Investment Encouragement Law, Public Procurement Law. Other related laws include Banking Law, Corporate Law, Pension Law, Education Law and Health law among a set of economic and social laws, were issued.

The laws of the first group went through many reforms and some are still under review according to recommendations of the IMF and the World Bank

(public Pension Law and Civil Services Law). A plan to restructure electricity was approved in 2012. In addition, reforms have been made to corporate and industry laws. Recently, a law regarding movable assets was issued.

Reviewing the IMF reports regarding the latest legal reforms, their main thrust appear to act as tools to serve the main fiscal policy goal of reducing the deficit/GDP ratio in order to reach a sustainable fiscal stance and reduce dependence on international assistance. On the other hand, these multiple changes lead to undesired instability of the legal environment of fiscal policy.

### **Procedural and Administrative Developments**

The MoF has achieved notable successes in the procedural and administrative issues related to the preparation of the budget to the extent that it rightly deserved the description made by the IMF that it became “able to manage the fiscal situation according to best international practice”. These achievements took place over the years, accelerating since 2008. These achievements include:

- budget preparation according to international standards;
- applying the budget organic law;
- implementing the reforms (agreed upon with international experts) especially the collection of all PNA investments and commercial activities in the Palestinian Investment Fund;
- placing all public revenues and all public expenditures under the authority of the MoF;
- establishing the “single treasury account” (STA) and having all the revenues gathered into it (dismantled in early 2006 and revived late 2007); and,
- unifying public employment policies and procedures in the WBGS, the General Personnel Council, after enforcing authority of the MoF on the public employment office in Gaza Strip, which was a separate institute before the establishment of the PNA.

Furthermore, after establishment of the PNA, fiscal operations were unified in the various districts and comprehensive training programs implemented in all areas. MoF employees monitor and audit the activities of the other ministries and other expenditure centers. A government financial data unit and economic studies unit were established. The value added tax department has been merged with customs department. The income tax court was established as well as the general accountant department as part of a computerized system that connects all expenditure centers. Another unit, for public debt, was established and an administrative council was appointed to oversee the

implementation of the new procurement law and to approve the operational procedures to support its legal aspects. Strategic development planning has been adopted by the MoF through the successive three- years development plans. Tax reform plans adopted in 2013 aim at widening tax bases, increasing tax compliance, reducing tax evasion and empowering the big taxpayer unit. Efforts to expand the base and collection of the property tax unit continue, covering more than 50 municipalities. The latest plans also included a call for a program to increase tax awareness among the taxpayers and the public at large.

### **The Palestinian Tax System and Fiscal Policy**

The Palestinian tax system continues to suffer from many problems including inappropriate legal environment, widespread tax evasion and not reflecting adequately the desired economic and social goals like equity, justice, simplicity, clarity, efficiency and elasticity. Lately (2015) the income tax was reformed changing the tax brackets and rates. These changes made it less progressive reducing the tax burden proportionately more for higher income brackets. It is assumed that these changes will induce consumption expenditures and thus increase economic activity. Preliminary reports do not substantiate such an outcome. As for property tax, a Palestinian law is yet to be issued; the Jordanian law of 1954 and Egyptian law of 1940 are still in force in the West Bank and Gaza Strip respectively.

Regarding some indirect taxes, the Paris Protocol only allows narrow margins for action by the PNA. The Protocol adopted the Israeli import system (rates, standards, licenses, country of origin, evaluation for custom purposes, etc) and value added tax (on locally produced and imported products) as a minimum for the Palestinian system, with some exceptions regarding the commodity exemption lists and the importation of oil and automobiles. It also allowed the PNA to charge VAT rates that are lower than those in Israel by no more than two percentage points.

However, the PNA can make use of the developments on the Israeli VAT system. It was found that Israel increased the maximum level of economic activity for exempted businesses to NIS100,000 as compared to NIS54,000 in the Palestinian economy. Moreover, the Israeli system uses the so called “zero file” to support some economic sectors. As for other indirect taxes (customs taxes, purchase tax and other fees), the Paris Protocol did not leave any margins for PNA intervention.

Reviewing Palestinian policies regarding indirect taxes, it is found that the PNA implemented the Israeli system as stated in the Protocol.

Despite the progressivity of income taxes, the larger dependence on the indirect taxes makes the Palestinian tax system as a whole regressive. Data analysis has proven that average tax rates are larger than marginal tax rates which means that taxes are regressive. On the other hand, it was shown that Palestinian taxes are unitary elastic and that their elasticity declined over the years, indicating that growth in GDP will cause a similar growth in taxes implying relatively lower tax efficiency.

### **Developments in Palestinian Fiscal Policy 1995 – 2015**

Developments in public budget indicators, both estimated and actual, during the period 1995-2015 are presented including:

- Developments in estimated and actual current expenditures, which is divided into salaries and wages, and none wage current expenditures. Expenditures on security and social categories are also tracked.
- Estimated and actual “development” expenditures, which is treated separately in the Palestinian budget.
- Estimated and actual public revenues which is divided into local revenues and clearance revenues and also divided into tax revenues and nontax revenues.
- Estimated and actual international aid which is divided into current budget support and donations to finance development budget.
- Estimated and actual current deficit and its finance by international aid, internal and external borrowing.
- Published actual public debt both internal and external (does not include arrears or the so called net borrowing).
- In addition, indicators derived from the budget ones are also presented:
  - Ratio of the budget indicators to GDP.
  - Ratios of the Expenditures to Revenues.
  - Ratios of parts of revenue to total revenues and parts of expenditures to total expenditures.
  - Coverage ratio of international aid, internal and external borrowing of current deficit.

### **Effectiveness of Palestinian Fiscal Policy**

The Palestinian economy experienced periods of recession, a fall in per-capita real GDP, and periods of recovery. The deepest recession was 2000-2002, where the decline in per-capita real GDP reached 16.2% in 2002. The highest rate of growth in per-capita real GDP took place in 2003 (10.2%). Then, levels of budget indicators during the various periods are tracked and compared:

It was shown that average government expenditures have been rising regardless of the status of the economy (recession or recovery). This emphasized the observation that the Budget has been prepared without taking into account the economic performance. Fiscal policy had been pro-cyclical and became contractionary since 2007. This aggravated conditions during recessions.

International assistance (both to support the budget and to finance development projects) has been countercyclical softening recession impacts.

Trend analysis shows that the correlation between GDP and the actual current public expenditures differed in two periods: 1996 -2009 and 2010 – 2014. There is positive correlation in the two periods and stronger in the second. The average effect of expenditures on GDP in the first period was 1.275. This is a rough estimate of the Government multiplier (an increase in government expenditures by 1 dollar would increase GDP by 1.275 dollars).

A stronger relation between GDP and total public expenditures (both current and development) is observed, with an increase in the multiplier to 1.288, meaning, as expected, that development expenditures are more effective on GDP.

Also, the relation between the current deficit (the raw one) differed in the same two periods. A positive relation is observed with an average effect of 1.85 in the first period. The relation switched to an inverse one in the second period!

In the same manner, international assistance affected GDP differently between periods 1996 – 2008 and 2009 – 2014. The effect was positive in the first period (a coefficient of 1.83) switching to a negative one in the second!

### **Recommendations**

Some of the recommendations supported by this study deal with weaknesses, others handle deficiencies, while others present suggestions for developments. Some (or may be all) of the latter group may need further studies to check their effectiveness or appropriateness.

### **Data:**

There is still a lot of room for improvement in the issues of transparency and accessibility to fiscal data and information:

- Data regarding all the details of Budget indicators should be available in time series. A well-structured data archive should be built to document all the changes made on indicator definitions and procedural processes. Data on tax bases and collections of various taxes are lacking. Actual quarterly data on the Budget indicators should be made available in the details requested by researchers.
- The web site of the MoF should be improved to contain a “public relations” icon to deal with questions and data requests.
- Another necessary icon on the MoF web site should provide all the related legal developments, their dates and reforms.

**Procedural:**

- The first budget circular should contain the economic and social goals of the Budget for the next year and the three coming years. Expenditure centers must take these goals into account in preparing their goals and budget requests.
- The mechanism of estimating public revenues and expenditures should be reversed. First the targeted economic growth rate (real GDP growth) should be set and then answers should be given to questions like: What rate of growth is needed in expenditures and revenues to achieve that GDP growth rate? Expenditure centers should first set the desired levels of their service indicators (for example the targeted levels of health indicators or education indicators etc.), then the required levels of resources needed to achieve those targets estimated. This will make the Budget a real tool to achieve economic and social goals, rendering the process a true “fiscal policy”.
- There is a need to evaluate all special projects of all expenditure centers according to the “zero budgeting mechanism” Some of the projects that were feasible (economically and socially) at the time of establishment may be no longer so, and it would be best to reallocate resources. This can be done during 2016.
- It is necessary to widen the hearing sessions to discuss the whole budget or the budgets of the various centers. Interested parties should be invited to give input. The public at large should be involved in serious discussions. In the absence of the Legislative Council, other mechanisms are suggested like academic conferences and public meetings organized for the purpose.

**Legal:**

- There is a need for laws that classify the WBGS into developmental zones. This will make it possible to adopt allocation priorities.

- There is a need to reform the Investment Encouragement Law to support a prioritized strategic investment plan. This should reduce the revenue loss of the Investment Encouragement Law.
  - There is a need to develop the legal environment of the various taxes: There is a serious need to stabilize the Income Tax Law.
  - There is a need to determine, through a professional study, the developmental requirements of a suitable VAT system and reform the existing one accordingly.
  - Electricity reforms should be reviewed and evaluated to check its effects on efficiency and costs and on “net lending”.
- Laws concerning the social services, which are provided by the Government, the private sector, international organizations and NGOs, need to be reformed so that to establish basis for wider private sector participation emphasizing quality improvements and accessibility by all social groups. This should be carried out according to a strategic plan to develop the quantity and quality of these services and to make sure to prevent dual systems where one is public and serves the poor and the other is private and caters to the rich.

#### **Tax System:**

- The Palestinian tax system must be made progressive to balance the social and economic injustices. The conditions lived by the Palestinian People and the suffering they have endured makes it unacceptable for the tax system to be regressive. This requires a detailed professional study. The main lines of action include:
  - Reforming the income tax law to include a wide zero layer without using discounts or exemptions, which have been proven to benefit the richer. Three or four other layers would suffice with progressive rates.
  - Adoption of standards in evaluating taxes to be paid by various professionals depending on their actual income so as to achieve the principles of justice and equity. Palestinian professionals like doctors, engineers, lawyers and craftsmen presently pay taxes according to deals negotiated with tax officers.
  - Reforming the VAT system so that its regressivity is reduced through:
    - ✧ Widening of the exempted class of businesses.
    - ✧ Widening the use of the so called “zero file” businesses.
    - ✧ To adopt a new system of multiple VAT rates according to a classification of goods and services (through a professional study). This might be rejected by Israel on the basis of violating Paris Protocol. However, the goals should be attainable through exploiting exceptions that exist in the Israeli VAT system, which

is supposed to establish the minimum levels for the Palestinian one.

- Reforming property tax to increase its share of total taxes with standards that differentiate between regions or areas.
- Strengthening the laws dealing with tax evasion and noncompliance so that punishments be preemptive.

**Fiscal Policy Effectiveness:**

- The philosophy governing Palestinian fiscal policy must be changed from being a reform program to becoming a tool to achieve economic and social goals. The most important aspect here is that the Palestinian economy operates at low levels of capacity utilization even during periods of growth. Unemployment has been above the 20% level for years. Thus there is no fear of the crowding out effects of an expansionary fiscal policy. On the other hand, it is known that the Palestinian economy imports its inflation from Israeli economy, which has been under control for a long time. Thus, there is no fear of inflationary effects of an expansionary Palestinian fiscal policy. Fiscal rules (levels of ratios of deficit or debt to GDP) can be adopted to ensure that things don't get out of hand.
- The change in allocations in favor of social services is a positive development, but security expenditures continue to be relatively high, and the quality indicators of social services are still lower than ambitions. Thus, the shift toward social services should continue at a higher pace. This should include a restructuring of public employment towards social services and a solution to the problem of disguised unemployment in the public sector.
- Treasury's share of financing development projects must be increased, especially in economic and social infrastructures to stimulate the economy. It is suggested that a strategy increasing private sector involvement in the provision of infrastructure services be adopted. This can rely on the Build-Operate-Transfer (BOT) programs, which preserve resources for future generations.
- The prevailing mechanism in preparing the Budget has not been fostering improvements in the prediction mechanism for the future values of the various indicators. A new mechanism should be used in order to predict the desired future values of the indicators to achieve goals.

**Relations with the Israeli Economy**

- Despite the success of the PNA, through international mediations, in convincing Israel to discuss the issue of revenue leakages through the existing mechanisms of the "clearance process", the understandings

reached in 2012 are still to be approved by the Israeli Government. It is suggested here that the PNA continue pressuring in that direction to reach a new mechanism relying on a macro equation of the trade relations rather than the “unified receipt” procedures.

- It is recommended that the PNA activates the use of the commodity lists stated in the Paris Protocol.
- Special attention should be given to change the Palestinian Israeli arrangements regarding the trade crossings with the Arab countries to give the PNA full control on its external trade.